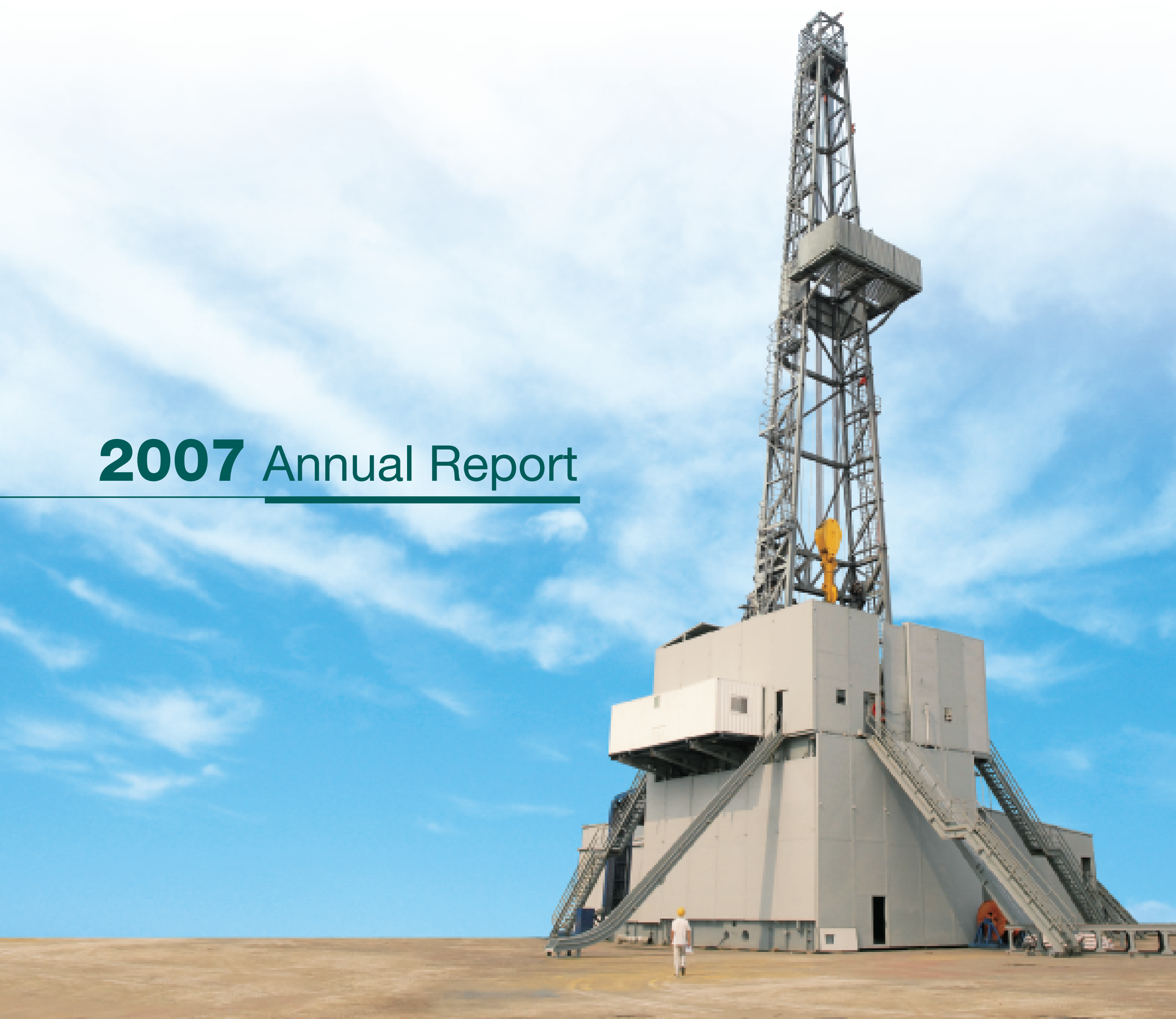
HONG HUA

# HONGHUA GROUP LIMITED
# 宏華集團有限公司

*(incorporated in the Cayman Islands with limited liability)*

Stock Code: 196



# 2007 Annual Report

# CONTENTS



# Financial Highlights

| | 2007 RMB'000 | 2006 RMB'000 | Changes |
|---|---|---|---|
| **Operating results** | | | |
| Revenue | **3,164,022** | 2,335,948 | 35.4% |
| Profit from operations | **727,975** | 590,254 | 23.3% |
| Profit before taxation | **684,516** | 567,113 | 20.7% |
| Earnings attributable to equity shareholders of the company | **583,235** | 412,814 | 41.3% |
| **Figures per share** | | | |
| Basic earnings per share (RMB Cents) | **23.3** | 16.5 | 41.2% |
| Dividends declared during the year | **–** | 19,533 | N/A |
| **Financial position** | | | |
| Total non-current assets | **794,951** | 286,659 | 177.3% |
| Total current assets | **3,136,002** | 1,895,735 | 65.4% |
| Total assets | **3,930,953** | 2,182,394 | 80.1% |
| Total current liabilities | **2,555,556** | 1,818,785 | 40.5% |
| Total non-current liabilities | **19,686** | 25,558 | (23.0%) |
| Total liabilities | **2,575,242** | 1,844,343 | 39.6% |
| Total equity | **1,355,711** | 338,051 | 301.0% |
| **Key financial ratios*** | | | |
| Gross margin | **34.1%** | 33.3% | 0.8% |
| Net margin | **18.4%** | 17.7% | 0.7% |
| Return on average assets | **19.1%** | 24.6% | (5.5%) |
| Return on average equity | **73.3%** | 203.9% | (130.6%) |
| Current ratio | **1.23** | 1.04 | 0.19 |
| Quick ratio | **0.82** | 0.66 | 0.16 |
| Total debt/Total asset | **22.2%** | 16.8% | 5.4% |

* Earnings exclude minority interests
Equity exclude minority interests

# Corporate Information

## BOARD OF DIRECTORS

**Executive Directors**

Zhang Mi *(Chairman)*
Ren Jie
Zhang Xu

**Non-executive Directors**

He Sean Xing
Wang Yaoxin
Xiang Qingsheng

**Independent Non-executive Directors**

Chen Guoming
Liu Xiaofeng
Liu Yinchun
Qi Daqing
Tai Kwok Leung, Alexander
Wang Chunlin
Wang Li

## BOARD COMMITTEE

**Audit Committee**

Qi Daqing *(Committee Chairman)*
Chen Guoming
Liu Xiaofeng
Liu Yinchun
Tai Kwok Leung, Alexander
Wang Chunlin
Wang Li

**Corporate Governance Committee**

Liu Xiaofeng *(Committee Chairman)*
Chen Guoming
Liu Yinchun
Qi Daqing
Tai Kwok Leung, Alexander
Wang Chunlin
Wang Li

**Remuneration Committee**

He Sean Xing *(Committee Chairman)*
Zhang Mi
Qi Daqing

## JOINT COMPANY SECRETARIES

Liu Gangqiang
Corinna Leung

## QUALIFIED ACCOUNTANT

Lu Hong (FCCA, HKICPA, CICPA)

## LEGAL ADVISORS

**as to Hong Kong law**

Arculli Fong & Ng
in association with King & Wood, PRC Lawyers

**as to U.S. law:**

Latham & Watkins LLP

**as to PRC law:**

King & Wood

**as to Cayman Islands law:**

Appleby

# Corporate Information

## PRINCIPAL BANKERS

Bank of China, Deyang Branch
Industrial and Commercial Bank of China, Guanghan Sub-branch
China Merchants Bank, Chengdu Branch
China Construction Bank, Guanghan Sub-branch

## AUDITOR

KPMG
Certified Public Accountants

## COMPLIANCE ADVISER

CCB International Capital Limited

## REGISTERED OFFICE

Clifton House, 75 Fort Street,
PO Box 1350, Grand Cayman
KY1-1108

## HEAD OFFICE

99 East Road, Information Park,
Jinniu District
Chengdu, Sichuan 610036
PRC

## PLACE OF BUSINESS IN HONG KONG

Room 908, Hutchison House,
Central, Hong Kong

## PRINCIPAL SHARE REGISTRAR AND TRANSFER OFFICE

Appleby Trust (Cayman) Ltd.
Clifton House, 75 Fort Street,
PO Box 1350, Grand Cayman,
KY1-1108, Cayman Islands

## HONG KONG BRANCH SHARE REGISTRAR AND TRANSFER OFFICE

Computershare Hong Kong Investor Services Limited
Shops 1712–1716,
17th Floor Hopewell Centre
183 Queen's Road East
Wanchai
Hong Kong

## STOCK CODE

The Stock Exchange of Hong Kong Limited: 0196

## WEBSITE:

http://www.hh-gltd.com

The Annual Report is prepared in both English and Chinese. Should there be any discrepancy between the English and Chinese versions, the English version shall prevail.

# Corporate Overview

Honghua Group Limited, which is registered in the Cayman Islands, manufactures drilling rigs, drilling parts and components, and offers drilling-related training as well as after-sales support services to its customers, Honghua Group Limited mainly conducts business though its affiliate companies, including Sichuan Honghua Petroleum Equipment Co., Ltd. registered in China, Chengdu Hongtian Electric Drive Engineering Co., Ltd. registered in China, Sichuan Honghua Youxin Petroleum Machinery Co., Ltd. registered in China, Honghua International Co., Ltd. registered in China, Honghua America, LLC registered in USA, Honghua Golden Coast Equipment FZE registered in Dubai (UAE), and Egyptian Petroleum HH Rig Manufacturing Shareholder Co. incorporated in Egypt.

As the principal subsidiary of Honghua Group Limited, Sichuan Honghua Petroleum Equipment Co., Ltd. was established in 1997, located at the birthplace of Ancient Shu Culture of China, hometown of Sanxingdui, Guanghan City Sichuan Province of China. In the beginning, we were only a smaller land rig manufacturer. During the past ten years, we have achieved significant progress. According to "The Global Land Drilling Rig Manufacturing Market" published by Spears & Associates Inc. in February 2008, we are the second largest land rig manufacturer in the world in terms of revenue and sales volume.

## WE HAVE MANY COMPETITIVE ADVANTAGES AS FOLLOWS:

### We offer a large and diverse range of drilling equipment, together with support services

We offer our customers a comprehensive supply of customized drilling rigs and rig parts and components, as well as training and follow-up support services. Our diverse line of drilling rig products ranges from heavy 9,000-meter depth drilling rigs to light 1,000-meter depth drilling rigs and offshore drilling modules. We also realize earnings from the sale of rig parts and components, which are used either for replacement or refurbishment purposes in the existing drilling rig market, or sold to other drilling rig manufacturers. Our customer services include training at our main production facility in China and after-sales technical support administered at our customers' drilling sites by a team of experienced engineers.

### We are a low cost manufacturer of high performance, quality land rigs

We believe that we provide high performance, quality drilling rigs at a lower cost than our international competitors, allowing for increased price competitiveness and greater profit margins. We are able to maintain a low cost structure due to our highly-skilled yet low-cost labor force, our integrated approach to the manufacturing of rigs and rig parts and components, our proximity to a supply network of parts and components and raw materials, and our large scale of production. We produce rigs utilizing many of the world's leading rig technologies, such as those used in our digitally-controlled VFD rigs. We have implemented the ISO 9001 system and the API quality standard to ensure effective quality control of our products. We believe that our integrated approach to the manufacturing of select parts and components and the manufacturing of rigs ensures a high level of quality and guarantees reliable delivery of rig orders, thus encouraging continuous business from existing customers.

# Corporate Overview

## WE HAVE MANY COMPETITIVE ADVANTAGES AS FOLLOWS: (continued)

### We have an well-established global marketing network

We have a diverse global marketing network that includes our overseas affiliates in Houston, Texas (USA), Cairo (Egypt) and Dubai (UAE), as well as our local distributor networks in other key drilling rig markets, such as Russia, Indonesia. Our subsidiary in Houston assembles and sells our drilling rigs and rig parts and components to drilling contractors based in North America and Latin America. We believe that this provides a sound base for further expansion in the North American and Latin American markets. In Egypt, We have formed a joint venture with three enterprises to increase our market share in Africa. Our subsidiary in Dubai serves our customers across the Middle East. In Russia, Indonesia, our close relationships with local distributors have helped us enhancing our presence in the oil and gas drilling equipment markets within these countries.

### We have strong R&D capabilities and a track record of developing successful new technologies

We are one of the leading developers of land rig technologies in China, and we have created a wide range of patented technologies and proprietary designs which enhance the function and performance of our rigs. We are strongly committed to strengthening the global competitiveness of our rigs and rig parts and components. We have focused on research and development, assembling a team headed by leading Chinese experts in the oil and gas equipment industry. As a result of our dedication to technological innovation, we have successfully developed globally-competitive products such as our digitally-controlled VFD rigs which, since being developed in 2001, have become our best selling rigs. More recently, we have developed low-temperature tolerant rigs for the Russian market, semi-trailer drilling rigs for the markets in the USA, the Middle East and India, and digitally controlled offshore drilling modules for the offshore drilling market.

### We have an experienced and dedicated management team

We are able to quickly adapt to changing trends in the regional and global drilling markets because our top management and key technical personnel are major shareholders, who are involved in the everyday operations and have first-hand knowledge of the latest market developments through direct customer contact. All of these individuals have extensive experience in the drilling equipment industry; Chairman Zhang, in particular, has over 20 years of experience in the industry. Our strategic shareholder, COOS through its parent Company, CNOOC, actively supports and participates in our Company's marketing and product development for offshore drilling products. CNOOC, founded in 1982, is one of the largest state-owned oil companies in China, as well as China's largest offshore oil and gas producer. It is authorized to cooperate with foreign partners for oil and gas exploitation in China's offshore areas. We have an established record of rapid growth, from a relatively-small land rig manufacturer in China to the second largest in the world and the largest in China in terms of revenue and production volume in 2006, within a period of 10 years.

# Chairman's Statement


"In 2007, The Group had leapt forward in terms of product quality, revenue from core businesses, profit from operation and overall profitability."

Dear Shareholders,

On behalf of the board of directors (the "Board") of Honghua Group Limited ("Honghua" or the "Group"), I am pleased to announce the annual results for the year ended 31 December 2007 (the "Year").

In 2007, the Group made remarkable progress in its overall operations and maintained a steady growth in its financial results. Revenue generated from the Group's main products continued to achieve satisfactory growth. Meanwhile, the Group further enhanced its production capacity and expanded its global sales platform to maximize revenue. At the same time, the Group adopted a strategy of applying technical improvements throughout its production lines, as well as tapping into the offshore drilling rig manufacturing business, to further consolidate its foundation for future development.

During the Year, the Group recorded a revenue of approximately RMB3,164 million, representing an increase of approximately 35.4% as compared to 2006. Gross profit and Earnings attributable to equity shareholders of the Company amounted to approximately RMB1,080 million and RMB583 million, representing an increase of approximately 38.9% and 41.3% respectively.

## MARKET OVERVIEW

The rapid global development of the drilling platform industry has persistently driven up the demand for drilling rig products. Between 2002 and 2007, the number of active land rigs worldwide had increased from 3,013 units to 4,951 units, representing a compounded annual growth rate ("CAGR") of 10.4%. During this time, the CAGR of capital expenditure on drilling and the number of drilling wells reached 22% and 11% respectively. It is expected that from 2007 to 2012, the number of newly built land rigs in the world will reach a new height of 2,900 units, representing 491 new rigs in average per each year.

# Chairman's Statement

In the years ahead, the demand for land drilling rigs will be shifted to rising new markets. It is anticipated that China and Russia will dominate the global demand for newly-built land drilling rigs. The demand for rigs in China will persistently increase with the exploitation of new oil and gas fields and the continued drilling operation in mature oilfields (e.g. the Daqing Oilfield). On the other hand, the oil and gas drilling equipment in Russia is expected to reach the end of their useful life span in the coming few years, therefore the need for replacement and renewal will drive robust growth in demand for new rigs and related products.

## BUSINESS DEVELOPMENT

In 2007, with the concerted devotion of all the staff, the Group had successfully met various performance benchmarks such as product quality, revenue, profit from operations and overall profitability. During the Year, the Group sold 94 units of drilling rigs, 132 units of mud pumps and related parts and components of rigs.

During the Year, the Group had consistently expanded its international market coverage, achieving a breakthrough in South America and successfully capturing the booming market of Africa. Coupled with the well-planned development of the Middle Eastern and South East Asian markets, rig products of the Group are gradually covering all major oil-producing countries and regions of the world.

The Group had also strategically focused on developing the emerging market of Russia, and attempted to penetrate the market with advanced technology by developing low-temperature tolerant drilling rigs that can operate at a temperature of -45°C. During the Year, by securing an approximately US$300 million contract, which mainly includes low-temperature tolerant drilling rigs, the Group had inaugurated a new era in the rig-building industry. The relevant project is currently underway and progressing smoothly. The Group expects the project in Russia will act as a strong growth impetus in the future.

During the Year, the Group had also accomplished significant results in the research and development of new rig products. Other than the low-temperature tolerant rigs customized for the market of Russia, in order to accommodate the distinctive landscapes of new oil-fields and drilling platforms in different geographical locations, the Group had developed a super rig capable of 9,000 meter drilling depth, a high-speed transporter targeted for North America, Russia and the Middle East, and a coiled tubing rig targeted for the

# Chairman's Statement

Chinese market. Our strategy of enriching the Group's product portfolio in order to meet the demands of different geographical areas will help us efficiently penetrating new market segments.

## PUBLIC LISTING

On 7 March 2008, the Group's successful listing on the main board of the Stock Exchange of Hong Kong Listing (the "Stock Exchange") marked its first step to accessing the international capital market. The total proceeds from IPO (before deducting the underwriting fee and the expenses payable in respect of the Global Offer) amounted to approximately HK$3.192 billion.

Approximately 60% of the proceeds from Group's listing will be used to finance the construction of an offshore equipment manufacturing base. The manufacture of offshore equipment represents the development direction of the industry, as well as the Group's core focus for the next 10 years. Approximately 12% of the proceeds from the listing will be used to finance the expansion of production capacity and the research and development of new land rig equipment and related parts and components, with an aim to consolidate our leading position in the land rig industry.

## OUTLOOK

The first decade for Honghua, from 1997 to 2007, represents not only a key chronological marker, but also a new starting point for scaling new heights. The demand for rig products goes up with the increasing global demand for oil and the soaring oil prices, the increase in capital expenditure of the oil exploration industry and the strong growth of the global oil drilling industry. We shall capitalize on the enormous opportunities that come with such favorable macro-environmental conditions. Year 2008 will be a critical period for Honghua to carry forward our business into the future.

By the end of 2008, our annual production capacity will be increased to 150 units of rigs and 500 units of mud pumps. The Group will accelerate the research and development of products such as offshore tower-rig mast, offshore-equipped land built mobile system, 12,000 meter-drilling depth rigs, coiled tubing rigs and top drives and the like, in order to further enhance our product portfolio and to perfect our value chain, solidifying our advantage in terms of industry technology.

At the same time as we celebrate the Group's successful listing on the Stock Exchange and achievements during the Year, on behalf of the Board, I also want to take this opportunity to express sincere thanks to all our shareholders, customers, business partners and employees for their unwavering support, which has made the Group's continuous success possible. We promise to dedicate our best efforts to lead Honghua to a bright and prosperous future with the aim to bring maximum returns to our shareholders.

**Zhang Mi**
*Chairman*
Chengdu, the PRC, 27 April 2008

# Management Discussion and Analysis

# Management Discussion and Analysis

## BUSINESS REVIEW

### Financial Highlights

During the Year the Group recorded a revenue of approximately RMB3,164 million, representing an increase of approximately 35.4% as compared to approximately RMB2,336 million in 2006. Earnings attributable to equity shareholders of the company amounted to approximately RMB583 million representing an increase of approximately 41.3%.

During the Year, our export revenue amounted to approximately RMB1,959 million, representing an increase of approximately RMB9 million as compared to 2006 and accounted for approximately 61.9% of revenue. Our major export markets were Russia, North America, Africa and the Middle East.

### Operations Review

Honghua Group is a leading manufacturer of land drilling rigs in China, with a focus on production and sales of land drilling rigs and related rig parts and components; as well as the provision of technical support services to customers. During the Year, by proactively exploring new markets, our core business of drilling rigs manufacture recorded remarkable growth. In addition to drilling rigs, we also offered rig parts and components used for newly-built and refurbished drilling rigs to customers, allowing us to become a one-stop solution provider. During the Year, the business of rig parts and components also achieved satisfactory growth.

### Land Drilling Rigs Business

During the Year, our revenue from sales of land drilling rigs amounted to approximately RMB2,774 million, representing a significant increase of approximately 36.2% as compared to approximately RMB2,037 million in 2006, and contributing approximately 87.7% to revenue of the Group.

Products of the Group comprise digitally-controlled land rigs and conventional land rigs. During the Year, total sales of drilling rigs

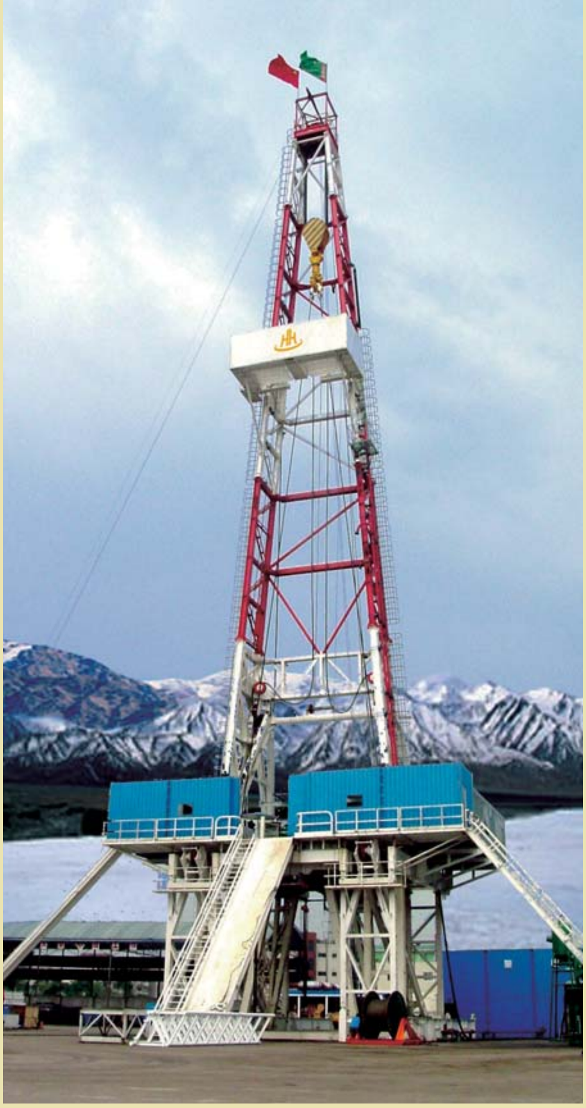
amounted to 94 units, among which, 57 units were digitally-controlled land rigs and 37 units were conventional land rigs, representing an increase of 7 units and 5 units respectively as compared to 2006. Gross margin of drilling rigs reached

# Management Discussion and Analysis

approximately 34.1%, representing an increase of 1.0% compared to approximately 33.1% of 2006. Gross margin of conventional land rigs reached approximately 34.8%, representing a significant increase of 6.9% compared to approximately 27.9% of 2006. The margin improvement was mainly attributable to the increase in exports of conventional land rigs which generally had a higher gross margin.

Our drilling rig products range from 1,000 metre light drilling rigs to 9,000 metre heavy drilling rigs. Due to the market demand shifting to drilling rigs with higher depth ratings and more functions, during the year, we changed our fist products to 7,000 meter depth drilling rigs from 5,000 meter depth drilling rigs. We sold 36 units of 7,000 metre heavy drilling rigs and 24 units of 5,000-metre mid-level drilling rigs in aggregate during the Year, representing an increase of 26 units and a decrease of 15 units respectively as compared to 2006. The sales volumes for 2,000-metre, 3,000-metre and 4,000-metre drilling rigs were 6, 17 and 11 units respectively.

During the Year, we proactively expanded the PRC market. Sales volume of drilling rigs to this market amounted to 49 units, representing an increase of 17 units as compared to 32 units of 2006. Sales volume of drilling rigs to the North American market decreased to 15 units, due to the fall in numbers of drilling rigs delivered to Nabors. The Russian market grew rapidly. Drilling rigs sold to this market increased to 19 units during the Year from 1 unit in 2006. The Middle Eastern market was basically stable. Drilling rigs sold to this market amounted to 2 units as compared to 3 units of 2006. Other emerging markets such as Africa, Southeast Asia and South Asia also observed active expansion with a total sales volume of 9 units, representing an increase of 8 units over last year.



The rapid development of the Group was supported by clients of excellent quality. Our stable clients include leaders in their industries such as Nabors, Northern Expedition in Russia, CNPC, Sinopec and CNOOC. We have a sophisticated global marketing network in which we distribute the Group’s products through our overseas subsidiaries in Houston, Texas (USA), Cairo (Egypt) and Dubai (UAE), as well as local distributors in key drilling rig markets, such as Russia and Indonesia. Our subsidiary in Houston assembles and sells our drilling rig parts and

# Management Discussion and Analysis

components to drilling contractors based in North America and Latin America. We believe that this lays a solid foundation for further expansion in the North American and Latin American markets. In Egypt, we have formed a joint venture company with three enterprises to increase our market share in Africa. Our subsidiary in Dubai serves our customers across the Middle East. In Russia and Indonesia, our close relationships with local distributors have enhanced our position in the oil and gas drilling equipment markets within these countries.

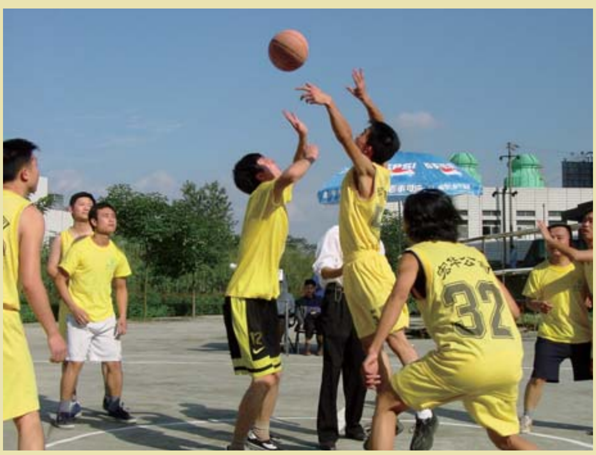
**Rig Parts and Components Business**

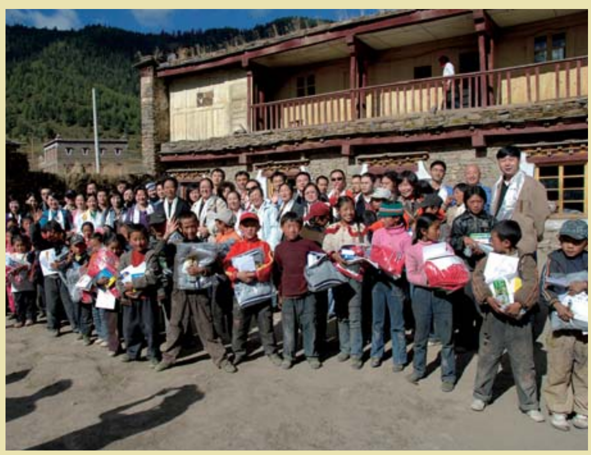
During the Year, the Group recorded approximately RMB390 million from sales of rig parts and components, representing a significant increase of approximately 30.5% as compared to approximately RMB299 million of 2006, contributing approximately 12.3% to our revenue.

Our products include mud pumps and other parts and components. During the Year, the sales volume of mud pumps amounted to 132 units, representing a fall of 59 units as compared to 191 units of 2006. However, due to the improvement of the configuration of the mud pumps, the average selling price increased by approximately RMB501,600, which effectively offset the decrease in sales. The annual revenue for mud pump products amounted to approximately RMB166 million, representing an increase of approximately RMB22 million as compared to the previous year. Sales of other parts and components grew rapidly and its revenue amounted to approximately RMB224 million, representing an increase of approximately RMB69 million compared to last year. The increase was mainly driven by the growth of sales of VFD, diesel-engine generators, electrical machine and etc.

During the Year, the average gross margin for rig parts and components reached approximately 34.6%, and was on a par with approximately 34.5% of 2006.

The Group adopted a series of measures to control the costs. It also increased the selling prices by enhancing product qualities. As a result, each business segment recorded steady growth in profitability.





# Management Discussion and Analysis

## Production and Service

During the Year, Honghua has further developed as a global and group focused company. Significant improvement in rig production was realized in terms of product diversification, quantity and quality. As a result, the Group achieved an obvious improvement in both production and operations.

Production: the Group had completed 101 sets of drilling rigs and approximately 600 sets of rig parts and components, of which 290 sets of mud pumps.

Technical services: it ensured post-sales services of the Group's products, including on-site installation, debugging, reparation and training, as well as internal assembly shakedown testing and shipment tracking, compensated and non-compensated technical training offered to the clients, employees' skills training, practical operation training and demonstration to visitors. With the utter support and concerted devotion from various departments of the Group, the installation and debugging tasks of carry-over rigs and newly-dispatched rigs, as well as the emergency reparation services for ex-factory rigs, were both well-completed and ensured.

## Technological Development and Implementation

During the Year, the Group completed 22 technical research and development projects. Investment in research and development totaled approximately RMB27 million, representing an increase of approximately 69.0% as compared to the previous year. The Group placed high emphasis on its in-house research and development capability and will commit to developing new products in accordance with market demand.

In 2007, the main research and development directions of the Group were as follows:

1. *9,000-metre ultra-depth rigs*

   By adopting the DBS technology which was domestically-initiated, the Group had realized digital control over primary functions of ultra-depth rigs and broken monopoly of developed countries in the ultra-depth rigs market. This project has been listed in the key technical innovation projects in Sichuan Province in 2007; in early 2008, an order for the first 9,000-metre ultra-depth rig in the PRC was secured by us.

2. *ZJ50DBS low-temperature tolerant rigs*

   The product was tailor-made for the Russian market. Combining the DBS technology and low-temperature tolerant technology the product solved the problem of rigs' adaptability under the condition of low temperature (-45°C). The Group is the domestic pioneer of producing low temperature tolerant rigs and hence possesses ample room for market expansion. This project has been listed in 2007 Sichuan provincial major technical equipment innovation research project. In July 2007, the Group received an order of 30 units of this type of rigs from Clusseter Limited, in Russia. We had 6 units delivered during the year and more to be delivered in 2008.

3. *High speed transferring rigs*

   The product targets at the North America, Russia and Middle East markets. DBS technology was applied to achieve the high-speed transfer as well as to adapt to

# Management Discussion and Analysis

the development direction of high-speed evading and unloading and the development of transferring technology which meets API specification and HSE requirements. This project has been successfully developed and the Group has applied for this project to be listed in the 2008 State major new product program project. During the year, the Group had respectively sold 1 unit of this type of rigs in China and India.

4. *Continuous pipe rigs*

Via the development of continuous pipe rigs with internationally-advanced, copyrighted technology, the void in China was filled. The Group attempted to gradually lessen the China's reliance of imported continuous pipe rigs by manufacturing quality rigs locally at a lower cost, and meanwhile seeks new profit growing points for its own development. This project is jointly run by the Group's Technology Centre and Southwest Petroleum University, and has been listed in 2008 Sichuan Provincial Technological Supporting Program Project. It is currently undergoing the stage of research and development.

## FUTURE PROSPECT

### Business Environment

In 2008, despite global economy slowdown, it is predicted by International Energy Agency that the global demand for oil products in 2008 will increase by 2.5%, implying the persistent growth of global oil demand. US International Energy Advisory Administration also forecasted that global oil price will observe an ever-increasing trend. Stimulated by oil price hike, the capital expenditure for petroleum drilling and mining globally will continue to increase. It is forecasted that substantial amount of investment will drive the development of petroleum drilling rigs further upward. Other than traditional oil-producing countries such as North America and the Middle-east, the emerging markets such as Russia and the PRC will become the largest source of demand for petroleum equipment.

From 2006 to 2007, annual growth of demand for rigs is mainly attributable to the increase in capital expenditure for rigs in North America. In the next five years, substantial demand for rigs will nevertheless be shifted to the emerging markets, Russia and the PRC in particular; and they will dominate the demand for newly-built land drilling rigs. We expect that by the end of 2012, Russia and the PRC will jointly account for nearly 80% of global total demand for new rigs.

### Business Objective

We plan to enhance production capability which is being considered as the substantial orders in the international market. We will apply 12% of the proceeds from IPO on production capacity expansion as well as the research and development of new land rigs equipment and rig parts and components. In 2008, the production capacity of drilling rigs will increase from 101 units in 2007 to 150 units.

Many active rigs will reach the stage of reparation and equipment renewal in the coming years. To cater for the continuously increasing demand, the Group will proactively enhance the production capacity of rig parts and components and strive to increase the annual production of mud pumps from the existing 290 units to 500 units in 2008. The Group believes that enhancement in capacity will be conducive to coping with the increasing demand for rigs and rig parts and components in the global market and further enhance the Group's profitability.

# Management Discussion and Analysis

Moreover, offshore jack-up rigs market represents a golden opportunity for the development of the Group. From 1979 to 1983, investment on offshore rigs experienced a peak. However, the rigs manufactured in that period are already entering into the end of their life span while the supply is very limited. Since 1983, there is a serious insufficiency in investment in offshore rigs, thereby causing the rates to increase two-fold since 2006. Meanwhile, the demand for drilling has never ceased to increase. These markets with high growth are exactly those that we intend to put our focus on.

## FINANCIAL REVIEW

During the year, we recorded gross profit and earnings attributable to equity shareholders of the company respectively RMB1.08 billion and RMB0.583 billion representing an increase of 38.9% and 41.3% respectively over the year 2006. Gross margin and net margin were 34.1% and 18.4% respectively. During the year, the increase in our earnings was mainly due to the active exploration of new markets and cost control and profitability enhancing and other measures taken by management.

### Revenue

During the year, our revenue amounted to RMB3.164 billion, representing an increase of 35.4% as compared to RMB2.336 billion in 2006. This increase was mainly attributable to the strong demand for petroleum drilling rigs globally and rapid growth of the emerging markets such as the PRC, Russia and Africa.

During the year, sales by geographical areas of the PRC, North America, Europe, Middle East and other areas were respectively RMB1.205 billion, RMB595 million, RMB801 million, RMB156 million and RMB407 million. Revenue from export of the Group amounted to approximately RMB1.959 billion, representing an increase of RMB9 million as compared to last year and accounted for 61.9% of revenue. The export markets of the Group were mainly Russia, North America, Africa and Middle East.

During the year, sales by product categories of drilling rigs and rig parts and components respectively amounted to RMB2.774 billion and RMB390 million, and representing a respectively increase of 36.2% and 30.5% as compared to 2006. Among which, digitally-controlled rigs and conventional rigs were approximately RMB2.232 billion and RMB542 million respectively, representing an increase of 45.2% and 8.4% respectively. Mud pump and other parts and components amounted to approximately RMB166 million and RMB224 million, representing an increase of approximately 15.0% and 45.0% respectively. Sales values for various products also increased steadily.

### Cost of Sales

During the Year, the Group's cost of sales amounted to approximately RMB2,084 million, representing an increase of approximately RMB526 million or 33.7% as compared to 2006. The increase was mainly attributable to the corresponding increase of the Group's revenue.

# Management Discussion and Analysis

### Gross Profit and Gross Margin

During the year, the Group's gross profit was approximately RMB1,080 million, representing an increase of 38.9% as compared to last year. Gross margin was approximately 34.1%, representing an increase of 0.8 percentage point. Gross profit from drilling rigs amounted to approximately RMB945 million and gross profit from rig parts and components amounted to approximately RMB135 million, representing an increase of 40.1% and 30.8% respectively. Among which, gross profit from digitally-controlled land rigs amounted to approximately RMB757 million and that of conventional land rigs amounted to approximately RMB189 million, that of mud pumps amounted to approximately RMB61 million and that of other parts and components amounted to approximately RMB76 million, representing an increase of 41.1%, 35.0%, 34.1% and 30.2% respectively.

The gross margins for various products were basically stable as compared to the previous year: gross margin for drilling rigs was approximately 34.1%, representing an increase of approximately 1.0 percentage points; gross margin for rig parts and components was approximately 34.6%, representing an increase of 0.1 percentage point as compared to last year. Among which, gross margin for digitally-controlled land rigs was approximately 33.9%, representing a decrease of 1.0 percentage point as compared to last year; gross margin for conventional land rigs was 34.8%, representing an increase of 6.9 percentage points as compared to last year; gross margin for mud pump was approximately 36.6%, representing an increase of 5.3 percent points as compared to last year; gross margin for other parts and components was approximately 33.8%, representing a decrease of 3.8 percentage points as compared to last year. The stable gross margins were attributable to effective measures on cost control taken by the Group.

### Other Net Operating Revenue and Other Net Income

During the Year, the Group's other net operating revenue amounted to approximately RMB22 million, representing an increase of approximately RMB19 million or 500.4% as compared to last year. The increase is mainly attributable to a significant increase in the operating revenue from transfer of technical know-how to, HH Egyption Company, a jointly controlled entity. Other net income amounted to approximately RMB22 million, representing an increase of RMB19 million or 628.5% as compared to last year. The increase was mainly attributable to a significant increase in government subsidy.

### Expenses in the Period

During the Year, the Group's selling expenses amounted to approximately RMB210 million, representing an increase of 149.9% or RMB126 million as compared to the corresponding period of the previous year. The increase was mainly attributable to the significant increase in transportation cost and proxy sales commission of approximately RMB73 million and RMB26 million over last year respectively.

During the Year, the Group's general and administrative expenses amounted to approximately RMB187 million, representing an increase of 69.3% or RMB76 million as compared to 2006. The increase was mainly attributable to the increase in labor cost and research and development expenses.

During the Year, the Group's net financing cost amounted to approximately RMB50 million, representing an increase of 115.8% or RMB27 million as compared to last year. The increase was mainly attributable to the significant increase in short term loans.

# Management Discussion and Analysis

### Share of Profits from a Jointly-controlled Entity

During the Year, the Group's share of profits from a jointly-controlled entity amounted to approximately RMB6 million. The profits was mainly attributable to the business commencement of HH Egyptian Company, a joint-venture company with three subsidiaries of Egypt's State Petroleum Company.

### Profit before Taxation

During the Year, profit before taxation of the Group amounted to approximately RMB685 million, representing an increase of 20.7% or approximately RMB117 million as compared to 2006. The increase was mainly attributable to the growth of the Group's sales for drilling rigs and rig parts and components.

### Income Tax Expenses

During the Year, the Group's income tax expense amounted to approximately RMB68 million, representing a decrease of approximately 34.6% or RMB36 million as compared to 2006. The decrease was mainly attributable to the fact that the Group enjoyed various degrees of State preferential tax policies. Among which, income tax rate for Sichuan Honghua Petroleum Equipment Co., Ltd. decreased from 33% on 30 September 2006 to 3%.

### Profit for the Year

During the Year, the Group's profit for the year amounted to approximately RMB617 million, representing an increase of 33.0% or RMB153 million as compared to last year. Among which, earnings attributable to equity shareholders of the company was approximately RMB583 million, while minority interest was approximately RMB34 million.

### Dividend

During the year, the Group has not declared any dividends.

### Sources of Capital and Borrowings

The Group's principal sources of capital include cash from operations, bank borrowings and capital injection from investors. Raw material purchasing and other operational expenses, acquisition of land use rights and other fixed assets as well as settlement of interest and loan constitute the demand of the Group for cash.

As at 31 December 2007, the Group's bank borrowings amounted to approximately RMB856 million, representing an increase of approximately RMB504 million as compared to early 2007; borrowings from financial institutions amounted to approximately RMB15 million, representing an increase of approximately RMB1.58 million as compared to early 2007. Among which, borrowings repayable within one year amounted to approximately RMB856 million, representing an increase of approximately RMB511 million as compared to early 2007; borrowings repayable after one year amounted to approximately RMB0.38 million, representing a decrease of approximately RMB7.17 million as compared to early 2007.

# Management Discussion and Analysis

## Deposit and Cash Flow

At the end of the year, the Group's cash and cash equivalents amounted to approximately RMB195 million, representing an increase of approximately RMB37 million as compared to early 2007.

During the Year, the Group's operating cash outflow amounted to approximately RMB470 million; investment cash outflow amounted to approximately RMB179 million; cash inflow from financing activities amounted to approximately RMB686 million.

## Assets Structure and Changes Thereof

At the end of the year, the Group's total assets amounted to approximately RMB3,931 million, representing an increase of approximately 80.1% or approximately RMB1,749 million as compared to early 2007; among which, current assets amounted to approximately RMB3,136 million, accounting for approximately 79.8% of total assets; non-current assets amounted to approximately RMB795 million, accounting for approximately 20.2% of total assets.

## Liabilities

At the end of the year, the Group's total liabilities amounted to approximately RMB2,575 million, representing an increase of approximately RMB731 million as compared to early 2007; among which, current liabilities amounted to approximately RMB2,556 million, accounting for approximately 99.2% of total liabilities; non-current liabilities amounted to approximately RMB20 million, accounting for approximately 0.8% of total liabilities. As at 31 December 2007, the Group's gearing ratio is approximately 22.2%.

## Total Equity

At the end of the year, total equity amounted to approximately RMB1,356 million, representing an increase of approximately RMB1,018 million as compared to early 2007; total equity attributable to equity shareholders of the company amounted to approximately RMB1,288 million, representing an increase of approximately RMB984 million as compared to early 2007; minority interests totaled approximately RMB68 million, representing an increase of approximately RMB34 million as compared to early 2007; net assets value reached approximately RMB0.54 per share. During the Year, the Group's return on average equity was approximately 73.3%.

## Contingent Liabilities and Pledge

At the end of the year, details of contingent liabilities are set out in note 36 to the financial statements of this annual report. The Group have pledged bank deposits of approximately RMB261 million, representing an increase of approximately RMB193 million as compared to early 2007.

## Capital Expenditure and Major Investment

During the Year, capital expenditure of the Group on infrastructure and technical improvements amounted to approximately RMB136 million.

For investment plan, our commitment for petroleum drilling rigs equipment sets export base project, 7,000 metre depth current VF motor rigs project and digitally-controlled VFD rigs technological transformation project (phrase II) are totalling RMB247 million, these projects are aimed at enhancing production capacity of various rigs and optimizing the craft of production.

# Management Discussion and Analysis

### Foreign currency risk

The Group is exposed to foreign currency risk arising from several assets or liabilities denominated in a currency other than the functional currency of the entity to which they relate. The total amount exposed to foreign currency risk at the balance sheet date was disclosed in note 31(d) to the financial statements.

### Use of Proceeds from the Initial Public Offerings

To implement our business strategy of increasing equipment production capacity, improving the technology and innovation of our product lines, and expanding product and service lines, we intend to use these net proceeds for the following general purposes.

(i) Approximately 60% is to be used for the construction of an offshore equipment manufacturing base in the eastern coastal area of China, to produce jack-up rigs and fixed rigs as well as large structures. This includes acquiring land and coastline in Shanghai or neighboring provinces, investing in research and development of new equipment, and constructing new factories.

(ii) Approximately 12% is to be used for increasing production capacity, and for the research and development of new land rig equipment and rig parts and components. In order to increase the annual rig production capacity to 150 rigs by 2008, the Group needs capital investment, including fixed capital (for such items as expansion of the ground for final assembly tests, expansion of workshops, and increase in production and testing equipment).

(iii) Approximately 20% is to be used for acquisitions, establishing joint ventures and strategic alliances with international partners, in order to expand our product offerings to the oil and gas exploration and mining industry.

(iv) The remaining proceeds will be used for working capital and day to day expenses.

### Employee Remuneration and Benefit

At the end of the year, the Group has 3,140 employees and an average of 2,974 employees throughout the year. The total remuneration and benefit amounted to approximately RMB183 million, representing an increase of approximately 56.8% or approximately RMB117 million as compared to 2006. The Group maintains a people-oriented principle and fully develops the potential of the staff. Along with offering a broad platform to fulfill one's value as well as providing training opportunity with diverse, specific and level-categorized bases, the Group intends to improve the value of the staff. The Group strictly follow the State's law and regulation to implement remuneration and benefit system, meanwhile determining one's individual remuneration based on his job duties, work performance and individual capability.

# Biographical Details of Directors and Senior Management

## EXECUTIVE DIRECTORS

*Mr. Zhang Mi* (張弭先生), aged 51, has been Chairman of the Company and an executive director of the Company since June, 2007. He is also President of the Company. Positions held by Mr. Zhang in the Company's subsidiaries are set forth in the table below.

| Subsidiary | Position | Term of Office |
|---|---|---|
| Asia Harbour | Director | Since August 18, 2006 |
| Honghua Company | Chairman, executive director and general manager | Since December 31, 1997 |
| HH Egyptian Company | Director | Since April 26, 2007 |
| Honghua America | Chairman and executive director | Since October 11, 2004 |
| Honghua International | Chairman and executive director | Since January 13, 2004 |

Mr. Zhang graduated from the Sichuan Petroleum Administration Vocational University in 1982, with a diploma in machinery manufacture, design and equipment. He graduated from the Party Institute of Sichuan Provincial Committee Correspondence College in 1998, with a degree in Economics and Management. In 2004 he then obtained a senior engineer qualification granted by the Committee for Evaluation of Senior Technical Positions of the China National Petroleum Corp.. He has been receiving special subsidies granted by the State Council of the PRC government since February 2007, for his significant contribution to the development of machinery engineering in the PRC.

Mr. Zhang is particularly involved in enhancing the company's technological innovation. Mr. Zhang is responsible for the development of the ZJ70LC drilling rig, which was one of the major ultra-deep drilling rigs used in China. He is also responsible for the development of the digitally-controlled VFD rig (DBS), the first of its kind in China. The DBS has been included in the State Critical Technological Equipment Innovation Research Project (國家重大技術裝備創新研製項目), the State Key New Products (國家重點新產品) and the National Torch Plan Project (國家級火炬計劃項目). In 2005, Mr. Zhang was awarded the Sichuan Province Prize for Outstanding Talent in Innovation (四川省第三屆傑出創新人才獎), by the Sichuan Provincial Party Committee and the Sichuan Provincial People's Government. In 2007, he was granted the May 1 Labor Medal of Sichuan Province (四川省五一勞動獎章) by the Sichuan Provincial Federation of Trade Unions in 2007.

*Mr. Ren Jie* (任杰先生), aged 41, has been an executive director of the Company since January 18, 2008. He is also a Vice-president of the Company. In 1990, Mr. Ren earned a Bachelor's degree in mining machinery from Southwest Petroleum University, located in Sichuan Province, specializing in petroleum and natural gas. In 1995, Mr. Ren obtained an engineering qualification, granted by the China National Petroleum Corp., Sichuan Petroleum Administration. In November 2007, he also became a member of the 5th Edition Committee of the Oil Field Equipment Journal. Mr. Ren is employed as an engineer by Honghua Company.

# Biographical Details of Directors and Senior Management

In the early stages of Honghua Company, Mr. Ren successfully designed a rotary table transmission unit, a drawworks bevel gear box, and universal shaft equipment for the ZJ70LC drilling rigs, which contributed greatly to the development of the Company. Mr. Ren, together with his research and development team, also successfully developed a set of digitally-controlled VFD rigs, after the development of the first digitally controlled VFD rig (DBS).

Positions held by Mr. Ren in the Company's subsidiaries are set forth in the table below.

| Subsidiary | Position | Term of Office |
|---|---|---|
| Asia Harbour | Director | Since August 18, 2006 |
| Honghua Company | Director and | Since December 31, 1997 |
| | deputy general manager | Since March 1, 2003 |
| Youxin Company | Director | Since December 8, 2006 |
| Honghua International | Director | Since January 13, 2004 |

*Mr. Zhang Xu* (張旭先生), aged 47, has been an executive director of the Company since January 18, 2008. He has been a director of Honghua Company since December 31, 1997 and a director of Asia Harbour since August, 2006. Mr. Zhang graduated from Southwest University of Finance and Economics in 1998. Mr. Zhang obtained a senior accountancy qualification in 2007, granted by the Personnel Bureau of Sichuan Province, and had over 10 years of accounting experience prior to joining Honghua Company. From January, 1986, to June, 1991, Mr. Zhang was an accounting staff member in the Chuannan Mining District Transport Team, Sichuan Petroleum Administration. From June, 1991, to January, 1995, Mr. Zhang was an accounting staff member and subsequently an accountant in Tarim Sichuan Drilling Company. From January, 1995, to January, 1996, Mr. Zhang was an accountant for Guanghan Drilling and Production Equipment Plant, Sichuan Petroleum Administration.

Positions held by Mr. Zhang in the Company's subsidiaries are set forth in the table below.

| Subsidiary | Position | Term of Office |
|---|---|---|
| Asia Harbour | Director | Since August 18, 2006 |
| Honghua Company | Director | Since December 31, 1997 |

# Biographical Details of Directors and Senior Management

## NON-EXECUTIVE DIRECTORS

*Mr. He Sean Xing* (何欣先生), aged 43, has been a non-executive director of the Company since January 18, 2008. He has been a director of Honghua Company, since March, 2007. He has been a director of Asia Harbour since December 6, 2006. He has been a director of Anshine International Group (incorporated in the Cayman Islands) since September 10, 2006. He has been a director of Informax Optical Technology Corporation since May, 2002. He has been a director of eBIS Co., Ltd., since May 28, 2003. He is also a managing director of Carlyle Funds. Mr. He graduated from Zhejiang University in 1985, with a Bachelor's degree in structural engineering, and in 1991 he received a Master's degree in engineering from Carleton University (Canada). In 1994, he earned an MBA from the Schulich School of Business, York University (Canada). In 1997, Mr. He qualified as an American Chartered Financial Analyst (CFA).

*Mr. Wang Yaoxin* (王堯鑫先生), aged 47, has been a non-executive director of the Company since January 18, 2008. He has been a Director of Asia Harbour since August, 2006 and a director of Sichuan Honghua Petroleum Equipment Co., Ltd., since December 31, 1997. Since April, 2005, he served as the plant manager of the Sichuan Petroleum Administration Chengdu General Machinery Plant (based in Guanghan) Thermal Processing Sub-plant. From 2004 to 2005, he was the plant manager of the Sichuan Petroleum Administration Drilling Equipment Factory Valve Sub-plant. From 1996 to 2004, he was the plant manager of the Maintenance Sub-plant of the Sichuan Petroleum Administration Drilling Equipment Factory. In 1981, Mr. Wang completed a course in machinery manufacturing at the Chengdu Petroleum School. In 1990, Mr. Wang completed a course in quality management at the Chengdu Science and Technology University, Management Science and Engineering Department. In 2000, Mr. Wang completed a course in economic management at the Party Institute of Sichuan Provincial Committee Correspondence College. He obtained an engineering qualification from China National Petroleum Corp in 1995.

*Mr. Xiang Qingsheng* (相慶生先生), aged 61, has been a non-executive director of the Company since January 18, 2008. He has been a director of Asia Harbour since March, 2007. Since 2004, he has been a director and general manager of COOS, a director of China Nanshan Development (Group) Incorporation, a vice-chairman of Nanhai West Oil Oilfield Service (Shen Zhen) Co., Ltd., and a director of CNOOC Insurance Limited. Mr. Xiang completed an English course at Guangdong Huanan Normal University in 1988. He obtained a senior economist qualification from CNOOC in 1997.

# Biographical Details of Directors and Senior Management

## INDEPENDENT NON-EXECUTIVE DIRECTORS

*Mr. Chen Guoming* (陳國明先生), aged 45, has been an independent non-executive director of the Company since January 18, 2008. In 1982, Mr. Chen graduated from the Mechanical Department of the East China Petroleum Institute with a Bachelor's Degree, and then worked as an assistant engineer in the Lanzhou General Machinery Plant from 1982 to 1983. He earned his Master's degree in 1986, from the Beijing Graduate School of East China Petroleum Institute. He then worked as a teacher in this Institute and was promoted to Associate Professor and then Professor in 1992 and 1995, respectively. He was a visiting scholar at the University of California, Berkeley, from 1996 to 1997. He obtained his Ph.D. degree in 1999, and was promoted to Ph.D. candidate supervisor in 2000. He is now a Professor and a Ph.D. candidate supervisor in the Department of Mechanical and Electrical Engineering, China University of Petroleum. Currently, Mr. Chen is the Chief of Shandong Key Laboratory of Petroleum Mechanical Engineering and the Research Office of the Offshore Petroleum Engineering; a member of the Quality & Reliability Committee of China Petroleum Society, the Offshore Engineering Committee of China Naval Architects and Marine Engineers' Society and China Mechanical Engineering Society; and a member of the Editorial Committee of the Journal of Petroleum Science, the Journal of Oil Mining Field Machinery and the Journal of China University of Petroleum (Natural Science Edition). He has been receiving special subsidies granted by the State Council of the PRC government (政府特殊津貼) since August 2005, for his significant contribution to the development of higher education in China, and was awarded the National Labor Day Medal in 2007.

*Mr. Tai Kwok Leung Alexander* (戴國良先生), aged 50, has been an independent non-executive director of the Company since January 18, 2008. Mr. Tai graduated from Victoria University of Wellington in New Zealand with a degree in Bachelor of Commerce and Administration in 1982 and became an associate member of the Hong Kong Institute of Certified Public Accountants in 1983. Mr. Tai has extensive accountancy, corporate finance and investment experience in Hong Kong and overseas. Mr. Tai is a shareholder and an executive director of Access Capital Limited, a licensed corporation under the SFO to conduct Type 1 (dealing in securities), Type 4 (advising on securities), Type 6 (advising on corporate finance) and Type 9 (asset management) regulated activities.

*Mr. Liu Xiaofeng* (劉曉峰先生), aged 45, has been an independent non-executive director of the Company since January 18, 2008. He is currently a Managing Director of DBS Asia Capital, and an independent non-executive Director of CNPC (Hong Kong) Limited and Haier Electronics Group Co., Ltd., both of which are publicly-listed companies on the Stock Exchange. He has over 14 years of experience in corporate finance and has worked with various international financial institutions since 1993, including NM Rothschild & Sons, JP Morgan, and DBS. Mr. Liu obtained a Master's degree and a Ph.D. from the Faculty of Economics, University of Cambridge in 1988 and 1993 respectively, a Master of Science degree in Development Studies from the University of Bath, England, in 1987, and a Bachelor of Economics degree from Sichuan Finance University (Southwest University of Finance and Economics, China) in 1983.

# Biographical Details of Directors and Senior Management

*Mr. Liu Yinchun* (劉銀春先生), aged 61, has been an independent non-executive director of the Company since January 18, 2008. Mr Liu served as director of East China Oil Bureau from 2002 to 2007. Mr. Liu graduated from Beijing Geosciences College (now known as China University of Geosciences) in 1969. He has extensive experience in oil drilling and business management. In 1997, he served as the deputy director and Chief Engineer of East China Oil and Geology Bureau from 1996 to 2002. He was awarded Senior Engineer at professor level and has been receiving special subsidies granted by the State Council of the PRC government (政府特殊津貼) since February 1998, for his significant contribution to the development of engineering technology in China.

*Mr. Qi Daqing* (齊大慶先生), aged 43, has been an independent non-executive director of the Company since January 18, 2008. Mr. Qi is a Professor of accounting and Associate Dean at Cheung Kong Graduate School of Business (CKGSB). He taught at the School of Accounting, Chinese University of Hong Kong, from 1996 to 2002. His research interests primarily focus on financial reporting and strategy execution. He has published many articles in accounting and finance journals, and he has extensive executive training and consulting experience in accounting and corporate finance.

His clients include:

| **Type of client** | **Name of client** | **Duration of service** |
|---|---|---|
| Government: | Shanghai Municipal Government | 2000–2001 |
| | Ministry of Information Industries of PRC | 1998–2000 |
| Private Sector: | Huawei Technologies Co., Ltd. | 2006 |
| | Lenovo Group Limited | 2004–2005 |
| | Digital China Holdings Limited | 2004 |
| | Siemens Ltd., China | 2002 |
| | China Telecommunications Corporation | 2001 |
| | Nokia (China) Investment Co., Ltd. | 1999–2001 |

He received his Ph.D. in accounting from Michigan State University in 1996, his MBA from the University of Hawaii at Manoa in 1992, and his Bachelor's degrees in Biophysics and International Journalism from Fudan University in 1985 and 1987, respectively. Mr. Qi is not a certified public accountant; he became a member of the American Accounting Association in 1996. With over ten years of experience as a professor of accounting, a Ph.D in accounting, an MBA and extensive executive training and consulting experience in accounting and corporate finance, Mr. Qi's experience means that he has the requisite expertise as required by the Listing Rules. Therefore, whilst Mr. Qi does not hold formal accounting professional qualifications, he meets the criteria for accounting and related financial management expertise as required by Rule 3.10(2) of the Listing Rules.

# Biographical Details of Directors and Senior Management

Mr. Qi is chairman of the Audit Committee of two listed companies. He is currently Chairman of the Audit Committee of Hongyuan Securities Company Limited (a PRC listed company) and is directly involved in the improvement and compliance of its audit process. He is also Chairman of the Audit Committee of Sohu (a NASDAQ listed company) and is directly involved in the formulation of accounting policies and audit processes.

*Mr. Wang Chunlin* (王春林先生), aged 44 has been an independent non-executive director of the Company since January 18, 2008. Mr. Wang graduated from the University of International Business & Economics in Beijing in 1986. In 1999, he obtained a MBA from Murdoch University in Australia and in 2003 he was awarded the Master of Science in International Shipping & Transport Logistics by Hong Kong Polytechnic University. Mr. Wang became a consultant of Pacific Basin Shipping Limited on 1 December 2005 responsible for group business development and was confirmed as its permanent employee on 1 March 2006. On 21 August 2006, Mr. Wang was appointed executive director of Pacific Basin Shipping Limited with effect from 1 September 2006. He is also a director of Asia Pacific Maritime & Infrastructure Group Limited in Hong Kong, Bermuda, BVI, Asia Pacific Fortune Limited and Asia Pacific Fortune (HK) Limited. Mr. Wang joined the Sinotrans Group in 1986 and until 2002 assumed several senior positions in various subsidiaries and joint ventures of Sinotrans Group and was responsible for overseeing a wide range of activities. In 2002 he was promoted to Assistant President of Sinotrans Group and Managing Director of Sinotrans Shipping Limited. In April 2005 Mr. Wang joined the IMC Group where he was responsible for developing its business in Hong Kong and China.

*Mr. Wang Li* (王礫先生), aged 37, has been an independent non-executive director of the Company since January 18, 2008. Mr. Wang graduated from China University of Political Science and Law in 1992 with a Bachelor's Degree in Civil Law and in 2001 received a Master's Degree in International Law from Napier University Edinburgh. Mr. Wang also studied law in international business and international electronic business at Asia Economy Management College of the University of California in 1996. Mr. Wang specializes in legal services in finance, stock exchange, real estate and international trade. His clients include, among others, Bank of China (Chengdu branch), Citigroup Global Markets Asia Ltd and Construction Bank of China (International Division of Sichuan Branch). Mr. Wang is a director of the Sichuan Lawyers Association.

## SENIOR MANAGEMENT

*Mr. Liu Zhi* (劉智先生), aged 43, is a vice-president of the Company. Mr. Liu has been a director of HH Egyptian Company since April 26, 2007. He has been a Deputy General Manager of Honghua Company since January 1, 2001, and he is in charge of domestic and overseas sales, and financial and accounting management. He was a director of Honghua Company from August 17, 2006 to March 8, 2007. He has respectively been a director of Hongtian Company since December 8, 2006, a director of Honghua International since January 13, 2004, and has been the general manager of Honghua International since January 6, 2004. Mr. Liu has contributed to the expansion of Honghua Group's markets inside and outside of China. Mr. Liu graduated from Southwest Petroleum University in 2003, with a Master's degree in oil and gas storage and transportation.

# Biographical Details of Directors and Senior Management

*Mr. Luo Qiping* (羅啟平先生), aged 44, is a vice-president of the Company. He has respectively been a deputy general manager of Honghua Company since June, 2007, and a director of Honghua International since January 13, 2004. In 1993, he completed a course in machinery manufacture and design at the No. 2 Heavy Machinery Plant Vocational University, and obtained an engineering qualification from the Personnel Bureau of Sichuan Province, in September, 1997. He joined Honghua Company as an engineer in 1999. Prior to joining Honghua Company, he worked as a technician and then an engineer in Dongfang Petro Chemical General Equipment Factory (東方石化通用設備總廠) from 1982 to 1999. Mr. Luo has extensive experience in production management. He passed an examination in ISO9000: 2000 Quality Management System Requirements and Internal Auditing Skills in April 2001 and awarded by Det Norske Veritas ("DNV") certificate of training.

*Mr. Liu Gangqiang* (劉剛強先生), aged 38, has been the secretary of the Board and a joint Company secretary of the Company since January 21, 2008. He has been the secretary of the Board and the company secretary of Honghua Company since March, 2004. He is mainly responsible for company Reorganisation and Listing preparation, capital and corporate finance management, financial information management, establishment of internal control systems, compliance and legal affairs, intellectual property protection, investor and shareholder relations, government and regulatory authority coordination, and day-to-day administration of the Board of Directors.

From February, 2003, to September, 2003, he conducted research on the development of state-owned enterprises, in the Work Technology Center of the Sichuan State-Owned Enterprise Supervisory Committee. From October, 2000, to September, 2003, he was an assistant general manager of Sichuan Aerospace High-tech Co., Ltd., and general manager of Aerospace Network Communications System Engineering Co., Ltd. From September, 1997, to October, 2000, he served as an economist in Sichuan Trust & Investment Co., Ltd., and was engaged in securities analysis, investment financing, capital planning, asset management and legal affairs. From September, 1991, to May, 1994, he was a technician at Beijing Yanshan Petroleum & Chemicals Co., Ltd. Mr. Liu graduated from Chengdu Science and Technology University (now Sichuan University), with a Bachelor's degree in high polymer material and engineering, in 1991. He earned a Master's degree in Economics from Southwest University of Finance and Economics in 1997. In 2003, he received a Ph.D. in Economics from Southwest University of Finance and Economics.

*Ms. Corinna Leung* (梁慧嫻女士), aged 40, has been a joint Company secretary of the Company since January 21, 2008. She is a senior manager of the Corporate Services Department of Tricor Services Limited. She is an associate with the Institute of Chartered Secretaries and Administrators and the Hong Kong Institute of Chartered Secretaries. She provides corporate services to companies that are listed on the Main Board, Growth Enterprise Market of the Stock Exchange and private companies.

# Biographical Details of Directors and Senior Management

## QUALIFIED ACCOUNTANT

*Ms. Lu Hong* (魯紅), aged 38, was appointed financial controller of Honghua Company in May, 2007,and has been the financial controller and the qualified accountant of the Company since June, 2007. Ms. Lu was responsible for financial and accounting management before Ms. Lu joined the Group in May, 2007. After Ms. Lu joined the Company, Ms. Lu became responsible for the Company's financial and accounting work concerning manufacturing and operations, and Ms. Lu was responsible for the financial and accounting work concerning the Listing. Upon the Company's Listing, Ms. Lu will be responsible for all the financial and accounting work of the Company and its subsidiaries. Ms. Lu was the company secretary, qualified accountant and assistant financial controller of Guangdong Nanyue Logistics Co., Ltd., a company listed on the Stock Exchange, from February, 2005, to December, 2006. She is a Certified Public Accountant in China, a Certified Public Accountant in Hong Kong, and has obtained a fellowship from the Association of Chartered Certified Accountants (FCCA). Ms. Lu graduated from China University of Geosciences, Beijing, with a Master's degree in 1994.

# Corporate Governance Report

The board of directors ("Board") of the Company is pleased to present this Corporate Governance Report in the Group's annual report for the year ended 31 December 2007.

The key corporate governance principles and practices of the Company are summarised as follows:

## CORPORATE GOVERNANCE PRACTICES

The Group is committed to achieving high standards of corporate governance to safeguard the interests of shareholders and to enhancing corporate value and accountability.

The Group strives to attain and maintain high standards of corporate governance to enhance shareholder value and safeguard shareholder interests. The Group's corporate governance principles emphasize a quality Board, effective internal control and accountability to shareholders.

The Board of the Company believes that good corporate governance practices are increasingly important for maintaining and promoting shareholder value and investor confidence.

The Company has applied the principles as set out in the Code on Corporate Governance Practices ("CG Code") contained in Appendix 14 of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited ("Stock Exchange") ("Listing Rules").

CG Code contained in the Listing Rules sets out the principles of good corporate governance and two levels of corporate governance practices:

(a) Code provisions which listed issuers are expected to comply with or to give considered reasons for any deviation; and

(b) Recommended best practices for guidance only, which listed issuers are encouraged to comply with or to give considered reasons for deviation.

The Company has adopted various measures to ensure a high standard of corporate governance and has put in place corporate governance practices that are considered to be relevant to the Group, to meet the CG Code contained in the Listing Rules.

In the opinion of the directors, the Company has complied with all the major code provisions as set out in the CG Code throughout the year under review. There have been certain deviations from the code provisions such as the holding of Board meeting with a minimum of 4 times a year, the separation of roles of Chairman and President (Chief Executive Officer). Some of the deviations were due to the fact that the Company was only listed on 7 March 2008. Details of these deviations will be explained below.

# Corporate Governance Report

The Company regularly reviews its corporate governance practices to ensure compliance with the CG Code.

The Company is committed to enhancing its corporate governance practices appropriate to the conduct and growth of its business and to reviewing its corporate governance practices from time to time to ensure that they comply with the statutory and professional standards and align with the latest development.

## THE BOARD OF DIRECTORS

### Responsibilities

The Board is responsible for the leadership and control of the Company and oversees the Group's businesses, strategic decisions and performance. The Board has delegated to the senior management the authority and responsibilities for the day-to-day management and operations of the Group. In addition, the Board has established Board committees and has delegated to these Board committees various responsibilities as set out in their respective terms of reference.

All directors have carried out their duties in good faith and in compliance with the standards of applicable laws and regulations, and have acted in the interests of the Company and its shareholders at all times.

### Delegation of Management Functions

The Board reserves for its decisions all major matters of the Company, including: the approval and monitoring of all policy matters, overall strategies and budgets, internal control and risk management systems, material transactions (in particular those that may involve conflicts of interest), financial information, appointment of directors and other significant financial and operational matters.

All directors have full and timely access to all relevant information as well as the advice and services of the Company Secretary, with a view to ensuring that Board procedures and all applicable rules and regulations are followed. Each director is normally able to seek independent professional advice in appropriate circumstances at the Company's expense, upon making request to the Board.

The day-to-day management, administration and operation of the Company are delegated to the President (Chief Executive Officer) and the senior management. The delegated functions and work tasks are periodically reviewed. Approval has to be obtained from the Board prior to any significant transactions to be entered into by the abovementioned officers.

The Board has the full support of the Chief Executive Officer and the senior management to discharge its responsibilities.

### Board Composition

The Board currently comprises 13 members, consisting of 3 executive directors, 3 non-executive directors and 7 independent non-executive directors.

# Corporate Governance Report

The Company has adopted the recommended best practice under the CG Code for the Board to have at least one-third of its members comprising independent non-executive directors.

The Board of the Company comprises the following directors:

***Executive directors:***

| | |
|---|---|
| Zhang Mi | *(Chairman and President, Member of Remuneration Committee)* |
| Ren Jie | *(Vice-President)* |
| Zhang Xu | |

***Non-executive directors:***

| | |
|---|---|
| Wang Yaoxin | |
| Xiang Qingsheng | |
| He Sean Xing | *(Chairman of Remuneration Committee)* |

***Independent non-executive directors:***

| | |
|---|---|
| Qi Daqing | *(Chairman of Audit Committee and member of Remuneration Committee and Corporate Governance Committee)* |
| Liu Xiaofeng | *(Member of Audit Committee and Chairman of Corporate Governance Committee)* |
| Chen Guoming | *(Member of Audit Committee and Corporate Governance Committee)* |
| Liu Yinchun | *(Member of Audit Committee and Corporate Governance Committee)* |
| Wang Li | *(Member of Audit Committee and Corporate Governance Committee)* |
| Tai Kwok Leung Alexander | *(Member of Audit Committee and Corporate Governance Committee)* |
| Wang Chunlin | *(Member of Audit Committee and Corporate Governance Committee)* |

None of the members of the Board is related to one another.

# Corporate Governance Report

Since the date of listing of 7 March 2008, the Board has at all times met the requirements of the Listing Rules relating to the appointment of at least three independent non-executive directors with at least one independent non-executive director possessing appropriate professional qualifications, or accounting or related financial management expertise.

The Company has received a written annual confirmation from each independent non-executive director of his independence pursuant to the requirements of the Listing Rules. The Company considers all independent non-executive directors to be independent in accordance with the independence guidelines set out in the Listing Rules.

All directors, including non-executive directors and independent non-executive directors, have brought a wide spectrum of valuable business experience, knowledge and professionalism to the Board for its efficient and effective functioning. Independent non-executive directors have been invited to serve on the Audit, Remuneration and Corporate Governance Committees of the Company.

### Appointment and Re-election of Directors

The procedures and process of appointment, re-election and removal of directors are laid down in the Company's Articles of Association. The Board as a whole is responsible for reviewing the Board composition, monitoring the appointment and succession planning of directors and assessing the independence of independent non-executive directors.

Each of the directors (including executive and non-executive directors) of the Company is engaged in a service contract for a term of 3 years. The appointment may be terminated by a not less than 3 months' written notice.

In accordance with the Company's Articles of Association, all directors of the Company are subject to retirement by rotation at least once every three years and any new director appointed to fill a causal vacancy or as an addition to the Board shall submit himself/herself for re-election by shareholders at the first general meeting after appointment.

The Board reviews its own structure, size and composition regularly to ensure that it has a balance of expertise, skills and experience appropriate for the requirements of the business of the Company.

Where vacancies on the Board exist, the Board will carry out the selection process by making reference to the skills, experience, professional knowledge, personal integrity and time commitments of the proposed candidates, the Company's needs and other relevant statutory requirements and regulations.

All the directors shall retire and being eligible, offer themselves for re-election at the 2008 annual general meeting pursuant to the Company's Articles of Association.

The Board recommended the re-appointment of the directors standing for re-election at the next forthcoming annual general meeting of the Company.

# Corporate Governance Report

The Company's circular to be issued will contain detailed information of the directors standing for re-election.

## Induction and Continuing Development for Directors

Immediately prior to the listing of the Company, all the directors have attended a formal, tailor-made and comprehensive training.

Each newly appointed director would also receive induction on the first occasion of his/her appointment, so as to ensure that he/she has adequate understanding of the business and operations and governance policies of the Company and that he/she is fully aware of his/her responsibilities and obligations under the Listing Rules and relevant regulatory requirements.

Continuing briefing and professional development for directors would be arranged for whenever necessary.

## Board Meetings

### *Number of Meetings, Directors' Attendance and Practices and Conduct of Meetings*

Since the incorporation of the Company and up to 17 January 2008, Mr Zhang Mi was the only director of the Company and all the decisions have been recorded by way of resolutions in writing.

With the appointment of other directors in forming the existing Board, the Board would comply with the CG Code relating to the Board such as the holding of at least 4 Board meetings for a financial year, the giving of sufficient notice and agenda to the directors and the keeping of minutes.

Annual meeting schedules and draft agenda of each meeting would be made available to directors in advance.

Notices of regular Board meetings would be served to all directors at least 14 days before the meetings. For other Board and committee meetings, reasonable notice would be given.

Board papers together with all appropriate, complete and reliable information would be sent to all directors at least 3 days before each Board meeting or committee meeting to keep the directors apprised of the latest developments and financial position of the Company and to enable them to make informed decisions. The Board and each director would also have separate and independent access to the senior management whenever necessary.

The senior management would attend all regular Board meetings and where necessary, other Board and committee meetings to advise on business developments, financial and accounting matters, statutory compliance, corporate governance and other major aspects of the Company.

# Corporate Governance Report

The Company Secretary would be responsible to take and keep minutes of all Board meetings and committee meetings. Draft minutes would normally be circulated to directors for comment within a reasonable time after each meeting and the final version would be open for directors' inspection.

The Company's Articles of Association contain provisions requiring directors to abstain from attending any meeting of the board and voting, and not to be counted in the quorum at meetings for approving transactions in which such directors or any of their associates have a material interest.

## CHAIRMAN AND CHIEF EXECUTIVE OFFICER

Since 7 March 2008 (date of listing of the Company), the Company has at all times complied with the CG Code contained in the Listing Rules, except for the following deviations:

As set out in Provision A.2.1 of the CG Code, the roles of Chairman and President (Chief Executive Officer) should be separated and should not be performed by the same individual. Mr Zhang Mi has been appointed as the Chairman of the Board of Directors and President (Chief Executive Officer) of the Company. As Mr Zhang Mi is one of the founders of the Group and possees a rich knowledge and experience of the industry and the related industries, therefore, the Board of Directors believes that vesting the roles of both Chairman and President (Chief Executive Officer) in the same person provides the Company with strong and consistent leadership, facilitates effective and efficient planning and implementation of business decisions and strategies, and ensures the shareholders' benefits. In addition, the balance between the power and responsibilities in the roles of Chairman and President (Chief Executive Officer) is achieved through the cooperation of the Board of Directors and the Committees.

The Company will continue to review the effectiveness of the Group's corporate governance structure and consider whether any changes, including the separation of roles of Chairman and President (Chief Executive Officer) are necessary.

## BOARD COMMITTEE

The Board has established 3 committees, namely, the Remuneration Committee, Audit Committee and Corporate Governance Committee, for overseeing particular aspects of the Company's affairs. All Board committees of the Company are established with defined written terms of reference. The terms of reference of the Board committees are posted on the Company's website and are available to shareholders upon request.

The members of Audit Committee and Corporate Governance Committee are all independent non-executive directors whereas the majority of the members of Remuneration Committee are non-executive directors.

# Corporate Governance Report

The Board committees are provided with sufficient resources to discharge their duties and, upon reasonable request, are able to seek independent professional advice in appropriate circumstances, at the Company's expense.

### Remuneration Committee

The Remuneration Committee comprises 3 members, namely He Sean Xing (Chairman), Zhang Mi and Qi Daqing the majority of them are non-executive directors.

The primary objectives of the Remuneration Committee include:

- To make recommendations on the establishment of procedures for developing remuneration policy and structure of the executive directors and the senior management, which policy shall ensure that no director or any of his/her associates will participate in deciding his/her own remuneration.

- To make recommendations on the remuneration packages of the executive directors and the senior management.

- To review and approve the remuneration packages of the executive directors and the senior management by reference to the performance of the individual and the Company as well as market practice and conditions.

- To review and approve the compensation arrangements for the executive directors and the senior management.

The Remuneration Committee would meet at least once a year for reviewing the remuneration policy and structure and determining the annual remuneration packages of the executive directors and the senior management and other related matters. No meeting of the Remuneration Committee has been held for the year ended 31 December 2007 as the Remuneration Committee was not established until 2008.

### Audit Committee

The Audit Committee comprises all the seven independent non-executive directors, namely Qi Daqing (Chairman), Liu Xiaofeng, Chen Guoming, Liu Yinchun, Wang Li, Tai Kwok Leung Alexander and Wang Chunlin including four independent non-executive directors with the appropriate professional qualifications and accounting and related financial management expertise.

The main duties of the Audit Committee include the following:

- To review the financial statements and reports and consider any significant or unusual items raised by the qualified accountant, internal auditor or external auditors before submission to the Board.

# Corporate Governance Report

- To review the relationship with the external auditors by reference to the work performed by the auditors, their fees and terms of engagement, and make recommendation to the Board on the appointment, re-appointment and removal of external auditors.

- To review the adequacy and effectiveness of the Company's financial reporting system, internal control system and risk management system and associated procedures.

The Audit Committee would hold at least 2 meetings for a year to review the financial results and reports, financial reporting and compliance procedures, the report from management on the Company's internal control and risk management review and processes, and the re-appointment of the external auditors.

The external auditors would be invited to attend the meeting without the presence of the executive directors to discuss with the Audit Committee issues arising from the audit and financial reporting matters. No meeting of the Audit Committee has been held for the year ended 31 December 2007 as the Audit Committee was not established until 2008.

The Company's annual results for the year ended 31 December 2007 have been reviewed by the Audit Committee.

### Corporate Governance Committee

The Corporate Governance Committee comprises all the seven independent non-executive directors, namely Liu Xiaofeng (Chairman), Qi Daqing, Chen Guoming, Liu Yinchun, Wang Li, Tai Kwok Leung Alexander and Wang Chunlin.

The main duties of the Corporate Governance Committee include the following:

- To review the compliance of the corporate governance issues of the Company pursuant to the Listing Rules and other applicable rules and regulations.

- To review the corporate governance report to be included in the annual report and interim report of the Company.

- To review the corporate governance policy and practices of the Company.

The Corporate Governance Committee would meet at least twice a year for reviewing the compliance of the corporate governance issues, the corporate governance report and the corporate governance policy. No meeting of the Corporate Governance Committee has been held for the year ended 31 December 2007 as the Corporate Governance Committee was not established until 2008.

# Corporate Governance Report

## MODEL CODE FOR SECURITIES TRANSACTIONS

The Company has adopted the Model Code for Securities Transactions by Directors of Listed Issuers (the "Model Code") as set out in Appendix 10 to the Listing Rules.

Specific enquiry has been made of all the directors and the directors have confirmed that they have complied with the Model Code throughout the year ended 31 December 2007.

The Company has also established written guidelines on no less exacting terms than the Model Code (the "Employees Written Guidelines") for securities transactions by employees who are likely to be in possession of unpublished price-sensitive information of the Company.

No incident of non-compliance of the Employees Written Guidelines by the employees was noted by the Company.

## DIRECTORS' RESPONSIBILITIES FOR FINANCIAL REPORTING

The directors acknowledge their responsibility for preparing the financial statements of the Company for the year ended 31 December 2007.

The Board is responsible for presenting a balanced, clear and understandable assessment of annual and interim reports, price-sensitive announcements and other disclosures required under the Listing Rules and other regulatory requirements.

Management has provided such explanation and information to the Board as necessary to enable the Board to carry out an informed assessment of the financial information and position of the Company and these have been put to the Board for approval.

## EXTERNAL AUDITORS AND AUDITORS, REMUNERATION

The statement of the external auditors of the Company about their reporting responsibilities for the financial statements is set out in the "Independent Auditor's Report" on page 57.

During the year under review, the remuneration paid to the Company's external auditors, Messrs KPMG, is set out below:

| Category of services | Fee paid/payable |
|---|---|
| Audit services | HK$2,700,000 |
| Non-audit services | 50,000 |
| Tax review services | 13,000 |
| | HK$2,763,000 |

# Corporate Governance Report

## INTERNAL CONTROLS

Since the listing of the Company, the Board has conducted a review of the effectiveness of the internal control system of the Company.

The Board is responsible for maintaining an adequate internal control system to safeguard shareholder investments and Company assets, and reviewing the effectiveness of such on an annual basis by the Audit Committee.

The Audit Committee would provide supervision of the internal control system of the Group and review the internal audit report submitted by the senior management, and report to the Board on any material issues and make recommendations.

The Company has adopted certain internal control policies to manage and minimize financial and other risks, to ensure timely and accurate preparation and reporting of financial information, and to monitor compliance with laws by the senior management in the performance of their duties. For example, the Company has established an investment policy and a guarantee policy that are to be followed by all of the subsidiaries and that require Board resolution for investments of guarantees exceeding certain amounts. The Company has also established an internal control office as part of the management under the Board, it has the functions of monitoring compliance with laws by the senior management and in the daily operations, and of carrying out investigations for suspected breaches of law. However, certain control procedures, which are new may need further adjustment and development to operate effectively. The directors are in the process of establishing additional policies and procedures. The Company plans to establish a strategic investment committee under the Board, to evaluate, approve and monitor large investment projects.

## COMMUNICATIONS WITH SHAREHOLDERS AND INVESTORS

The Company considers that effective communication with shareholders is essential for enhancing investor relations and investor understanding of the Group's business performance and strategies. The Company also recognizes the importance of transparency and timely disclosure of corporate information, which will enable shareholders and investors to make the best investment decisions.

The general meetings of the Company provide an important channel for communication between the Board and the shareholders. The Chairman of the Board as well as chairmen of the Remuneration Committee, Audit Committee and Corporate Governance Committee and, in their absence, other members of the respective committees would attend and be available at the annual general meeting and other relevant shareholders' meeting to answer questions from shareholders.

The Company continues to enhance communications and relationships with its investors. Designated senior management maintains regular dialogue with institutional investors and analysts to keep them abreast of the Company's developments. Enquiries from investors are dealt with in an informative and timely manner. Investors may write directly to the Company at its place of business in Hong Kong at Room 908, Hutchison House, Central, Hong Kong or via email to bso.hh@163.com for any enquiries.

# Corporate Governance Report

To promote effective communication, the Company maintains a website at http://www.hh-gltd.com, where extensive information and updates on the Company's business developments and operations, financial information, corporate governance practices and other information are posted.

## SHAREHOLDER RIGHTS

To safeguard shareholder interests and rights, separate resolutions would be proposed at shareholder meetings on each substantial issue, including the election of individual directors.

The rights of shareholders and the procedures for demanding a poll on resolutions at shareholder meetings are contained in the Company's Articles of Association. Details of rights to demand a poll would be included in all circulars to shareholders and explained in the proceedings of meetings.

Poll results would be posted on the websites of the Company and of the Stock Exchange after the shareholder meeting at which voting is taken on a poll.

# Report of the Directors

The Board is pleased to present its first annual report, together with the audited financial statements of the Group for the year ended 31 December 2007.

## PRINCIPAL ACTIVITIES

The Company and its major subsidiaries is specially engaged in research, design, manufacture, setting and maintanance of equipments for petroleum drilling and mining. Its key products include the DC rig, Digitally-Controlled VFD rigs, mechanical rig, trailer drilling rig and mechanical rig with Independent Electrical Drive Rotary Table with 1,000 meters to 9,000 meters depth, and its supporting drilling well pump, sliding system, fixed control system and electrically-controlled system.

Our substantial revenues were from export. For the year ended 31 December 2007, export revenue for our products amounted to approximately RMB1.959 billion, accounting for approximately 61.9% of revenue. Our export areas mainly include more than 10 countries and regions such as America, Russia, and Middle East, Middle Asia, Africa.

Among our revenue in 2007, approximately RMB1,205 million was from domestic sales, which accounted for approximately 38.1% of revenue.

## RESULTS AND DISTRIBUTION

### I. Results and Distribution

The results of the Group for the year ended 31 December 2007 are set out in the consolidated income statement on page 59.

The Board recommended the profit after taxation and minority interests to be appropriated as follows:

1. RMB62,764,000 was set aside as statutory surplus reserve.

2. In order to finalize the name list of the shareholders entitled to attending the annual general meeting, the Company's register of members will be closed from Monday 23 June 2008 to Friday 27 June 2008 both days inclusive, during which period no transfer of shares will be effected. In order to qualify for attending the annual general meeting and voting at the meeting, shareholders who have not yet registered and transferred must lodge all transfers accompanied by the relevant share certificates with the Company's share registrars and transfer branch in Hong Kong, Computershare Hong Kong Investor Services Limited, at shops 1712–1716, 17th Floor, Hopewell Centre, 183 Queen's Road East, Wanchai, Hong Kong for registration no later than 4:30 p.m. on 20 June 2008.

## SHARE CAPITAL

Changes in the share capital of the Company during the year are set out in Note 29 to the Financial Statement.

## PRE-EMPTIVE RIGHT

There is no provision under the Company's articles of association and the laws of the Cayman Islands stipulating that the Company shall offer new shares to shareholders in proportion.

# Report of the Directors

## PURCHASE, SALE OR REDEMPTION OF LISTED SHARES OF THE COMPANY

The Company has not purchased, sold or redeemed any of its shares for the year.

## RESERVES

As of 31 December 2007, the Group has a total of approximately RMB1,054 million worth of reserve. Details of movements in the reserves of the Group during the year are set out in the consolidated statement of changes in equity in the Financial Statements.

## SUBSIDIARIES

Details of the Company's subsidiaries as of 31 December 2007 are set out in Note 26 to the Financial Statement.

## SIGNIFICANT CONTRACT

No contract of significance was entered into between the Company and its any subsidiaries and the controlling shareholders.

## DIRECTORS

The Directors of the Company during the year and as of the date of this annual report are:

***Executive Directors:***

| | |
|---|---|
| Mr. Zhang Mi[2] | (Chairman) |
| Mr. Ren Jie | (Appointed on 18 January 2008) |
| Mr. Zhang Xu | (Appointed on 18 January 2008) |

***Non-Executive Directors:***

| | |
|---|---|
| Mr. Wang Yaoxin | (Appointed on 18 January 2008) |
| Mr. He Sean Xin[2] | (Appointed on 18 January 2008) |
| Mr. Xiang Qingsheng | (Appointed on 18 January 2008) |

# Report of the Directors

***Independent non-executive Directors:***

| | |
|---|---|
| Mr. Qi Daqing[1 2 3] | (Appointed on 18 January 2008) |
| Mr. Liu Xiaofeng[1 3] | (Appointed on 18 January 2008) |
| Mr. Chen Guoming[1 3] | (Appointed on 18 January 2008) |
| Mr. Liu Yinchun[1 3] | (Appointed on 18 January 2008) |
| Mr. Wang Li[1 3] | (Appointed on 18 January 2008) |
| Mr. Tai Kwok Leung Alexander[1 3] | (Appointed on 18 January 2008) |
| Mr. Wang Chunlin[1 3] | (Appointed on 18 January 2008) |

Notes:
1. Audit Committee Members
2. Remueration Committee Members
3. Corporate Governance Committee Members

In accordance with the Articles of Association of the Company, all directors shall retire from office by rotation at the forthcoming annual general meeting and, being eligible, shall offer themselves for re-election.

According to the independent guidelines under the Listing Rules, the Company has received the annual confirmation of their independence from each independent non-executive director, and the Company still considers such directors as independent.

## DIRECTORS' SERVICE CONTRACTS

Each of the Directors of the Company has entered into a service contract with the Company, pursuant to which each of Directors was appointed for a term of three years with effective from the Listing date (i.e. 7 March 2008) and is required to re-election at the general meeting in accordance with the Company's articles of association or may be terminated by the Company or the related directors giving three month's notice in writing (unless it was otherwise specified in service contract).

None of the Directors has a service contract with the Company which is not determinable within one year without payment of compensation, other than statutory compensation.

### Directors' interests in Contracts

No other contracts of significance in relation to the Group's business to which the Company or its subsidiaries was a party, and in which a Director of the Company had a material interest, whether directly or indirectly, subsisted at the end of the year or at any time during the year.

### Remuneration for Directors and Senior Management

For the year ended 31 December 2007, details of remuneration for the Directors and Senior Management are set out in Notes 9 and 10 to the Financial Statements.

# Report of the Directors

## DIRECTORS' AND CHIEF EXECUTIVES' INTERESTS AND/OR SHORT POSITIONS IN THE SHARES AND UNDERLYING SHARES OF THE COMPANY OR ANY ASSOCIATED CORPORATION

At 7 March 2008, date of listing of the Company, the interests and short positions of each Director and Chief Executive in the shares and underlying shares of the Company and its associated corporations (within the meaning of the Securities and Futures Ordinance ("SFO")), as recorded in the register required to be kept by the Company under Section 352 of Part XV of the SFO or as notified to the Company and the Stock Exchange pursuant to the Model Code for Securities Transactions by Directors of Listed Issuers (the "Model Code") contained in Appendix 10 to the Listing Rules were as follows:

### (a) Ordinary shares of HK$0.1 each of the Company

| | Long/Short position | Nature of interest | Number of shares held | % of the issued share capital of the Company |
|---|---|---|---|---|
| Mr Zhang Mi | Long | Corporate interest and settlor of a discretionary trust(1)(4) | 1,617,727,837 | 48.53 |
| Mr Ren Jie | Long | Corporate interest and settlor of a discretionary trust(2)(4) | 1,617,727,837 | 48.53 |
| Mr Zhang Xu | Long | Corporate interest and settlor of a discretionary trust(3)(4) | 1,617,727,837 | 48.53 |

(1) Zhang Mi is a member of the Concert Group. He is the settlor of a discretionary trust, The ZYL Family Trust, whose trustee, through Wealth Afflux Limited, holds the entire issued share capital of Ally Smooth Investments Limited, which in turn is the beneficial owner of 36% of the issued share capital of Ample Chance International Limited, which in turn is the beneficial owner of the entire issued share capital of Ally Giant Limited which holds 1,617,727,837 Shares.

(2) Ren Jie is a member of the Concert Group. He is the settlor of a discretionary trust, The RJDJ Victory Trust, whose trustee, through Mowbray Worldwide Limited, holds approximately 41.34% of the issued share capital of Charm Moral International Limited, which in turn is the beneficial owner of approximately 19.09% of the issued share capital of Ample Chance International Limited, which in turn is the beneficial owner of the entire issued share capital of Ally Giant Limited which holds 1,617,727,837 Shares.

(3) Zhang Xu is a member of the Concert Group. He is the settlor of a discretionary trust, The Hong Xu Family Trust, whose trustee, through Cavendish Global Corporation, holds approximately 22.77% of the issued share capital of Beauty Clear Holdings Limited, which in turn is the beneficial owner of approximately 18.51% of the issued share capital of Ample Chance International Limited, which in turn is the beneficial owner of the entire issued share capital of Ally Giant Limited which holds 1,617,727,837 Shares.

(4) Concert Group is defined in the prospectus of the Company dated 25 February 2008.

# Report of the Directors

### (b) Share options of the Company

| | Long/Short position | Number of options held — Personal interest | Number of options held — Interest of the Concert Group |
|---|---|---|---|
| Mr Zhang Mi | Long | 9,900,000 | 15,676,000 |
| Mr Ren Jie | Long | 3,100,000 | 22,476,000 |
| Mr Zhang Xu | Long | 1,191,000 | 24,385,000 |

Saved as disclosed above, on 7 March 2008, none of the Directors and Chief Executives (including their spouse and children under 18 years of age) had any interest in, or had been granted, or exercised, any rights to subscribe for shares (or warrants or debentures, if applicable) of the Company and its associated corporations required to be disclosed pursuant to the SFO.

## SUBSTANTIAL SHAREHOLDERS' INTERESTS AND/OR SHORT POSITIONS IN THE SHARES AND UNDERLYING SHARES OF THE COMPANY

The register of substantial shareholders required to be kept under section 336 of Part XV of the SFO shows that at 7 March 2008, the date of listing of the Company, the Company had been notified of the following substantial shareholders' interests and short positions, being 5% or more of the Company's issued share capital. These interests are in addition to those disclosed above in respect of the Directors and Chief Executives of the Company.

| | | Number of shares held | | | | | |
|---|---|---|---|---|---|---|---|
| Name | Long/Short position | Personal interest | Corporate interest | Corporate interest and settlor of a discretionary trust | Interest of the Concert Group | Total | % of the issued share capital of the Company |
| Ally Giant Limited | Long | 1,617,727,837 | NIL | NIL | 25,576,000 | 1,643,303,837[1] | 49.30 |
| Ample Chance International Limited | Long | NIL | 1,617,727,837 | NIL | 25,576,000 | 1,643,303,837[2] | 49.30 |
| Wealth Afflux Limited | Long | NIL | 1,617,727,837 | NIL | 25,576,000 | 1,643,303,837[3] | 49.30 |
| Ally Smooth Investments Limited | Long | NIL | 1,617,727,837 | NIL | 25,576,000 | 1,643,303,837[3] | 49.30 |
| Equity Trustee Limited | Long | NIL | NIL | (trustee of a discretionary trust) 1,617,727,837 | NIL | 1,617,727,837[3] (5)(6)(9)(10)(14)(20)(22) | 48.53 |
| Charm Moral International Limited | Long | NIL | 1,617,727,837 | NIL | 25,576,000 | 1,643,303,837[4] | 49.30 |
| Mowbray Worldwide Limited | Long | NIL | 1,617,727,837 | NIL | 25,576,000 | 1,643,303,837[5] | 49.30 |
| Mr Liu Zhi | Long | 2,800,000 | NIL | 1,617,727,837 | 22,776,000 | 1,643,303,837[6] | 49.30 |

# Report of the Directors

| Name | Long/Short position | Personal interest | Corporate interest | Corporate interest and settlor of a discretionary trust | Interest of the Concert Group | Total | % of the issued share capital of the Company |
|---|---|---|---|---|---|---|---|
| | | Number of shares held | | | | | |
| Ecotech Enterprises Corporation | Long | NIL | 1,617,727,837 | NIL | 25,576,000 | 1,643,303,837(6) | 49.30 |
| Mr Zheng Yong | Long | 1,390,000 | 1,617,727,837 | NIL | 24,186,000 | 1,643,303,837(7) | 49.30 |
| Beauty Clear Holdings Limited | Long | NIL | 1,617,727,837 | NIL | 25,576,000 | 1,643,303,837(8) | 49.30 |
| Mr Zuo Huixian | Long | 1,060,000 | NIL | 1,617,727,837 | 24,516,000 | 1,643,303,837(9) | 49.30 |
| Vast & Fast Corporation | Long | NIL | 1,617,727,837 | NIL | 25,576,000 | 1,643,303,837(9) | 49.30 |
| Cavendish Global Corporation | Long | NIL | 1,617,727,837 | NIL | 25,576,000 | 1,643,303,837(10) | 49.30 |
| Mr Wang Jiangyang | Long | 640,000 | 1,617,727,837 | NIL | 24,936,000 | 1,643,303,837(11) | 49.30 |
| Mr Chen Jun | Long | 540,000 | 1,617,727,837 | NIL | 25,036,000 | 1,643,303,837(12) | 49.30 |
| Believe Power International Limited | Long | NIL | 1,617,727,837 | NIL | 25,576,000 | 1,643,303,837(13) | 49.30 |
| Mr Fan Bing | Long | 1,175,000 | NIL | 1,617,727,837 | 24,401,000 | 1,643,303,837(14) | 49.30 |
| Brondesbury Enterprises Limited | Long | NIL | 1,617,727,837 | NIL | 25,576,000 | 1,643,303,837(14) | 49.30 |
| Mr Zhang Yanyong | Long | 1,000,000 | 1,617,727,837 | NIL | 24,576,000 | 1,643,303,837(15) | 49.30 |
| Mr Ao Pei | Long | 440,000 | 1,617,727,837 | NIL | 25,136,000 | 1,643,303,837(16) | 49.30 |
| Mr Tian Diyong | Long | 355,000 | 1,617,727,837 | NIL | 25,221,000 | 1,643,303,837(17) | 49.30 |
| Mr Shen Dingjian | Long | 175,000 | 1,617,727,837 | NIL | 25,401,000 | 1,643,303,837(18) | 49.30 |
| Benefit Way International Limited | Long | NIL | 1,617,727,837 | NIL | 25,576,000 | 1,643,303,837(19) | 49.30 |
| Mr Liu Xuetian (deceased) | Long | NIL | NIL | 1,617,727,837 | 25,576,000 | 1,643,303,837(20) | 49.30 |
| Dobson Global Inc. | Long | NIL | 1,617,727,837 | NIL | 25,576,000 | 1,643,303,837(20) | 49.30 |
| Ms Qu Yihong | Long | NIL | 1,617,727,837 | NIL | 25,576,000 | 1,643,303,837(21) | 49.30 |
| Mr Liu Ying | Long | NIL | 1,617,727,837 | NIL | 25,576,000 | 1,643,303,837(21) | 49.30 |
| Mr Zhou Bing | Long | 750,000 | NIL | 1,617,727,837 | 24,826,000 | 1,643,303,837(22) | 49.30 |
| Darius Enterprises Limited | Long | NIL | 1,617,727,837 | NIL | 25,576,000 | 1,643,303,837(22) | 49.30 |
| Ms Lu Lan | Long | 345,000 | 1,617,727,837 | NIL | 25,231,000 | 1,643,303,837(23) | 49.30 |
| Mr Tian Yu | Long | 240,000 | 1,617,727,837 | NIL | 25,336,000 | 1,643,303,837(24) | 49.30 |
| Mr Li Hangqiang | Long | 215,000 | 1,617,727,837 | NIL | 25,361,000 | 1,643,303,837(25) | 49.30 |
| Mr Liu Yingguo | Long | 125,000 | 1,617,727,837 | NIL | 25,451,000 | 1,643,303,837(26) | 49.30 |
| Ms Liu Lulu | Long | 135,000 | 1,617,727,837 | NIL | 25,441,000 | 1,643,303,837(27) | 49.30 |
| China Ocean Oilfields Services (Hong Kong) Limited | Long | 174,425,609 | NIL | NIL | NIL | 174,425,609(28) | 5.23 |
| China National Offshore Oil Corporation | Long | NIL | 174,425,609 | NIL | NIL | 174,425,609(28) | 5.23 |
| Nabros Drilling Interantional II Limited | Long | 450,000,000 | NIL | NIL | NIL | 450,000,000(29) | 13.50 |
| Nabros International Management Limited | Long | NIL | 450,000,000 | NIL | NIL | 450,000,000(29) | 13.50 |
| Nabros Global Holdings Limited | Long | NIL | 450,000,000 | NIL | NIL | 450,000,000(29) | 13.50 |
| Nabros Industries Ltd. | Long | NIL | 450,000,000 | NIL | NIL | 450,000,000(29) | 13.50 |

(1) Ally Giant Limited is wholly-owned by Ample Chance International Limited and holds 1,617,727,837 Shares.

# Report of the Directors

(2) Ample Chance International Limited is owned 36% by Ally Smooth Investments Limited, approximately 19.09% by Charm Moral International Limited, approximately 18.51% by Beauty Clear Holdings Limited, approximately 12.71% by Believe Power International Limited, approximately 10.50% by Benefit Way International Limited and approximately 3.19% by a corporation.

(3) The entire issued share capital of Ally Smooth Investments Limited is owned by Wealth Afflux Limited, which in turn is held by Equity Trustee Limited as trustee of The ZYL Family Trust. The ZYL Family Trust is a discretionary trust established by Zhang Mi as settlor, with Equity Trustee Limited as trustee. The beneficiaries under The ZYL Family Trust are Zhang Mi and his family members. Zhang Mi is a member of the Concert Group.

(4) Charm Moral International Limited is owned approximately 41.34% by Mowbray Worldwide Limited, approximately 29.33% by Ecotech Enterprises Corporation and approximately 29.33% by Zheng Yong.

(5) Approximately 41.34% of the issued share capital of Charm Moral International Limited is owned by Mowbray Worldwide Limited, which in turn is held by Equity Trustee Limited as trustee of The RJDJ Victory Trust. The RJDJ Victory Trust is a discretionary trust established by Ren Jie as settlor, with Equity Trustee Limited as trustee. The beneficiaries under The RJDJ Victory Trust are Ren Jie and his family members. Ren Jie is a member of the Concert Group.

(6) Approximately 29.33% of the issued share capital of Charm Moral International Limited is held by Ecotech Enterprises Corporation, which in turn is held by Equity Trustee Limited as trustee of The LZWM Family Trust. The LZWM Family Trust is a discretionary trust, established by Liu Zhi as settlor, with Equity Trustee Limited as trustee. The beneficiaries under The LZWM Family Trust are Liu Zhi and his family members. Liu Zhi is a member of the Concert Group.

(7) Zheng Yong is the beneficial owner of approximately 29.33% of the issued share capital of Charm Moral International Limited, which is in turn the beneficial owner of approximately 19.09% of the issued share capital of Ample Chance International Limited. Zheng Yong is a member of the Concert Group.

(8) Beauty Clear Holdings Limited is owned approximately 23.63% by Vast & Fast Corporation, approximately 22.77% by Cavendish Global Corporation, approximately 5.76% by Wang Jiangyang, approximately 5.10% by Chen Jun, and a total of approximately 42.74% by 3 other shareholders.

(9) Approximately 23.63% of issued share capital of Beauty Clear Holdings Limited is owned by Vast & Fast Corporation, which in turn is held by Equity Trustee Limited as trustee of The ZHH Family Trust. The ZHH Family Trust is a discretionary trust, established by Zuo Huixian as settlor, with Equity Trustee Limited as trustee. The beneficiaries under The ZHH Family Trust are Zuo Huixian and his family members. Zuo Huixian is a member of the Concert Group.

(10) Approximately 22.77% of the issued share capital of Beauty Clear Holdings Limited is held by Cavendish Global Corporation, which in turn is held by Equity Trustee Limited as trustee of The Hong Xu Family Trust. The Hong Xu Family Trust is a discretionary trust, established by Zhang Xu as settlor, with Equity Trustee Limited as trustee. The beneficiaries under The Hong Xu Family Trust are Zhang Xu and his family members. Zhang Xu is a member of the Concert Group.

(11) Wang Jiangyang is the beneficial owner of approximately 5.76% of the issued share capital of Beauty Clear Holdings Limited, which in turn is the beneficial owner of approximately 18.51% of the issued share capital of Ample Chance International Limited. Wang Jiangyang is a member of the Concert Group.

(12) Chen Jun is the beneficial owner of approximately 5.10% of the issued share capital of Beauty Clear Holdings Limited, which in turn is the beneficial owner of approximately 18.51% of the issued share capital of Ample Chance International Limited. Chen Jun is a member of the Concert Group.

(13) Believe Power International Limited is owned approximately 32.72% by Brondesbury Enterprises Limited, approximately 29.16% by Zhang Yanyong, approximately 5.53% by Ao Pei, approximately 2.85% by Tian Diyong, approximately 2.24% by Shen Dingjian, and a total of approximately 27.50% by 4 other shareholders.

(14) Approximately 32.72% of the issued share capital of Believe Power International Limited is held by Brondesbury Enterprises Limited, which in turn is held by Equity Trustee Limited as trustee of The FBX Family Trust. The FBX Family Trust is a discretionary trust, established by Fan

# Report of the Directors

Bing as settlor, with Equity Trustee Limited as trustee. The beneficiaries under The FBX Family Trust are Fan Bing and his family members. Fan Bing is a member of the Concert Group.

(15) Zhang Yanyong is the beneficial owner of approximately 29.16% of the issued share capital of Believe Power International Limited, which in turn is the beneficial owner of approximately 12.71% of the issued share capital of Ample Chance International Limited. Zhang Yanyong is a member of the Concert Group.

(16) Ao Pei is the beneficial owner of approximately 5.53% of the issued share capital of Believe Power International Limited, which in turn is the beneficial owner of approximately 12.71% of the issued share capital of Ample Chance International Limited. Ao Pei is a member of the Concert Group.

(17) Tian Diyong is the beneficial owner of approximately 2.85% of the issued share capital of Believe Power International Limited, which in turn is the beneficial owner of approximately 12.71% of the issued share capital of Ample Chance International Limited. Tian Diyong is a member of the Concert Group.

(18) Shen Dingjian is the beneficial owner of approximately 2.24% of the issued share capital of Believe Power International Limited, which in turn is the beneficial owner of approximately 12.71% of the issued share capital of Ample Chance International Limited. Shen Dingjian is a member of the Concert Group.

(19) Benefit Way International Limited is owned approximately 35.57% by Dobson Global Inc., approximately 19.36% by Darius Enterprises Limited, approximately 6.49% by Lu Lan, approximately 3.91% by Tian Yu, approximately 3.50% by Li Hanqiang, approximately 1.52% by Liu Yingguo, approximately 1.22% by Liu Lulu and approximately 28.43% by 6 other shareholders.

(20) Approximately 35.57% of the issued share capital of Benefit Way International Limited is held by Dobson Global Inc., which in turn is held by Equity Trustee Limited as trustee of The LXYY Family Trust. The LXYY Family Trust is a discretionary trust, established by Liu Xuetian (deceased) as settlor, with Equity Trustee Limited as trustee. The beneficiaries under The LXYY Family Trust are Liu Xuetian (deceased) and his family members. Liu Xuetian (deceased) was a member of the Concert Group and passed away on January 23, 2008.

(21) Qu Yihong and Liu Ying, family members of Liu Xuetian (deceased), are deemed to be interested in 1,617,727,837 Shares as directors of Dobson Global Inc.

(22) Approximately 19.36% of the issued share capital of Benefit Way International Limited is held by Darius Enterprises Limited, which in turn is held by Equity Trustee Limited as trustee of The Fang Zhou Family Trust. The Fang Zhou Family Trust is a discretionary trust, established by Zhou Bing as settlor, with Equity Trustee Limited as trustee. The beneficiaries under The Fang Zhou Family Trust are Zhou Bing and his family members. Zhou Bing is a member of the Concert Group.

(23) Lu Lan is the beneficial owner of approximately 6.49% of the issued share capital of Benefit Way International Limited, which in turn is the beneficial owner of approximately 10.50% of the issued share capital of Ample Chance International Limited. Lu Lan is a member of the Concert Group.

(24) Tian Yu is the beneficial owner of approximately 3.91% of the issued share capital of Benefit Way International Limited, which in turn is the beneficial owner of approximately 10.50% of the issued share capital of Ample Chance International Limited. Tian Yu is a member of the Concert Group.

(25) Li Hanqiang is the beneficial owner of approximately 3.50% of the issued share capital of Benefit Way International Limited, which in turn is the beneficial owner of approximately 10.50% of the issued share capital of Ample Chance International Limited. Li Hanqiang is a member of the Concert Group.

(26) Liu Yingguo is the beneficial owner of approximately 1.52% of the issued share capital of Benefit Way International Limited, which in turn is the beneficial owner of approximately 10.50% of the issued share capital of Ample Chance International Limited. LiuYingguo is a member of the Concert Group.

# Report of the Directors

(27) Liu Lulu is the beneficial owner of approximately 1.22% of the issued share capital of Benefit Way International Limited, which in turn is the beneficial owner of approximately 10.50% of the issued share capital of Ample Chance International Limited. Liu Lulu is a member of the Concert Group.

(28) China Ocean Oilfields Services (Hong Kong) Limited holds 174,425,609 Shares. The issued share capital of China Ocean Oilfields Services (Hong Kong) Limited was beneficially owned approximately 98.8% by China National Offshore Oil Corporation and approximately 1.2% by Overseas Oil & Gas Corporation Limited.

(29) Nabors Drilling International II Limited holds 450,000,000 Shares. The entire issued share capital of Nabors Drilling International II Limited was owned by Nabors International Management Limited. Nabors International Management Limited is wholly owned by Nabors Global Holdings Limited which is in turn wholly owned by Nabors Industries Ltd.

Save as disclosed above and so far as the Directors and Chief Executives of the Company are aware of, at 7 March 2008, there were no other person, other than the Directors or Chief Executives of the Company, who had interests or short positions in the shares and underlying shares of the Company which would fall to be disclosed to the Company in accordance with the provisions of Divisions 2 and 3 of Part XV of the SFO, or which would be required, pursuant to Section 336 of the SFO, to be entered in the register referred to therein.

## Share Option Scheme

The main terms of Pre-IPO share option scheme have been approved by resolution in writing by all shareholders on 21 January 2008. Up to the reporting period, 270 in total qualified participants have been conditionally granted options which may subscribe for an aggregate of 60,000,000 shares at exercise price of offer price of HK$3.83, representing approximately 2.4% of issued share capital of the Company immediately after the completion of global offering. Each of option grantees subject to pre-IPO share option scheme have not exercised the options held by him.

Upon conditional approval by resolution in writing by all shareholders of the Company on 21 January 2008 and by a resolution of the Board on 21 January 2008, the Company adopted a share option scheme. As at the date of reporting, there were no share options which have been granted. Details of this Scheme are as follows:

## Purpose

The Company operates the Scheme for the purpose of providing incentive and rewards to participants who contribute to the success of the Group's operation and/or for the purpose that the Group may recruit or retain high calibre employees and attract people for the Group.

The Scheme may provide the participants with opportunity of holding the shares of the Company individually, and (a) facilitate the participants to use their best effort to improve their performance and effect; and (b) attract and retain participants who are significant to long term development and profitability of the Group.

# Report of the Directors

### Participants

(a) any executive Directors, employees or semi-employees (whether full time or part time) or any member of the Group; (b) any Non-executive Directors (including Independent Non-executive Directors) of any member of the Group; (c) suppliers of goods or services to any member of the Group; (d) any customers of any members of the Group; (e) any advisor, consultant, any person or entities with professional or other services who provides research, development or other technical support to any members of the Group; (f) any shareholder of any members of the Group or any holder of any securities issued by any members of the Group; (g) any joint venture, business or strategic alliance partners of any members of the Group; (h) discretionary trust whose discretionary objects are as follows: any executive Directors, employees or prospective employees (whether full time or part time) and any Non-executive Directors (including Independent Non-executive Directors) of any member of the Group, suppliers of goods or services to any member of the Group, any customers of any members of the Group, any advisor, consultant, any person or entities with professional or other services who provides research, development or other technical support to any members of the Group, any shareholder of any members of the Group or any holder of any securities issued by any members of the Group and any joint venture, business or strategic alliance partners of any members of the Group.

### Maximum entitlement of each participant

The maximum number of shares issued and to be issued upon exercise of the share options (including those already exercised and outstanding share options) granted to each eligible participant under the Share Option Scheme in any 12-month period (until date of grant of share options) is limited to 1% of the shares of the Company in issue. Any further grant of share options in excess of this limit is subject to shareholders' approval in a general meeting but the participant and its associates must abstain from voting at the meeting. In this case, the Company must despatch a circular to shareholders, containing identity of the participants, numbers of share options to be granted by the participant and related terms (and share options previously granted to this participant) and all other data as required by the Listing Rules. The numbers and terms of the share options to be granted to this participant (including exercise price) must be determined before approval by the shareholder. In calculating the subscription price, the date on which Board meeting is held for proposed further grant of share options is deemed as date of grant.

### The period in which ordinary shares must be subscribed for under share options

Share option may be exercised at any time during the period expiring tenth anniversary from the date of grant of share option as determined by the Board of Directors, but subject to early termination provisions of the terms of share option scheme.

### Amounts to be paid on acceptance of option

Grantee of share option must pay HK$1.00 to the Company upon acceptance of share option offer.

### Basis of determining the exercise price

The subscription price of the share option granted under share option scheme is solely determined and notified to the participants by the Directors, but not less than the highest of (i) the closing price of the Company's shares as stated in the daily quotations sheet of The Stock Exchange of Hong Kong Limited (the "Stock Exchange") on the date of the grant; (ii) the average closing price of the Company's shares as stated in the Stock Exchange's daily quotations sheet for the five trading days immediately preceding the date of the grant; and (iii) the nominal value of the Company's shares as at date of grant.

### Validity period of the Scheme

Share option scheme is conditional on the Listing Committee of the Hong Kong Stock Exchange granting approval of the listing of, and permission to deal in, the Shares which may fall to be issued pursuant to the exercise of options granted under the Share Option Scheme. The Company (by virtue of resolutions of general meeting) or the Board may at any time termination the operation of share option scheme, under which circumstance, there will be no new share option to be granted, but the options granted before the termination will continue to be effective and enforceable under the provisions of share option scheme.

## CONTINUING CONNECTED TRANSACTIONS

The following arrangements constitute non-exempt continuing connected transactions under the Listing Rules and will be subject to the reporting, announcement and independent shareholders' approval requirements under Rules 14A.35(3) and (4) of the Listing Rules.

Given their recurring nature our Company has applied to the Stock Exchange for waivers from strict compliance with the announcement and independent shareholders' approval requirements, under Rule 14A.42(3) of the Listing Rules, for the non-exempt continuing connected transactions mentioned in paragraphs (1) through (3), on the following conditions:

(a) our Company will comply with Rules l4A.35(l) and (2), 14A.36, 14A.37, 14A.38, 14A.39 and 14A.40 of the Listing Rules, concerning each of the non-exempt continuing connected transactions;

(b) the aggregate value of the non-exempt continuing connected transactions for the relevant period will not exceed the amounts stated above; and

(c) our Company will comply with Rules 14A.35(3) and (4) of the Listing Rules if any of the amounts described above is exceeded, or when the relevant agreement is renewed, or when there is a material change to the terms of the relevant agreement.

# Report of the Directors

**(1) Purchase Framework Agreement Entered into between Hongtai Company**

Hongtai Company is owned as to 73.125% by the spouse of the group acting in concert group, therefore Hongtai Company is a connected person of the Company according to Rule 14A11(4) of the Listing Rules.

During the year, the total purchases made by our Group from Hongtai Company amounted to approximately RMB41,071,000. The total sales to Hongtai Company amounted to approximately RMB45,000. Our Group intends to continue to purchase paint, tools, welding materials and worker-protection items from Hongtai Company following the Listing. Accordingly, Honghua Company entered into a purchase framework agreement dated February 15, 2008 with Hongtai Company, for a term commencing from January 1,2007 to December 31, 2009. The purchase framework agreement provides a framework for the purchase of paint, tools, welding materials and worker-protection items from Hongtai Company. The Directors expect that the aggregate annual purchases for each of the two years ended December 31, 2008 and 2009 will not surpass RMB50,000,000. The Directors also expect that the aggregate annual purchases for each of the two years ended December 31, 2008 and 2009 will reach RMB30,000,000 and RMB30,000,000 respectively.

**(2) Sale of rigs, mud pumps, mud pump sets, parts and components and provision of after-sales services to Nabors Group**

Nabors Group is a group of companies comprising Nabors Industries and its subsidiaries. Nabors Group, through, Nabors International, holds approximately 13.5% equity interest in our Company and hence a connected person of our Company under the Listing Rules.

During the year, the total income received by the Group from Nabors Group in respect of sales and provision of after-sales services amounted to approximately RMB 530,923,000. As at the Latest Practicable Date, the Company has not applied for waivers under the Listing Rules in respect of any future sales or after-sales services it may enter into with Nabors Group. However, if and when this becomes necessary, the Company will apply for the appropriate waiver at that stage.

**(3) Purchase of a top drive drilling system from Nabors Group**

During the year, the total purchases made by the Group from Nabors Group amounted to approximately RMB 149,000. Although our Group and Nabors Group have not reached a definitive legally binding master agreement or agreement of a similar nature as at the Latest Practicable Date, the Group entered into a purchase contract dated January 8, 2008 with Nabors Group in respect of the purchase of a top drive drilling system from Nabors Group. The purchase price of the top drive drilling system under the purchase contract is approximately US$1,739,700 (which is approximately equivalent to RMB12,599,600). As at the Latest Practicable Date, the Company has not applied for waivers under the Listing Rules in respect of any future purchase transactions it may enter into with Nabors Group. However, if and when this becomes necessary, the Company will apply for the appropriate waiver at that stage.

# Report of the Directors

Our Directors (including our Independent Non-executive Directors) have reviewed the continuing connected transactions and confirmed that these transactions are:

(1) Entered into in the ordinary course of the business of our Group;

(2) Based on arm's length negotiations and on normal commercial terms; and

(3) Fair and reasonable and in the best interests of the Shareholders as a whole.

## BANK LOANS

Details of our bank loans and other borrowings are set out in Note 22 to the Financial Statements.

## USE OF PROCEEDS FROM INITIAL PUBLIC OFFERINGS

On 7 March 2008, the Company issued 833,360,000 ordinary shares at a price of HK$3.83 per share on the main board of the Stock Exchange, raising a total capital (before netting underwriting fee and the payables in respect of the Global Offering) of approximately HK$3.192 billion. To implement our business strategy of increasing equipment production capacity, improving the technology and innovation of our product lines, and expanding product and service lines, we intend to use these net proceeds for the following general purposes.

(i) Approximately 60% is to be used for the construction of an offshore equipment manufacturing base in the eastern coastal area of China, to produce jack-up rigs and fixed rigs as well as large structures. This includes acquiring land and coastline in Shanghai or neighboring provinces, investing in research and development of new equipment, and constructing new factories.

# Report of the Directors

(ii) Approximately 12% is to be used for increasing production capacity, and for the research and development of new land rig equipment and rig parts and components. In order to increase the annual rig production capacity to 150 rigs by 2008, the Group needs capital investment, including fixed capital (for such items as expansion of the ground for final assembly tests, expansion of workshops, and increase in production and testing equipment).

(iii) Approximately 20% is to be used for acquisitions, establishing joint ventures and strategic alliances with international partners, in order to expand our product offerings to the oil and gas exploration and production industry.

(iv) The remaining proceeds will be used for working capital and day to day expenses.

To the extent that our net proceeds are not immediately applied to the aforementioned purposes, and to the extent permitted by PRC law and regulations, we intend to deposit such proceeds into short-term demand deposits and/or money market instruments.

## FINANCIAL SUMMARY

Our financial summary for the past four years are set out in the section headed "Four-Year Financial Highlights" of this annual report.

## STAFF RETIREMENT AND BENEFIT SCHEME

Details of the staff retirement and benefit scheme are set out in Notes 24 & 7(b) to the Financial Statement of this annual report.

## FIXED ASSETS

Details of the changes of the fixed assets of the Group are set out in Note 14 to the Financial Statement.

## MAJOR CUSTOMERS AND SUPPLIERS

1. In the period, the Group's five largest suppliers accounted for approximately 50.8% of total purchases and the largest supplier was Chengdu Zhongyeda Co. Ltd., which accounted for approximately 23.9% of total purchases. The others in descending proportions were respectively Xi'an Jieli Electrical and Electronic Technology Company Limited, Chongqing Iron and Steel Co. Ltd., Shanghai Nanyang Electric Cable Works Co. Ltd. and Caterpillar S.A.R. Singapore Branch, which account for approximately 10.3%, 5.7%, 5.5% and 5.4% respectively.

2. In the period, the Group five largest customers in total accounted for approximately 52.4% of revenue, and the largest customer was Nabors Drilling International Ltd, accounting for approximately 16.4% of revenue. The others in descending proportions were Clusseter Ltd., and Equipment Department of Sinopec, Greatwall Drilling Company Limited of CNPC and China Petroleum Technology and Development Corporation, which accounting for approximately 14.1%, 9.4%, 6.6% and 5.9% respectively.

3. None of the Directors of the Company, their associates or any shareholder (which to the knowledge of the Directors owns more than 5% of the Company's share capital) Corporation had an interest in the above suppliers or customers.

## ENTRUST DEPOSITS AND ENTRUST LOANS

As at 31 December 2007, the Company has no entrust deposits or entrust loans being placed with commercial banks or non-commercial banks and other finance institutions.

## TAXATION POLICY

Before the new Corporate Income Tax Law took effect on 1 January 2008, the enterprise income tax rate for PRC incorporated Companies is at the rate of 33%. And some subsidiaries of the Group are qualified to be entitled to preferential tax treatment. As a foreign invested company, Sichuan Honghua Petroleum Equipment Co. Ltd. is entitled to a preferential income tax rate of 3% for the period from 1 October 2006 to 31 December 2007 and may be entitled to preferential income tax rate of 12.5% for three years with effect from early 2008. As advised by our PRC Law counsel King & Wood, the tax preferential treatment enjoyed by Sichuan Honghua Petroleum Equipment Co. Ltd. may continue to apply under the new Corporate Income Law. The details of the Group's income taxation policy and payment of income tax is set out in Note 8 to the Financial Statements.

## SUFFICIENCY OF PUBLIC FLOAT

Based on the information that is publicly available to the Company and within the knowledge of the Directors, the Company has maintained sufficient public float since listing and up till the date of this annual report.

# Report of the Directors

## SUBSEQUENT EVENTS

The details on the Group's subsequent events is set out in Note 37 to the Financial Statements.

### Qualified Accountant

The Company has a qualified accountant as required by Rule 3.24 of the Listing Rules who performs the duties of supervising the financial reporting process and internal control of the Company.

### Auditor

A resolution to renew the appointment of KPMG as auditor of the Company will be proposed at the annual general meeting of the Company.

By the order of the Board
**Honghua Group Limited**
*Chairman*
**Zhang Mi**

The PRC, 27 April 2008

# Independent Auditor's Report

**To the shareholders of Honghua Group Limited**
*(Incorporated in the Cayman Islands with limited liability)*

We have audited the consolidated financial statements of Honghua Group Limited (the "Company") set out on pages 59 to 129, which comprise the consolidated and company balance sheets as at 31 December 2007, and the consolidated income statement, the consolidated statement of changes in equity and the consolidated cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

## DIRECTORS' RESPONSIBILITY FOR THE FINANCIAL STATEMENTS

The directors of the Company are responsible for the preparation and the true and fair presentation of these financial statements in accordance with International Financial Reporting Standards issued by the International Accounting Standards Board and the disclosure requirements of the Hong Kong Companies Ordinance. This responsibility includes designing, implementing and maintaining internal control relevant to the preparation and the true and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

## AUDITOR'S RESPONSIBILITY

Our responsibility is to express an opinion on these financial statements based on our audit. This report is made solely to you, as a body, and for no other purpose. We do not assume responsibility towards or accept liability to any other person for the contents of this report.

We conducted our audit in accordance with Hong Kong Standards on Auditing issued by the Hong Kong Institute of Certified Public Accountants. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance as to whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and true and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

# Independent Auditor's Report

## OPINION

In our opinion, the consolidated financial statements give a true and fair view of the state of affairs of the Company and of the Group as at 31 December 2007 and of the Group's profits and cash flows for the year then ended in accordance with International Financial Reporting Standards and have been properly prepared in accordance with the disclosure requirements of Hong Kong Companies Ordinance.

**KPMG**
*Certified Public Accountants*
8th Floor, Prince's Building
10 Chater Road
Central, Hong Kong

27 April 2008

# Consolidated Income Statement

For the year ended 31 December 2007 (Expressed in Renminbi)

| | Note | 2007 RMB'000 | 2006 RMB'000 |
|---|---|---|---|
| **Revenue** | 5 | **3,164,022** | 2,335,948 |
| Cost of sales | | **(2,083,888)** | (1,558,121) |
| **Gross profit** | | **1,080,134** | 777,827 |
| Other operating revenue | 6 | **22,999** | 4,620 |
| Other operating expenses | | **(768)** | (917) |
| Selling expenses | | **(210,319)** | (84,176) |
| General and administrative expenses | | **(186,546)** | (110,185) |
| Other net income | 6 | **22,475** | 3,085 |
| **Profit from operations** | | **727,975** | 590,254 |
| Net financing costs | 7(a) | **(49,927)** | (23,141) |
| Share of profits from a jointly controlled entity | | **6,468** | — |
| **Profit before taxation** | 7 | **684,516** | 567,113 |
| Income tax expenses | 8(a) | **(67,511)** | (103,203) |
| **Profit for the year** | | **617,005** | 463,910 |
| **Attributable to:** | | | |
| Equity shareholders of the Company | 11 | **583,235** | 412,814 |
| Minority interests | | **33,770** | 51,096 |
| **Profit for the year** | | **617,005** | 463,910 |
| **Dividends** | 12 | | |
| Dividends declared during the year | | **—** | 19,533 |
| **Earnings per share** | 13 | | |
| — Basic (RMB) | | **0.233** | 0.165 |

The notes on pages 67 to 129 form part of these financial statements.

# Consolidated Balance Sheet

At 31 December 2007 (Expressed in Renminbi)

| | Note | 2007<br>RMB'000 | 2006<br>RMB'000 |
|---|---|---|---|
| **Non-current assets** | | | |
| Fixed assets | 14 | | |
| — Property, plant and equipment | | **259,453** | 210,418 |
| — Interests in leasehold land held for own use under operating leases | | **54,830** | 24,616 |
| — Freehold land | | **5,880** | 6,295 |
| | | **320,163** | 241,329 |
| Deposit paid for acquisition of leasehold land | | **28,513** | 21,171 |
| Construction in progress | 15 | **38,741** | 11,071 |
| Intangible assets | 16 | **389,691** | — |
| Interest in a jointly controlled entity | 28 | **6,006** | — |
| Deferred tax assets | 25 | **11,837** | 13,088 |
| **Total non-current assets** | | **794,951** | 286,659 |
| **Current assets** | | | |
| Inventories | 17 | **1,031,768** | 690,391 |
| Trade and other receivables | 18 | **1,606,960** | 869,374 |
| Amounts due from related companies | 33(b) | **40,798** | 1,998 |
| Restricted bank deposit | 19 | **—** | 107,875 |
| Pledged bank deposits | 20 | **261,109** | 67,746 |
| Cash and cash equivalents | 21 | **195,367** | 158,351 |
| **Total current assets** | | **3,136,002** | 1,895,735 |
| **Total assets** | | **3,930,953** | 2,182,394 |

# Consolidated Balance Sheet

At 31 December 2007 (Expressed in Renminbi)

| | Note | 2007 RMB'000 | 2006 RMB'000 |
|---|---|---|---|
| **Current liabilities** | | | |
| Interest-bearing borrowings | 22 | **856,059** | 345,000 |
| Amounts due to related companies | 33(b) | **46,490** | 54,859 |
| Loan from immediate holding company | 33(b) | **405,488** | 262,656 |
| Loans from shareholders of the holding company | 33(b) | **76,850** | — |
| Trade and other payables | 23 | **1,136,892** | 1,091,647 |
| Current taxation | | **33,777** | 64,623 |
| **Total current liabilities** | | **2,555,556** | 1,818,785 |
| **Net current assets** | | **580,446** | 76,950 |
| **Total assets less current liabilities** | | **1,375,397** | 363,609 |
| **Non-current liabilities** | | | |
| Interest-bearing borrowings | 22 | **15,703** | 21,299 |
| Deferred tax liabilities | 25 | **3,983** | 4,259 |
| **Total non-current liabilities** | | **19,686** | 25,558 |
| **Total liabilities** | | **2,575,242** | 1,844,343 |

# Consolidated Balance Sheet

At 31 December 2007 (Expressed in Renminbi)

| | Note | **2007** **RMB'000** | 2006 RMB'000 |
|---|---|---|---|
| **Equity** | | | |
| Share capital | 29 | **233,155** | — |
| Reserves | 30 | **1,054,348** | 303,613 |
| **Total equity attributable to equity shareholders of the Company** | | **1,287,503** | 303,613 |
| **Minority interests** | | **68,208** | 34,438 |
| **Total equity** | | **1,355,711** | 338,051 |
| **Total liabilities and equity** | | **3,930,953** | 2,182,394 |

Approved and authorised for issue by the board of directors on 27 April 2008

| **Zhang Mi** | **Ren Jie** |
|---|---|
| *Director* | *Director* |

The notes on pages 67 to 129 form part of these financial statements.

# Balance Sheet

At 31 December 2007 (Expressed in Renminbi)

| | Note | 2007 RMB'000 |
|---|---|---|
| **Non-current assets** | | |
| Intangible assets | 16 | **389,691** |
| Investment in a subsidiary | 26 | **233,155** |
| **Total non-current assets** | | **622,846** |
| **Current assets** | | |
| Amount due from a subsidiary | 27 | **46** |
| **Total current assets** | | **46** |
| **Total assets** | | **622,892** |
| **Current liabilities** | | |
| Trade and other payables | 23 | **2,517** |
| **Total current liabilities** | | **2,517** |
| **Net current liabilities** | | **2,471** |
| **Total assets less current liabilities** | | **620,375** |
| **Total liabilities** | | **2,517** |
| **Equity** | | |
| Share capital | 29 | **233,155** |
| Reserves | 30(e) | **387,220** |
| **Total equity** | | **620,375** |
| **Total liabilities and equity** | | **622,892** |

Approved and authorised for issue by the board of directors on 27 April 2008

| **Zhang Mi** | **Ren Jie** |
|---|---|
| *Director* | *Director* |

The notes on pages 67 to 129 form part of these financial statements.

# Consolidated Statement of Changes in Equity

For the year ended 31 December 2007 (Expressed in Renminbi)

| | | Attributable to equity shareholders of the Company | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | Share capital | Share premium | Other reserve | Statutory reserve | Exchange reserve | Retained profits | Sub-total | Minority interests | Total equity |
| | | RMB'000 | RMB'000 | RMB'000 | RMB'000 | RMB'000 | RMB'000 | RMB'000 | RMB'000 | RMB'000 |
| | Note | (note 29) | | (note 30(d)) | (note 30(a)) | (note 30(b)) | | | | |
| At 1 January 2006 | | 21,011 | – | – | 24,386 | – | 55,940 | 101,337 | 43,509 | 144,846 |
| Capital reduction | 29(c) | (12,941) | – | – | (9,340) | – | (64,850) | (87,131) | – | (87,131) |
| Acquisition of minority interests | 30(d)(i), (ii) | – | – | 10,762 | – | – | – | 10,762 | (60,167) | (49,405) |
| Dividends paid during the year | 12 | – | – | – | – | – | (19,533) | (19,533) | – | (19,533) |
| Capital injection | 29(d) | 10,680 | 29,470 | – | – | – | – | 40,150 | – | 40,150 |
| Arising from reorganisation | 29(e)(i) | (18,750) | – | (136,008) | – | – | – | (154,758) | – | (154,758) |
| Exchange difference | | – | – | – | – | (28) | – | (28) | – | (28) |
| Appropriation to statutory reserve | | – | – | – | 62,852 | – | (62,852) | – | – | – |
| Profit for the year | | – | – | – | – | – | 412,814 | 412,814 | 51,096 | 463,910 |
| At 31 December 2006 | | *– | 29,470 | (125,246) | 77,898 | (28) | 321,519 | 303,613 | 34,438 | 338,051 |

| | | **Attributable to equity shareholders of the Company** | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | **Share capital** | **Share premium** | **Other reserve** | **Statutory reserve** | **Exchange reserve** | **Retained profits** | **Sub-total** | **Minority interests** | **Total equity** |
| | | **RMB'000** | **RMB'000** | **RMB'000** | **RMB'000** | **RMB'000** | **RMB'000** | **RMB'000** | **RMB'000** | **RMB'000** |
| | Note | **(note 29)** | | **(note 30(d))** | **(note 30(a))** | **(note 30(b))** | | | | |
| At 1 January 2007 | | ***–** | **29,470** | **(125,246)** | **77,898** | **(28)** | **321,519** | **303,613** | **34,438** | **338,051** |
| Shares issued for group re-organisation | **29(e)(ii) and 30(d)(iv)** | **233,155** | **(29,470)** | **(203,685)** | **–** | **–** | **–** | **–** | **–** | **–** |
| Intangible assets contributed from holding company | **30(d)(iii)** | **–** | **–** | **389,691** | **–** | **–** | **–** | **389,691** | **–** | **389,691** |
| Exchange difference | | **–** | **–** | **–** | **–** | **10,964** | **–** | **10,964** | **–** | **10,964** |
| Appropriation to statutory reserve | | **–** | **–** | **–** | **62,764** | **–** | **(62,764)** | **–** | **–** | **–** |
| Profit for the year | | **–** | **–** | **–** | **–** | **–** | **583,235** | **583,235** | **33,770** | **617,005** |
| At 31 December 2007 | | **233,155** | **–** | **60,760** | **140,662** | **10,936** | **841,990** | **1,287,503** | **68,208** | **1,355,711** |

* Denotes share capital of HK$1 (see note 29(b)).

The notes on pages 67 to 129 form part of these financial statements.

# Consolidated Cash Flow Statement

For the year ended 31 December 2007 (Expressed in Renminbi)

| | Note | 2007 RMB'000 | 2006 RMB'000 |
|---|---|---|---|
| **Operating activities** | | | |
| Profit before taxation | | **684,516** | 567,113 |
| Adjustments for: | | | |
| — Amortisation and depreciation | | | |
| — assets held for use under operating leases | | **1,187** | 396 |
| — other assets | | **22,601** | 13,892 |
| — Interest income | | **(6,967)** | (2,356) |
| — Interest expense | | **39,194** | 9,130 |
| — Share of profits from a jointly controlled entity | | **(6,468)** | — |
| — (Gain)/loss on disposals of fixed assets | | **(384)** | 169 |
| — Construction in progress disposed of to staff as staff benefit | | **—** | 3,775 |
| — Unrealised foreign exchange loss | | **17,158** | 1,250 |
| **Operating profit before change in working capital** | | **750,837** | 593,369 |
| Increase in inventories | | **(297,980)** | (391,774) |
| Increase in trade and other receivables | | **(737,586)** | (531,727) |
| (Increase)/decrease in amounts due from related parties | | **(38,800)** | 2,271 |
| Decrease/(increase) in restricted bank deposit | | **107,875** | (107,875) |
| (Increase)/decrease in pledged bank deposits | | **(193,363)** | 20,461 |
| Increase in trade and other payables | | **45,245** | 110,130 |
| (Decrease)/increase in amounts due to related parties | | **(8,369)** | 47,479 |
| **Cash used in operations** | | **(372,141)** | (257,666) |
| Income tax paid | | **(97,385)** | (48,888) |
| **Net cash used in operating activities** | | **(469,526)** | (306,554) |

# Consolidated Cash Flow Statement

For the year ended 31 December 2007 (Expressed in Renminbi)

| | Note | 2007 RMB'000 | 2006 RMB'000 |
|---|---|---|---|
| **Investing activities** | | | |
| Payment for addition of fixed assets (excluding interests in leasehold land) | | **(53,733)** | (82,688) |
| Proceeds from disposals of fixed assets | | **3,064** | 3,398 |
| Payment for construction in progress | | **(50,752)** | (50,717) |
| Deposit placed for acquisition of leasehold land | | **(19,968)** | (10,105) |
| Payment for leasehold land | | **(19,896)** | (9,280) |
| Acquisition of minority interests | | **—** | (49,410) |
| Capital contribution to a jointly controlled entity | | **(45,091)** | — |
| Interest received | | **6,967** | 2,356 |
| **Net cash used in investing activities** | | **(179,409)** | (196,446) |
| **Financing activities** | | | |
| Proceeds from new bank loans | | **907,059** | 388,455 |
| Repayment of bank loans | | **(403,172)** | (67,083) |
| Proceeds from a loan from a financial institution | | **1,576** | 13,743 |
| Payment for repurchase of shares | 29(c) | **—** | (87,131) |
| Proceeds from shareholders loans | | **76,850** | — |
| Dividends paid | | **—** | (19,533) |
| Interest paid | | **(39,194)** | (9,130) |
| Loan from ultimate holding company | | **142,832** | 262,656 |
| Appropriations to shareholders | | **—** | (154,758) |
| Issue of share capital | | **—** | 40,150 |
| **Net cash generated from financing activities** | | **685,951** | 367,369 |
| **Net increase/(decrease) in cash and cash equivalents** | | **37,016** | (135,631) |
| **Cash and cash equivalents at 1 January** | | **158,351** | 293,982 |
| **Cash and cash equivalents at 31 December** | 21 | **195,367** | 158,351 |

**Significant non-cash transactions:**

During the year, the immediate holding company of the Company contributed several technology licenses amounting to US$52,768,000 (equivalent to RMB389,691,000) (note 16) to the Company for nil consideration (note 30(d)(iii)).

The notes on pages 67 to 129 form part of these financial statements.

# Notes to the Financial Statements

(Expressed in Renminbi)

## 1 GENERAL INFORMATION

Honghua Group Limited (the "Company") was incorporated in the Cayman Islands on 15 June 2007 as an exempted company with limited liability under the Companies Law, Cap 22 (Law 3 of 1961, as consolidated and revised) of the Cayman Islands.

The consolidated financial statements for the year ended 31 December 2007 comprise the Company and its subsidiaries (collectively referred to as the "Group") and the Group's interests in a jointly controlled entity.

## 2 GROUP REORGANISATION

The companies comprising the Group underwent reorganisation (the "reorganisation") which involved a series of equity transactions in connection with the Company's acquisition of equity interest in Sichuan Honghua Petroleum Equipment Co., Ltd ("Honghua Company") and its subsidiaries, to rationalise the Group's structure in preparation for the listing of the Company's shares on the Main Board of The Stock Exchange of Hong Kong Limited (the "Stock Exchange"). Details of the reorganisation are set out in note 29. The Company's shares were listed on the Stock Exchange on 7 March 2008.

The consolidated financial statements have been prepared on the basis that the Company was the holding company of the Group for both years presented, rather than from the date of the reorganisation. Accordingly, the consolidated results of the Group for the years ended 31 December 2006 and 2007 include the results of the Company and its subsidiaries since their respective dates of incorporation or at the date that common control was established, if later, as if the current group structure had been in existence throughout the two years presented.

As the Company was incorporated on 15 June 2007, no comparative figures are presented in respect of the Company's balance sheet.

# Notes to the Financial Statements

(Expressed in Renminbi)

## 3 SIGNIFICANT ACCOUNTING POLICIES

### (a) Statement of compliance

These financial statements have been prepared in accordance with all applicable International Financial Reporting Standards ("IFRSs"), which collective term includes all applicable individual International Financial Reporting Standards, International Accounting Standards ("IASs") and Interpretations issued by the International Accounting Standards Board ("IASB") and the requirements of the Hong Kong Companies Ordinance. These financial statements also comply with the applicable disclosure provisions of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited. A summary of the significant accounting policies adopted by the Group is set out below.

The IASB has issued certain new and revised IFRSs that are first effective or available for early adoption for the current accounting period of the Group and the Company. The adoption of the new and revised IFRSs did not result in significant changes to the Group's accounting policies applied in these financial statements for the years presented. The Group has not applied any new standard or interpretation that is not yet effective for the current accounting period (see note 38).

### (b) Basis of preparation of the financial statements

The financial statements are presented in Renminbi ("RMB"), rounded to the nearest thousand. Items included in the financial statements of each entity in the Group are measured using the currency that best reflects the economic substance of the underlying events and circumstances relevant to that entity ("functional currency"). Most of the companies comprising the Group are operating in the People's Republic of China (the "PRC") and their functional currency is RMB.

The measurement basis used in preparation of the financial statements is the historical cost basis.

The preparation of financial statements in conformity with IFRSs requires management to make judgements, estimates and assumptions that affect the application of policies and reported amounts of assets, liabilities, income and expenses. 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 these estimates.

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

## 3 SIGNIFICANT ACCOUNTING POLICIES (continued)

### (b) Basis of preparation of the financial statements (continued)

Judgements made by management in the application of IFRSs that have significant effect on the financial statement and estimates with a significant risk of material adjustment in the next year are discussed in note 35.

### (c) Subsidiaries and minority interests

Subsidiaries are entities controlled by the Group. Control exists when the Group has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. In assessing control, potential voting rights that presently are exercisable are taken into account.

An investment in a subsidiary is consolidated into the consolidated financial statements from the date that control commences until the date that control ceases. Intra-group balances and transactions and any unrealised profits arising from intra-group transactions are eliminated in full in preparing the consolidated financial statements. Unrealised losses resulting from intra-group transactions are eliminated in the same way as unrealised gains but only to the extent that there is no evidence of impairment.

Minority interests represent the portion of the net assets of subsidiaries attributable to interests that are not owned by the Company, whether directly or indirectly through subsidiaries, and in respect of which the Group has not agreed any additional terms with the holders of those interests which would result in the Group as a whole having a contractual obligation in respect of those interests that meets the definition of a financial liability. Minority interests are presented in the consolidated balance sheet within equity, separately from equity attributable to equity shareholders of the Company. Minority interests in the results of the Group are presented on the face of the income statement as an allocation of the total profit or loss for the year between minority interests and the equity shareholders of the Company.

Where losses applicable to the minority exceed the minority's interest in the equity of a subsidiary, the excess, and any further losses applicable to the minority, are charged against the Group's interest except to the extent that the minority has a binding obligation to, and is able to, make additional investment to cover the losses. If the subsidiary subsequently reports profits, the Group's interest is allocated all such profits until the minority's share of losses previously absorbed by the Group has been recovered.

In the Company's balance sheet, an investment in a subsidiary is stated at cost less impairment losses (see note 3(j)).

# Notes to the Financial Statements

(Expressed in Renminbi)

## 3 SIGNIFICANT ACCOUNTING POLICIES (continued)

### (d) Jointly controlled entities

A jointly controlled entity is an entity which operates under a contractual arrangement between the Group or company and other parties, where the contractual arrangement establishes that the Group or company and one or more of the other parties share joint control over the economic activity of the entity.

An investment in a jointly controlled entity is accounted for in the consolidated financial statements under the equity method and is initially recorded at cost and adjusted thereafter for the post acquisition change in the Group's share of the jointly controlled entity's net assets, unless it is classified as held for sale (or included in a disposal group that is classified as held for sale). The income statement includes the Group's share of the post-acquisition, post-tax results of the jointly controlled entities for the year.

When the Group's share of losses exceeds its interest in the jointly controlled entity, the Group's interest is reduced to nil and recognition of further losses is discontinued except to the extent that the Group has incurred legal or constructive obligations or made payments on behalf of the jointly controlled entity. For this purpose, the Group's interest in the jointly controlled entity is the carrying amount of the investment under the equity method together with the Group's long-term interests that in substance form part of the Group's net investment in the jointly controlled entity.

Unrealised profits and losses resulting from transactions between the Group and its jointly controlled entities are eliminated to the extent of the Group's interest in the jointly controlled entity, except where unrealised losses provide evidence of an impairment of the asset transferred, in which case they are recognised immediately in the income statement.

### (e) Fixed assets and depreciation

Fixed assets are stated in the balance sheet at cost less accumulated depreciation and impairment losses (see note 3(j)).

The cost of self-constructed items of property, plant and equipment includes the cost of materials, direct labour, the initial estimate, where relevant, of the costs of dismantling and removing the items and restoring the site on which they are located, and an appropriate proportion of production overheads.

Gains or losses arising from the retirement or disposal of a fixed asset are determined as the difference between the net disposal proceeds and the carrying amount of the asset and are recognised in the income statement on the date of retirement or disposal.

## 3 SIGNIFICANT ACCOUNTING POLICIES (continued)

### (e) Fixed assets and depreciation (continued)

Depreciation is calculated to write off the cost of items of fixed assets, less their estimated residual values, if any, using the straight-line method over their estimated useful lives as follows:

— Freehold land. . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . Not depreciated
— Buildings held for own use. . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 20–35 years
— Plant and machinery . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 5–10 years
— Fixtures, fittings and equipment. . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 5–10 years
— Motor vehicles . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 5–6 years

Both the useful life of an asset and its residual value, if any, are reviewed annually.

### (f) Construction in progress

Construction in progress represents property, plant and equipment under construction and equipment pending installation, and is stated at cost less impairment losses (see note 3(j)). Cost comprises direct costs of construction. Capitalisation of these costs ceases and the construction in progress is transferred to property, plant and equipment when substantially all of the activities necessary to prepare the assets for their intended use are complete.

No depreciation is provided in respect of construction in progress until it is substantially completed and ready for its intended use.

### (g) Intangible assets

Intangible assets represent the technology licences granted by the holding company and they are stated in the balance sheet at cost less accumulated amortisation (where the estimated useful life is finite) and impairment losses (see note 3 (j)).

Amortisation of intangible assets with finite useful lives is charged to the income statement on a straight-line basis over the assets' estimated useful lives. The following intangible assets with finite useful lives are amortised from the date they are available for use and their estimated useful lives as follows:

— Technology licences . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 10 years

Both the useful life and method of amortisation are reviewed annually.

# Notes to the Financial Statements

(Expressed in Renminbi)

## 3 SIGNIFICANT ACCOUNTING POLICIES (continued)

### (h) Lease prepayments

Lease prepayments represent cost of land use rights paid to the PRC's governmental authorities. Land use rights are carried at cost less accumulated amortisation and impairment loss (see note 3(j)). Amortisation is charged to the income statement on a straight-line basis over the respective periods of the rights.

### (i) Operating lease charges

Where the Group has the use of assets under operating leases, payments made under the leases are charged to the income statement in equal instalments over the accounting periods covered by the lease terms, except where an alternative basis is more representative of the pattern of benefits to be derived from the leased asset. Lease incentives received are recognised in the income statement as an integral part of the aggregate net lease payments made.

### (j) Impairment of assets

#### *(i) Impairment of trade and other receivables and other financial assets*

Trade and other current receivables and other financial assets carried at cost or amortised cost are reviewed at each balance sheet date to determine whether there is objective evidence of impairment. Objective evidence of impairment includes observable data that comes to the attention of the Group about one or more of the following loss events:

— significant financial difficulty of the debtor;

— a breach of contract, such as a default or delinquency in interest or principal payments;

— it becoming probable that the debtor will enter bankruptcy or other financial reorganisation; and

— significant changes in the technological, market, economic or legal environment that have an adverse effect on the debtor.

## 3 SIGNIFICANT ACCOUNTING POLICIES (continued)

### (j) Impairment of assets (continued)

#### *(i) Impairment of trade and other receivables and other financial assets (continued)*

If any such evidence exists the impairment loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows, discounted at the financial asset's original effective interest rate (i.e. the effective interest rate computed at initial recognition of these assets), where the effect of discounting is material. This assessment is made collectively where financial assets carried at amortised cost share similar risk characteristics, such as similar past due status, and have not been individually assessed as impaired. Future cash flows for financial assets which are assessed for impairment collectively are based on historical loss experience for assets with credit risk characteristics similar to the collective group.

If in a subsequent period the amount of an impairment loss decreases and the decrease can be linked objectively to an event occurring after the impairment loss was recognised, the impairment loss is reversed through the income statement. A reversal of an impairment loss shall not result in the asset's carrying amount exceeding that which would have been determined had no impairment loss been recognised in prior years.

Impairment losses are written off against the corresponding assets directly, except for impairment losses recognised in respect of trade debtors included within trade and other receivables, the recovery of which is considered doubtful but not remote. In this case, the impairment losses for doubtful debts are recorded using an allowance account. When the Group is satisfied that recovery is remote, the amount considered irrecoverable is written off against trade debtors directly and any amounts held in the allowance account relating to that debt are reversed. Subsequent recoveries of amounts previously charged to the allowance account are reversed against the allowance account. Other changes in the allowance account and subsequent recoveries of amounts previously written off directly are recognised in the income statement.

## 3 SIGNIFICANT ACCOUNTING POLICIES (continued)

### (j) Impairment of assets (continued)

#### *(ii) Impairment of other assets*

Internal and external sources of information are reviewed at each balance sheet date to identify indications that the following assets may be impaired or an impairment loss previously recognised no longer exists or may have decreased:

- property, plant and equipment;
- construction in progress;
- intangible assets;
- investment in subsidiary;
- lease prepayments; and
- freehold land.

If any such indication exists, the asset's recoverable amount is estimated.

— *Calculation of recoverable amount*

The recoverable amount of an asset is the greater of its net selling price and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of time value of money and the risks specific to the asset. Where an asset does not generate cash inflows largely independent of those from other assets, the recoverable amount is determined for the smallest group of assets that generates cash inflows independently (i.e. a cash-generating unit).

— *Recognition of impairment losses*

An impairment loss is recognised in the income statement whenever the carrying amount of an asset, or the cash-generating unit to which it belongs, exceeds its recoverable amount. Impairment losses recognised in respect of cash-generating units are allocated to reduce the carrying amount of the other assets in the unit (or group of units) on a pro rata basis, except that the carrying value of an asset will not be reduced below its individual fair value less costs to sell, or value in use, if determinable.

# Notes to the Financial Statements

(Expressed in Renminbi)

## 3 SIGNIFICANT ACCOUNTING POLICIES (continued)

### (j) Impairment of assets (continued)

#### *(ii) Impairment of other assets (continued)*

— *Reversals of impairment losses*

An impairment loss is reversed if there has been a favourable change in the estimates used to determine the recoverable amount.

A reversal of impairment losses is limited to the asset's carrying amount that would have been determined had no impairment loss been recognised in prior years. Reversals of impairment losses are credited to the income statement in the year in which the reversals are recognised.

### (k) Inventories

Inventories are carried at the lower of cost and net realisable value.

Cost is calculated using the weighted average cost formula and comprises all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.

Net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

When inventories are sold, the carrying amount of those inventories is recognised as an expense in the period in which the related revenue is recognised. The amount of any write-down of inventories to net realisable value and all losses of inventories are recognised as an expense in the period the write-down or loss occurs. The amount of any reversal of any write-down of inventories is recognised as a reduction in the amount of inventories recognised as an expense in the period in which the reversal occurs.

### (l) Trade and other receivables

Trade and other receivables are initially recognised at fair value and thereafter stated at amortised cost less impairment losses for bad and doubtful debts (see note 3(j)), except where the receivables are interest-free loans made to related parties without any fixed repayment terms or the effect of discounting would be immaterial. In such cases, the receivables are stated at cost less impairment losses for bad and doubtful debts (see note 3(j)).

# Notes to the Financial Statements

(Expressed in Renminbi)

## 3 SIGNIFICANT ACCOUNTING POLICIES (continued)

### (m) Interest-bearing borrowings

Interest-bearing borrowings are recognised initially at fair value less attributable transaction costs. Subsequent to initial recognition, interest-bearing borrowings are stated at amortised cost with any difference between cost and redemption value being recognised in the income statement over the period of the borrowings, together with any interest and fees payable, using the effective interest method.

### (n) Trade and other payables

Trade and other payables are initially recognised at fair value and thereafter stated at amortised cost unless the effect of discounting would be immaterial, in which case they are stated at cost.

### (o) Cash and cash equivalents

Cash and cash equivalents comprise cash at bank and on hand, demand deposits with banks and other financial institutions, and short-term, highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value, having been within three months of maturity at acquisition.

### (p) Employee benefits

(i) Salaries, annual bonuses, paid annual leave, contributions to defined contribution retirement scheme and the cost of non-monetary benefits are accrued in the year in which the associated services are rendered by employees. Where payment or settlement is deferred and the effect would be material, these amounts are stated at their present values.

(ii) Contributions to appropriate local defined contribution retirement scheme pursuant to the relevant labour rules and regulations in the PRC are recognised as an expense in the income statement as incurred, except to the extent that they are included in the cost of inventories not yet recognised as an expense.

## 3 SIGNIFICANT ACCOUNTING POLICIES (continued)

### (q) Income tax

Income tax for the year comprises current tax and movements in deferred tax assets and liabilities. Current tax and movements in deferred tax assets and liabilities are recognised in the income statement except to the extent that they relate to items recognised directly in equity, in which case they are recognised in equity.

Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantively enacted at the balance sheet date, and any adjustment to tax payable in respect of previous years.

Deferred tax assets and liabilities arise from deductible and taxable temporary differences respectively, being the differences between the carrying amounts of assets and liabilities for financial reporting purposes and their tax bases. Deferred tax assets also arise from unused tax losses and unused tax credits.

Apart from certain limited exceptions, all deferred tax liabilities, and all deferred tax assets to the extent that it is probable that future taxable profits will be available against which the asset can be utilised, are recognised. Future taxable profits that may support the recognition of deferred tax assets arising from deductible temporary differences include those that will arise from the reversal of existing taxable temporary differences, provided those differences relate to the same taxation authority and the same taxable entity, and are expected to reverse either in the same period as the expected reversal of the deductible temporary difference or in periods into which a tax loss arising from the deferred tax asset can be carried back or forward. The same criteria are adopted when determining whether existing taxable temporary differences support the recognition of deferred tax assets arising from unused tax losses and credits, that is, those differences are taken into account if they relate to the same taxation authority and the same taxable entity, and are expected to reverse in a period, or periods, in which the tax loss or credit can be utilised.

The amount of deferred tax recognised is measured based on the expected manner of realisation or settlement of the carrying amount of the assets and liabilities, using tax rates enacted or substantively enacted at the balance sheet date. Deferred tax assets and liabilities are not discounted.

The carrying amount of a deferred tax asset is reviewed at each balance sheet date and is reduced to the extent that it is no longer probable that sufficient taxable profit will be available to allow the related tax benefit to be utilised. Any such reduction is reversed to the extent that it becomes probable that sufficient taxable profits will be available.

# Notes to the Financial Statements

(Expressed in Renminbi)

## 3 SIGNIFICANT ACCOUNTING POLICIES (continued)

### (q) Income tax (continued)

Additional income taxes that arise from the distribution of dividends are recognised when the liability to pay the related dividends is recognised.

Current tax balances and deferred tax balances, and movements therein, are presented separately from each other and are not offset. Current tax assets are offset against current tax liabilities, and deferred tax assets against deferred tax liabilities if the Group has the legally enforceable right to set off current tax assets against current tax liabilities and the following additional conditions are met:

- in the case of current tax assets and liabilities, the Company or the Group intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously; or

- in the case of deferred tax assets and liabilities, if they relate to income taxes levied by the same taxation authority on either:

  — the same taxable entity; or

  — different taxable entities, which, in each future period in which significant amounts of deferred tax liabilities or assets are expected to be settled or recovered, intend to realise the current tax assets and settle the current tax liabilities on a net basis or realise and settle simultaneously.

### (r) Provisions and contingent liabilities

Provisions are recognised for liabilities of uncertain timing or amount when the Group has a legal or constructive obligation arising as a result of a past event, it is probable that an outflow of economic benefits will be required to settle the obligation and a reliable estimate can be made. Where the time value of money is material, provisions are stated at the present value of the expenditure expected to settle the obligation.

Where it is not probable that an outflow of economic benefits will be required, or the amount cannot be estimated reliably, the obligation is disclosed as a contingent liability, unless the probability of outflow of economic benefits is remote. Possible obligations, whose existence will only be confirmed by the occurrence or non-occurrence of one or more future events are also disclosed as contingent liabilities unless the probability of outflow of economic benefits is remote.

## 3 SIGNIFICANT ACCOUNTING POLICIES (continued)

### (s) Revenue recognition

Provided it is probable that the economic benefits will flow to the Group and the revenue and costs, if applicable, can be measured reliably, revenue is recognised in the consolidated income statement as follows:

#### *(i) Sale of goods*

Revenue from the sale of goods is recognised when the customer has accepted the related risks and rewards of ownership. Revenue excludes value-added tax or other sales taxes and is after deduction of any trade discounts.

#### *(ii) Transfer of technical know-how*

Revenue from the transfer of technical know-how is recognised when the right to use the technical know-how is transferred to the customer.

#### *(iii) Interest income*

Interest income is recognised as it accrues using the effective interest method.

#### *(iv) Government grants*

Government grants are recognised in the balance sheet initially when there is reasonable assurance that they will be received and that the Group will comply with the conditions attaching to them.

Grants that compensate the Group for expenses incurred are recognised as revenue in the income statement on a systematic basis in the same periods in which the expenses are incurred. Grants that compensate the Group for the cost of an asset are initially recognised as deferred income and subsequently recognised as revenue in the income statement on a systematic basis over the useful life of the related asset.

#### *(v) Rendering of repairing services*

Revenue is recognised when the service has been rendered.

## 3 SIGNIFICANT ACCOUNTING POLICIES (continued)

### (t) Translation of foreign currencies

Foreign currency transactions during the year are translated at the foreign exchange rates ruling at the transaction dates. Monetary assets and liabilities denominated in foreign currencies are translated at the foreign exchange rates ruling at the balance sheet date. Exchange gains and losses are recognised in the income statement.

Non-monetary assets and liabilities that are measured in terms of historical cost in a foreign currency are translated using the foreign exchange rates ruling at the transaction dates.

The results of operations outside the PRC are translated into RMB at the exchange rates approximating the foreign exchange rates ruling at the transaction dates. Balance sheet items are translated into RMB at the foreign exchange rates ruling at the balance sheet date. The resulting exchange differences are recognised directly in a separate component of equity.

On disposal of an operation outside the PRC, the cumulative amount of the exchange differences recognised in equity which relate to that foreign operation is included in the calculation of the profit or loss on disposal.

### (u) Borrowing costs

Borrowing costs are expensed in the income statement in the period in which they are incurred.

### (v) Research and development

Expenditure on research activities is recognised as an expense in the income statement in the period in which it is incurred.

Expenditure on development activities is capitalised if the product or process is technically and commercially feasible and the Group has sufficient resources and the intention to complete development.

The expenditure capitalised includes the cost of materials, direct labour and an appropriate proportion of overheads. Other development expenditure is recognised as an expense in the period in which it is as incurred.

## 3 SIGNIFICANT ACCOUNTING POLICIES (continued)

### (w) Warranty costs

Provision for warranty costs is based on historical trends in product defect rates and the expected material and labour costs to provide warranty services. In case of new products, expert opinions and industry data are also taken into consideration in estimating the product warranty accruals. Provision is only made where a warranty claim is probable.

### (x) Dividends

Dividends are recognised as a liability in the period in which they are declared.

### (y) Related parties

For the purposes of the financial statements, a party is considered to be related to the Group if:

(i) The party has the ability, directly or indirectly through one or more intermediaries, to control the Group or exercise significant influence over the Group in making finance and operating policy decisions, or has joint control over the Group;

(ii) The Group and the party are subject to common control;

(iii) The party is an associate of the Group or a joint venture in which the Group is a venturer;

(iv) The party is a member of key management personnel of the Group or the Group's parent, or a close family member of such an individual, or is an entity under the control, joint control or significant influence of such individuals;

(v) The party is a close family member of a party referred to in (i) or is an entity under the control, joint control or significant influence of such individuals; or

(vi) The party is a post-employment benefit plan which is for the benefit of employees of the Group or of any entity that is a related party of the Group.

Close family members of an individual are those family members who may be expected to influence, or be influenced by, that individual in their dealings with the entity.

# Notes to the Financial Statements

(Expressed in Renminbi)

## 3 SIGNIFICANT ACCOUNTING POLICIES (continued)

### (z) Segment reporting

A segment is a distinguishable component of the Group that is engaged either in providing products or services ("business segment"), or in providing products or services within a particular economic environment ("geographical segment"), which is subject to risks and rewards that are different from those of other segments.

In accordance with the Group's internal financial reporting system, the Group has chosen business segment information as the primary reporting format and geographical segment information as the secondary reporting format for the purposes of these financial statements.

Segment revenue, expenses, results, assets and liabilities include items directly attributable to a segment as well as those that can be allocated on a reasonable basis to that segment. Segment revenue, expenses, assets, and liabilities are determined before intra-group balances and intra-group transactions are eliminated as part of the consolidation process, except to the extent that such intra-group balances and transactions are between group entities within a single segment. Inter-segment pricing is based on similar terms as those available to other external parties.

Segment capital expenditure is the total cost incurred during the year to acquire segment assets (both tangible and intangible) that are expected to be used for more than one period.

Unallocated items mainly comprise cash and cash equivalents, interest-bearing borrowings, loan from related parties, net financing costs and income tax expenses.

## 4 SEGMENT REPORTING

Segment information is presented in respect of the Group's business and geographical segments. Business segment information is chosen as the primary reporting format because this is more relevant to the Group's internal financial reporting. Inter-segment pricing is determined on an arm's length basis.

### Business segments

The Group consists of the following main business segments:

| | | |
|---|---|---|
| Drilling rigs | — | Manufacture and sale of drilling rigs |
| Parts and components | — | Manufacture and sale of parts and components of drilling rigs |

# Notes to the Financial Statements

(Expressed in Renminbi)

## 4 SEGMENT REPORTING (continued)

### Business segments (continued)

| | Year ended 31 December 2006 | | | |
|---|---|---|---|---|
| | Drilling rigs RMB'000 | Parts and components RMB'000 | Eliminations RMB'000 | Total RMB'000 |
| Revenue | 2,037,272 | 605,273 | (306,597) | 2,335,948 |
| Cost of sales | (1,362,421) | (490,936) | 295,236 | (1,558,121) |
| Other income and expenses | (138,423) | (52,163) | — | (190,586) |
| Segment result | 536,428 | 62,174 | (11,361) | 587,241 |
| Unallocated | | | | 3,013 |
| Net financing costs | | | | (23,141) |
| Income tax expenses | | | | (103,203) |
| Profit for the year | | | | 463,910 |
| Segment assets | 1,480,684 | 295,628 | (199,457) | 1,576,855 |
| Unallocated assets | | | | 605,539 |
| Total assets | | | | 2,182,394 |
| Segment liabilities | 923,611 | 266,539 | (199,457) | 990,693 |
| Unallocated liabilities | | | | 853,650 |
| Total liabilities | | | | 1,844,343 |

| | Drilling rigs RMB'000 | Parts and components RMB'000 | Unallocated RMB'000 | Total RMB'000 |
|---|---|---|---|---|
| Capital expenditure | 66,037 | 65,687 | 10,961 | 142,685 |
| Amortisation and depreciation | 9,026 | 2,306 | 2,956 | 14,288 |
| Non-cash expenses other than amortisation and depreciation | 5,285 | 1,541 | — | 6,826 |

# Notes to the Financial Statements

(Expressed in Renminbi)

## 4 SEGMENT REPORTING (continued)

### Business segments (continued)

| | Year ended 31 December 2007 | | | |
|---|---|---|---|---|
| | Drilling rigs RMB'000 | Parts and components RMB'000 | Eliminations RMB'000 | Total RMB'000 |
| Revenue | 2,741,457 | 1,133,995 | (711,430) | 3,164,022 |
| Cost of sales | (1,995,611) | (761,559) | 673,282 | (2,083,888) |
| Other income and expenses | (286,067) | (101,357) | — | (387,424) |
| Segment result | 459,779 | 271,079 | (38,148) | 692,710 |
| Unallocated | | | | 35,265 |
| Net financing costs | | | | (49,927) |
| Share of profits from a jointly controlled entity | | | | 6,468 |
| Income tax expenses | | | | (67,511) |
| Profit for the year | | | | 617,005 |
| Segment assets | 2,439,844 | 1,143,158 | (481,231) | 3,101,771 |
| Unallocated assets | | | | 829,182 |
| Total assets | | | | 3,930,953 |
| Segment liabilities | 1,331,291 | 301,733 | (481,231) | 1,151,793 |
| Unallocated liabilities | | | | 1,423,449 |
| Total liabilities | | | | 2,572,242 |

| | Drilling rigs RMB'000 | Parts and components RMB'000 | Unallocated RMB'000 | Total RMB'000 |
|---|---|---|---|---|
| Capital expenditure | 94,334 | 19,778 | 21,774 | 135,886 |
| Amortisation and depreciation | 11,792 | 3,678 | 8,318 | 23,788 |
| Non-cash expenses other than amortisation and depreciation | 12,228 | 4,547 | — | 16,775 |

## 4 SEGMENT REPORTING (continued)

### Geographical segments

In presenting information on the basis of geographical segment, segment revenue is based on the geographical location of the customers. Segment assets are based on the geographical location of the assets.

| | Year ended 31 December 2006 | | | | | |
|---|---|---|---|---|---|---|
| | PRC RMB'000 | North America RMB'000 | Middle East RMB'000 | Europe RMB'000 | Others RMB'000 | Total RMB'000 |
| Revenue from external customers | 386,099 | 1,665,572 | 261,733 | 8,580 | 13,964 | 2,335,948 |
| Segment assets | 1,995,236 | 87,770 | 2,066 | — | 97,322 | 2,182,394 |
| Segment liabilities | 1,540,529 | 37,595 | — | — | 266,219 | 1,844,343 |
| Capital expenditure | 112,479 | 30,206 | — | — | — | 142,685 |

| | **Year ended 31 December 2007** | | | | | |
|---|---|---|---|---|---|---|
| | **PRC RMB'000** | **North America RMB'000** | **Middle East RMB'000** | **Europe RMB'000** | **Others RMB'000** | **Total RMB'000** |
| Revenue from external customers | **1,205,070** | **594,620** | **155,985** | **801,101** | **407,246** | **3,164,022** |
| Segment assets | **3,091,858** | **141,757** | **8,800** | **—** | **688,538** | **3,930,953** |
| Segment liabilities | **1,893,846** | **31,404** | **368** | **—** | **649,624** | **2,575,242** |
| Capital expenditure | **131,720** | **3,818** | **348** | **—** | **—** | **135,886** |

## 5 REVENUE

The principal activities of the Group are the manufacturing, sale and trading of drilling rigs and related parts and components. Revenue represents the sales value of goods supplied to customers less value-added tax, returns and trade discounts.

| | **2007 RMB'000** | 2006 RMB'000 |
|---|---|---|
| Sale of drilling rigs | **2,774,261** | 2,037,272 |
| Sale of parts and components | **389,761** | 298,676 |
| | **3,164,022** | 2,335,948 |

# Notes to the Financial Statements

(Expressed in Renminbi)

## 6 OTHER OPERATING REVENUE AND OTHER NET INCOME

| | 2007<br>RMB'000 | 2006<br>RMB'000 |
|---|---|---|
| **Other operating revenue** | | |
| Transfer of technical know-how to a jointly controlled entity | **12,975** | — |
| Rendering of repairing services | **9,276** | 4,526 |
| Others | **748** | 94 |
| | **22,999** | 4,620 |
| **Other net income** | | |
| Government grants | **10,153** | 2,252 |
| Gain/(loss) on disposals of fixed assets | **384** | (169) |
| Write-back of provision for compensation | **13,246** | — |
| Others | **(1,308)** | 1,002 |
| | **22,475** | 3,085 |

# Notes to the Financial Statements

(Expressed in Renminbi)

## 7 PROFIT BEFORE TAXATION

**Profit before taxation is arrived at after charging/(crediting):**

| | | 2007<br>RMB'000 | 2006<br>RMB'000 |
|---|---|---|---|
| (a) | Net financing costs | | |
| | Exchange loss, net | **14,078** | 15,359 |
| | Interest income | **(6,967)** | (2,356) |
| | Interest on interest-bearing borrowings wholly repayable within five years | **39,194** | 9,130 |
| | Bank charges | **3,622** | 1,008 |
| | | **49,927** | 23,141 |
| (b) | Staff costs | | |
| | Contributions to defined contribution retirement scheme | **10,399** | 3,159 |
| | Salaries, wages and other benefits | **173,035** | 113,799 |
| | | **183,434** | 116,958 |
| (c) | Other items | | |
| | Amortisation and depreciation | | |
| | — assets held for use under operating leases | **1,187** | 396 |
| | — other assets | **22,601** | 13,892 |
| | (Write-back)/provision for impairment losses of trade and other receivables (note 18(b)) | **(239)** | 1,637 |
| | Auditors' remuneration | **3,518** | 2,042 |
| | Operating lease charges: properties | **2,283** | 490 |
| | Provision for product warranty | **5,653** | 11,826 |
| | *Research and development costs | **27,387** | 16,208 |

* The amounts included staff costs of employees in the Research and Development Department, which are included in the total staff costs as disclosed in note 7(b).

# Notes to the Financial Statements

(Expressed in Renminbi)

## 8 INCOME TAX EXPENSES

### (a) Taxation in the income statement

| | 2007<br>RMB'000 | 2006<br>RMB'000 |
|---|---|---|
| **Current tax — the PRC** | | |
| Provision for the year | **66,260** | 104,503 |
| Under-provision in respect of prior years | **—** | 601 |
| | **66,260** | 105,104 |
| **Current tax — the United States of America** | | |
| Provision for the year | **—** | 3,978 |
| **Deferred tax** | | |
| Origination and reversal of temporary differences (note 25) | **1,251** | (5,879) |
| | **67,511** | 103,203 |

### (b) Taxation in the income statement represents:

#### *(i) Hong Kong Profits Tax*

No provision for Hong Kong Profits Tax has been made as the Group did not have assessable profits subject to Hong Kong Profits Tax for the year (2006: Nil).

#### *(ii) Cayman Islands*

The Company was incorporated in the Cayman Islands as an exempted company with limited liability under the Companies Law of the Cayman Islands and accordingly, is exempt from the payment of the Cayman Islands income tax.

#### *(iii) British Virgin Islands*

Pursuant to the rule and regulations of the British Virgin Islands, the Group is not subject to any tax in the British Virgin Islands.

## 8 INCOME TAX EXPENSES (continued)

### (b) Taxation in the income statement represents: (continued)

#### *(iv) United States of America*

Taxation for Honghua America, LLC. ("Honghua America") is charged at the appropriate current rates of taxation ruling in the relevant state.

#### *(v) United Arab Emirates*

Honghua Golden Coast Equipment FZE ("Golden Coast Company") is not subject to income tax in accordance with the relevant United Arab Emirates income tax laws and regulations.

#### *(vi) PRC enterprise income tax*

In accordance with the relevant PRC income tax laws and regulations, the applicable income tax rates of the Company's subsidiaries are as follows:

*(a) Honghua Company*

For the period from January to September 2006

Honghua Company was subject to an income tax rate of 33%.

For the period from October to December 2006 and for the year 2007

On 15 September 2006, Honghua Company changed from being a domestic enterprise to a wholly owned foreign invested enterprise, and was entitled to tax concessions from 1 October 2006 whereby the profit for the first two financial years commencing on the profit-making year (after netting off tax losses carried forward from prior years) is exempt from national income tax in the PRC and the profit for each of the subsequent three financial years is taxed at 50% of the prevailing tax rate set by the relevant authorities.

All income earned from 1 October 2006 to 31 December 2006 and for the year ended 31 December 2007 are exempt from national income tax. Honghua Company was still subject to a local income tax at a rate of 3%.

# Notes to the Financial Statements

(Expressed in Renminbi)

## 8 INCOME TAX EXPENSES (continued)

### (b) Taxation in the income statement represents: (continued)

#### *(vi)* ***PRC enterprise income tax*** *(continued)*

*(b) Chengdu Hongtian Electronic Drive Engineering Co., Ltd ("Hongtian Company") and Sichuan Honghua Youxin Petroleum Machinery Co., Ltd ("Youxin Company")*

Hongtian Company and Youxin Company are recognised as entities established in the western regions of the PRC with principal revenue of over 70% generated from the encouraged business activities. Pursuant to the approvals obtained from the relevant PRC tax authorities, the companies are entitled to a preferential income tax rate of 15%.

*(c) Honghua International Co., Ltd ("Honghua International")*

Pursuant to the income tax rules and regulations of the PRC, the income tax rate applicable to Honghua International is 33%.

*(d) Changes to the PRC tax legislation*

On 16 March 2007, the Fifth Plenary Session of the Tenth National People's Congress passed the Corporate Income Tax Law of the PRC ("New Tax Law") which will take effect on 1 January 2008 and the income tax rate will be reduced from 33% to 25%.

The State Council of the PRC passed an implementation guidance note on 26 December 2007, which sets out details of how existing preferential income tax rates will be adjusted to the standard rate of 25%.

Pursuant to the Notice on the Implementation Rules for Grandfathering Relief under the New Tax Law ("Notice 39") issued by The State Council on 26 December 2007, the entity eligible for tax holiday relief can still enjoy its relief which deemed to be commenced from 1 January 2008. Notice 39 also sets out that the existing preferential income tax policy pertaining to enterprises established in the western regions of the PRC will continue to be effective until 31 December 2010.

## 8 INCOME TAX EXPENSES (continued)

### (b) Taxation in the consolidated income statement represents: (continued)

***(vi) PRC enterprise income tax** (continued)*

*(d) Changes to the PRC tax legislation (continued)*

The above change in tax rate has been taken into account in the measurement of the subsidiaries' deferred tax assets and liabilities as at 31 December 2007, which are expected to be utilised subsequent to 1 January 2008. The enactment of the new tax law is not expected to have any financial effect on the amounts accrued in the consolidated balance sheet in respect of current tax payable.

Further under the new tax law, from 1 January 2008 onwards, non-resident enterprises without an establishment or place of business in the PRC or which have an establishment or place of business in the PRC but whose relevant income is not effectively connected with the establishment or a place of business in the PRC, will be subject to withholding tax at the rate of 10% on various types of passive income such as dividends derived from sources in the PRC. However, the Caishui (2008) No.1 approved by the Minister of Finance and State Administration of Tax on 22 February 2008 exempts the dividend distribution out of pre-2008 retained earnings of foreign investment enterprises from withholding tax.

### (c) Reconciliation between tax expense and accounting profit at applicable tax rates:

| | **2007**<br>**RMB'000** | 2006<br>RMB'000 |
|---|---|---|
| Profit before taxation | **684,516** | 567,113 |
| Notional tax on profit before taxation, calculated at the rates applicable to profits in the countries concerned | **212,705** | 149,663 |
| Tax effect of non-deductible expenses | **19,861** | 23,109 |
| Effect on deferred tax balances resulting from a change in tax rate | **2,269** | — |
| Under-provision in respect of prior years | **—** | 601 |
| Tax concessions | **(167,324)** | (70,170) |
| Income tax expenses | **67,511** | 103,203 |

# Notes to the Financial Statements

(Expressed in Renminbi)

## 9 DIRECTORS' REMUNERATION

Details of directors' remuneration are set out below:

| | Year ended 31 December 2006 | | | | |
|---|---|---|---|---|---|
| | Fees | Basic salaries, allowances and other benefits in kind | Contributions to defined contribution retirement scheme | Discretionary bonuses | Total |
| | RMB'000 | RMB'000 | RMB'000 | RMB'000 | RMB'000 |
| **Chairman and Executive Director** | | | | | |
| Zhang Mi | — | 538 | 12 | 665 | 1,215 |
| **Executive Director** | | | | | |
| Ren Jie | — | 350 | 8 | 440 | 798 |
| Zhang Xu | — | 211 | 9 | 126 | 346 |
| Total | — | 1,099 | 29 | 1,231 | 2,359 |

| | **Year ended 31 December 2007** | | | | |
|---|---|---|---|---|---|
| | **Fees** | **Basic salaries, allowances and other benefits in kind** | **Contributions to defined contribution retirement scheme** | **Discretionary bonuses** | **Total** |
| | **RMB'000** | **RMB'000** | **RMB'000** | **RMB'000** | **RMB'000** |
| **Chairman and Executive Director** | | | | | |
| Zhang Mi | **—** | **1,232** | **13** | **1,508** | **2,753** |
| **Executive Directors** | | | | | |
| Ren Jie | **—** | **316** | **12** | **956** | **1,284** |
| Zhang Xu | **—** | **226** | **13** | **283** | **522** |
| **Non-executive Directors** | | | | | |
| Wang Yaoxin | **—** | **19** | **—** | **—** | **19** |
| Total | **—** | **1,793** | **38** | **2,747** | **4,578** |

## 9 DIRECTORS' REMUNERATION (continued)

Nil amount was paid to the Company's other independent non-executive directors for the year ended 31 December 2007 (2006: Nil).

During the year, no amount was paid or payable by the Group to the directors or any of the five highest paid individuals set out in note 10 below as an inducement to join or upon joining the Group or as compensation for loss of office. There was no arrangement under which a director waived or agreed to waive any remuneration during the year.

## 10 INDIVIDUAL WITH HIGHEST EMOLUMENTS

The five highest paid individuals of the Group include two directors during the year ended 31 December 2007 (2006: two) whose emoluments are disclosed in note 9. Details of remuneration paid to the remaining three (2006: three) highest individuals of the Group are as follows:

| | **2007** | 2006 |
|---|---|---|
| | **RMB'000** | RMB'000 |
| Basic salaries, allowances and other benefits in kind | **2,107** | 819 |
| Discretionary bonuses | **1,552** | 3,316 |
| Contributions to defined contribution retirement scheme | **12** | 5 |
| | **3,671** | 4,140 |

The emoluments of these individuals are within the following band:

| | **2007** | 2006 |
|---|---|---|
| RMB Nil to RMB935,191 (equivalent to HK$ Nil to HK$1,000,000) | **–** | 2 |
| RMB935,192 to RMB1,402,787 (equivalent to HK$1,000,001 to HK$1,500,000) | **2** | – |
| RMB1,402,788 to RMB1,870,382 (equivalent to HK$1,500,001 to HK$2,000,000) | **1** | – |
| RMB1,870,383 to RMB2,337,978 (equivalent to HK$2,000,001 to HK$2,500,000) | **–** | – |
| RMB2,337,979 to RMB2,805,573 (equivalent to HK$2,500,001 to HK$3,000,000) | **–** | 1 |

## 11 PROFIT ATTRIBUTABLE TO EQUITY SHAREHOLDERS OF THE COMPANY

The profit attributable to equity shareholders of the Company includes a loss of RMB2,471,262 (2006: RMB nil) which has been dealt with in financial statements of the Company.

## 12 DIVIDENDS

Dividends payable for the year

| | **2007** | 2006 |
|---|---|---|
| | **RMB'000** | RMB'000 |
| Interim dividend declared and paid by certain subsidiaries of the Company | **–** | 19,533 |

For the year ended 31 December 2007, no final dividend has been declared by the Company (2006:Nil).

## 13 EARNINGS PER SHARE

The calculation of basic earnings per share for the year is based on the net profit attributable to equity shareholders of the Company of RMB583,235,000 (2006: RMB412,814,000) and the shares in issue of the Company of 2,500,000,000 as at the balance sheet date as if the shares were outstanding throughout the year and the prior year .

There were no dilutive potential ordinary shares during the year and, therefore, diluted earnings per share are not presented.

## 14 FIXED ASSETS

### The Group

| | Freehold land RMB'000 | Interests in leasehold land held for own use under operating leases RMB'000 | Buildings held for own use RMB'000 | Plant and machinery RMB'000 | Fixtures, fittings and equipment RMB'000 | Motor vehicles RMB'000 | Total RMB'000 |
|---|---|---|---|---|---|---|---|
| **Cost:** | | | | | | | |
| At 1 January 2006 | 6,506 | 16,895 | 37,870 | 43,670 | 20,408 | 12,391 | 137,740 |
| Additions | – | 9,280 | 23,404 | 27,759 | 24,317 | 7,208 | 91,968 |
| Transfer from construction in progress (note 15) | – | – | 49,371 | 240 | – | – | 49,611 |
| Disposals | – | – | (3,736) | (122) | (116) | (475) | (4,449) |
| Exchange difference | (211) | – | (873) | (43) | (114) | (57) | (1,298) |
| At 31 December 2006 | 6,295 | 26,175 | 106,036 | 71,504 | 44,495 | 19,067 | 273,572 |
| **Accumulated amortisation and depreciation:** | | | | | | | |
| At 1 January 2006 | – | 1,163 | 4,357 | 4,991 | 5,656 | 2,695 | 18,862 |
| Charge for the year | – | 396 | 2,548 | 5,728 | 3,952 | 1,664 | 14,288 |
| Written back on disposal | – | – | (298) | (115) | (101) | (368) | (882) |
| Exchange difference | – | – | (7) | (1) | (11) | (6) | (25) |
| At 31 December 2006 | – | 1,559 | 6,600 | 10,603 | 9,496 | 3,985 | 32,243 |
| **Net book value:** | | | | | | | |
| At 31 December 2006 | 6,295 | 24,616 | 99,436 | 60,901 | 34,999 | 15,082 | 241,329 |

# Notes to the Financial Statements

(Expressed in Renminbi)

## 14 FIXED ASSETS (continued)

### The Group (continued)

| | Freehold land RMB'000 | Interests in leasehold land held for own use under operating leases RMB'000 | Buildings held for own use RMB'000 | Plant and machinery RMB'000 | Fixtures, fittings and equipment RMB'000 | Motor vehicles RMB'000 | Total RMB'000 |
|---|---|---|---|---|---|---|---|
| **Cost:** | | | | | | | |
| At 1 January 2007 | 6,295 | 26,175 | 106,036 | 71,504 | 44,495 | 19,067 | 273,572 |
| Additions | – | 31,401 | 7,118 | 19,184 | 20,876 | 6,555 | 85,134 |
| Transfer from construction in progress (note 15) | – | – | 21,431 | – | 1,651 | – | 23,082 |
| Disposals | – | – | (418) | (106) | (2,518) | (294) | (3,336) |
| Exchange difference | (415) | – | (1,693) | (84) | (222) | (111) | (2,525) |
| At 31 December 2007 | 5,880 | 57,576 | 132,474 | 90,498 | 64,282 | 25,217 | 375,927 |
| **Accumulated amortisation and depreciation:** | | | | | | | |
| At 1 January 2007 | – | 1,559 | 6,600 | 10,603 | 9,496 | 3,985 | 32,243 |
| Charge for the year | – | 1,187 | 5,797 | 6,669 | 7,511 | 2,624 | 23,788 |
| Written back on disposal | – | – | (20) | (84) | (379) | (173) | (656) |
| Exchange difference | – | – | 12 | 139 | 62 | 176 | 389 |
| At 31 December 2007 | – | 2,746 | 12,389 | 17,327 | 16,690 | 6,612 | 55,764 |
| **Net book value:** | | | | | | | |
| At 31 December 2007 | 5,880 | 54,830 | 120,085 | 73,171 | 47,592 | 18,605 | 320,163 |

Interests in leasehold land held for own use under operating leases represent prepayments for land use rights in the PRC with a medium-term lease period.

# Notes to the Financial Statements

(Expressed in Renminbi)

## 15 CONSTRUCTION IN PROGRESS

| | The Group | |
|---|---|---|
| | **2007** | 2006 |
| | **RMB'000** | RMB'000 |
| Balance at 1 January | **11,071** | 13,740 |
| Additions | **50,752** | 50,717 |
| Disposals | **—** | (3,775) |
| Transfer to fixed assets (note 14) | **(23,082)** | (49,611) |
| Balance at 31 December | **38,741** | 11,071 |

Construction in progress comprises costs incurred on buildings and plant and equipment not yet completed at the respective balance sheet date.

## 16 INTANGIBLE ASSETS

| | The Group and the Company | |
|---|---|---|
| | **2007** | 2006 |
| | **RMB'000** | RMB'000 |
| **Cost:** | | |
| At 1 January | **—** | — |
| Addition through contribution by holding company | **389,691** | — |
| At 31 December | **389,691** | — |
| **Accumulated amortisation:** | | |
| At 1 January | **—** | — |
| Amortisation for the year | **—** | — |
| At 31 December | **—** | — |
| **Net book value:** | | |
| At 31 December | **389,691** | — |

# Notes to the Financial Statements

(Expressed in Renminbi)

## 17 INVENTORIES

### (a) Inventories in the balance sheet comprise:

| | The Group | |
|---|---|---|
| | **2007** | 2006 |
| | **RMB'000** | RMB'000 |
| Raw materials | **244,290** | 241,395 |
| Work in progress | **369,477** | 188,667 |
| Finished goods | **368,868** | 218,641 |
| Goods in transit | **49,133** | 41,688 |
| | **1,031,768** | 690,391 |

### (b) An analysis of the amount of inventories recognised as an expense is as follows:

| | The Group | |
|---|---|---|
| | **2007** | 2006 |
| | **RMB'000** | RMB'000 |
| Carrying amount of inventories sold | **2,105,823** | 1,542,970 |
| Write down of inventories | **31,183** | 8,168 |
| Reversal of write-down of inventories | **(19,520)** | — |
| | **2,117,486** | 1,551,138 |

## 18 TRADE AND OTHER RECEIVABLES

| | The Group | |
|---|---|---|
| | **2007** | 2006 |
| | **RMB'000** | RMB'000 |
| Trade receivables | **1,113,964** | 564,687 |
| Bills receivable | **57,663** | 12,550 |
| Less: allowance for doubtful debts (note 18(b)) | **(3,312)** | (3,551) |
| Sub-total | **1,168,315** | 573,686 |
| Value-added tax receivable | **129,372** | 54,046 |
| Other receivables | **55,944** | 64,958 |
| Prepayments | **253,329** | 176,684 |
| | **1,606,960** | 869,374 |

All of the trade and other receivables are expected to be recovered within one year.

### (a) Ageing analysis

Included in trade and other receivables are trade receivables and bills receivable (net of allowance for doubtful debts) with the following ageing analysis as of the balance sheet date:

| | The Group | |
|---|---|---|
| | **2007** | 2006 |
| | **RMB'000** | RMB'000 |
| Current | **964,933** | 545,874 |
| Less than 1 month past due | **78,828** | 649 |
| 1 to 3 months past due | **80,515** | 17,957 |
| More than 3 months but less than 12 months past due | **44,039** | 9,206 |
| | **1,168,315** | 573,686 |

The Group normally grants an average credit period of 30 to 90 days to its trade customers. Further details on the Group's credit policy are set out in note 31(a).

# Notes to the Financial Statements

(Expressed in Renminbi)

## 18 TRADE AND OTHER RECEIVABLES (continued)

### (b) Impairment of trade receivables and bills receivable

Impairment loss in respect of trade receivables and bills receivable are recorded using an allowance account unless the Group is satisfied that recovery of the amount is remote, in which case the impairment loss is written off against trade receivables and bills receivable directly (see note 3(j)).

The movement in the allowance for doubtful debts during the year, including both specific loss components, is as follows:

| | The Group | |
|---|---|---|
| | **2007** | 2006 |
| | **RMB'000** | RMB'000 |
| At 1 January | **3,551** | 1,914 |
| (Write-back of)/provision for impairment losses (note 7(c)) | **(239)** | 1,637 |
| At 31 December (note 18) | **3,312** | 3,551 |

The individually impaired receivables relate to customers that are in financial difficulties and management assesses the recoverability is remote. Consequently, specific allowances for doubtful debts were recognised. The Group does not hold any collateral over these balances.

### (c) Trade receivable that are not impaired

Receivables that were neither past due nor impaired (disclosed as current on the table given in note 18(a)) relate to a wide range of customers for whom there was no recent history of default.

Receivables that were past due but not impaired (as shown in the table in note 18(a)) relate to a number of independent customers that have a good track record with the Group. Based on past experience, management believes that no impairment allowance is necessary in respect of these balances as there has been no history of default and the balances are still considered fully recoverable. The Group does not hold any collateral over these balances.

# Notes to the Financial Statements

(Expressed in Renminbi)

## 19 RESTRICTED BANK DEPOSIT

As part of the financial covenants to the convertible note holder of Ally Giant Limited ("Ally Giant"), an immediate holding company, the Group agreed to set up an escrow account, whereby the escrow fund is restrictive in usage. The restricted deposit can only be released upon the receipt of a written notice from the representative of the convertible note holder. The restricted bank deposit was released by end of June 2007.

## 20 PLEDGED BANK DEPOSITS

The deposits are pledged to banks as security against certain banking facilities granted to the Group (see notes 22 and 23).

## 21 CASH AND CASH EQUIVALENTS

| | The Group | |
|---|---|---|
| | **2007** | 2006 |
| | **RMB'000** | RMB'000 |
| Cash at bank and in hand | **195,367** | 158,351 |

As at 31 December 2007 deposits that were placed with banks in the PRC and included in the cash and cash equivalents above amounted to RMB180,234,346 (2006: RMB83,383,002). Remittance of funds out of the PRC is subject to the exchange restrictions imposed by the PRC government.

## 22 INTEREST-BEARING BORROWINGS

The bank loans and the loan from a financial institution were secured as follows:

| | The Group | |
|---|---|---|
| | **2007** | 2006 |
| | **RMB'000** | RMB'000 |
| Bank loans | | |
| — secured | **25,384** | 72,556 |
| — unsecured | **831,059** | 280,000 |
| | **856,443** | 352,556 |
| Loan from a financial institution — secured | **15,319** | 13,743 |
| Total | **871,762** | 366,299 |

# Notes to the Financial Statements

(Expressed in Renminbi)

## 22 INTEREST-BEARING BORROWINGS (continued)

The bank loans were repayable as follows:

| | The Group | |
|---|---|---|
| | **2007** | 2006 |
| | **RMB'000** | RMB'000 |
| Within 1 year | | |
| — bank loans | **856,059** | 345,000 |
| After 1 year but within 2 years | | |
| — bank loans | **—** | 4,685 |
| After 2 years but within 5 years | | |
| — bank loans | **384** | — |
| — loan from a financial institution | **15,319** | 13,743 |
| After 5 years | | |
| — bank loans | **—** | 2,871 |
| | **15,703** | 21,299 |
| Total | **871,762** | 366,299 |

Bank loans of certain subsidiaries amounting to RMB25,384,349 as of 31 December 2007 (2006: RMB72,556,000) are secured by their leasehold land with an aggregate carrying value of RMB18,176,926 as of 31 December 2007 (2006: RMB24,540,000).

The bank loans as at 31 December 2007 bear interest at 5.30% to 9.25% per annum (2006: 5.28% to 9.68%).

## 22 INTEREST-BEARING BORROWINGS (continued)

The loan from a financial institution as at 31 December 2007 amounted to RMB15,318,660 (2006: RMB13,743,000) is secured by the equipment and inventories with an aggregate carrying value of RMB155,449,093 (2006: RMB48,345,485).

The loan from a financial institution as at 31 December 2007 bears interest at 6.50% per annum (2006: 6.50% per annum).

## 23 TRADE AND OTHER PAYABLES

| | The Group | | The Company |
|---|---|---|---|
| | **2007** | 2006 | **2007** |
| | **RMB'000** | RMB'000 | **RMB'000** |
| Trade payables | **600,089** | 408,152 | **–** |
| Bills payable | **135,890** | 82,147 | **–** |
| Receipts in advance | **226,368** | 485,266 | **–** |
| Other payables | **174,545** | 116,082 | **2,517** |
| | **1,136,892** | 1,091,647 | **2,517** |

Bills payable as at 31 December 2006 and at 31 December 2007 were secured by pledged bank deposits as disclosed in note 20.

An ageing analysis of the trade payables and bills payable is as follows:

| | The Group | | The Company |
|---|---|---|---|
| | **2007** | 2006 | **2007** |
| | **RMB'000** | RMB'000 | **RMB'000** |
| Within 3 months | **535,768** | 379,263 | **–** |
| 3 months to 6 months | **107,873** | 48,569 | **–** |
| 6 months to 1 year | **63,294** | 31,547 | **–** |
| Over 1 year | **29,044** | 30,920 | **–** |
| | **735,979** | 490,299 | **–** |

# Notes to the Financial Statements

(Expressed in Renminbi)

## 24 EMPLOYEE RETIREMENT BENEFITS

### Defined contribution retirement scheme

Pursuant to the relevant labour rules and regulations in the PRC, the PRC subsidiaries now comprising the Group participate in a defined contribution retirement benefit scheme (the "Scheme") organised by the PRC municipal government authority in Sichuan province whereby the Group is required to make contributions to the Scheme at the rate of 20% of the eligible employees' salaries. The local government authority is responsible for the entire pension obligations payable to retired employees.

The Group has no other material obligation for the payment of pension benefits associated with the Scheme beyond the annual contributions described above. The Group has no obligation for the payment of overseas pension benefits.

## 25 DEFERRED TAXATION

The components of deferred tax assets/(liabilities) recognised in the Group's balance sheet and the movements during the year are as follows:

| | Write down of Inventories RMB'000 | Provision for product warranty RMB'000 | *Insurance premium paid RMB'000 | Total RMB'000 |
|---|---|---|---|---|
| **Deferred tax arising from:** | | | | |
| At 1 January 2006 | 2,454 | 496 | — | 2,950 |
| Credited/(charged) to the income statement (note 8(a)) | 5,642 | 4,496 | (4,259) | 5,879 |
| At 31 December 2006 | 8,096 | 4,992 | (4,259) | 8,829 |
| At 1 January 2007 | **8,096** | **4,992** | **(4,259)** | **8,829** |
| Charged to the income statement (note 8(a)) | **—** | **(1,251)** | **—** | **(1,251)** |
| Exchange difference | **—** | **—** | **276** | **276** |
| At 31 December 2007 | **8,096** | **3,741** | **(3,983)** | **7,854** |

* Insurance premium paid will be refunded under the terms as set forth in the insurance contract. The refund received is subject to US income tax and therefore, the related tax effect is treated as a deferred tax liability.

## 25 DEFERRED TAXATION (continued)

| | The Group | |
|---|---|---|
| | **2007** | 2006 |
| | **RMB'000** | RMB'000 |
| Deferred tax assets recognised on the balance sheet | **11,837** | 13,088 |
| Deferred tax liabilities recognised on the balance sheet | **(3,983)** | (4,259) |
| | **7,854** | 8,829 |

## 26 INVESTMENT IN A SUBSIDIARY

| | **2007** |
|---|---|
| | **RMB'000** |
| Unlisted shares at cost | **233,155** |

# Notes to the Financial Statements

(Expressed in Renminbi)

## 26 INVESTMENT IN A SUBSIDIARY (continued)

Details of the subsidiaries at 31 December 2007 are set out below:

| Name of the Company | Place of incorporation/ establishment and operation | Issued and fully paid-up/ registered capital | Attributable equity interest Direct | Attributable equity interest Indirect | Principal activities |
|---|---|---|---|---|---|
| Asia Harbour (宏海國際有限公司) (note i) | Hong Kong | HK$1 | 100% | — | Investment holding |
| Honghua Company (四川宏華石油設備有限公司) (notes i, ii) | The PRC | RMB72,000,000 | — | 100% | Manufacturing of Petroleum equipment |
| Hongtian Company (成都宏天電傳工程有限公司) (notes i, ii) | The PRC | RMB7,000,000 | — | 80% | Manufacturing of panel of drilling rig |
| Youxin Company (四川宏華友信石油機械有限公司) (notes i, ii) | The PRC | RMB5,880,000 | — | 80% | Manufacturing of parts of drilling rig |
| Honghua International (四川宏華國際科貿有限公司) (notes i, ii) | The PRC | RMB3,200,000 | — | 80% | Trading of drilling rigs and related parts |
| Honghua America | United States of America | US$800,000 | — | 80% | Trading of drilling rigs and related parts |
| Golden Coast Company (宏華金海岸設備有限公司) (note i) | United Arab Emirates | AED1,000,000 | — | 80% | Trading of drilling rigs and related parts |
| Lucky Wish International Ltd. ("Lucky Wish") (note i) (泓運國際有限公司) (note i) | British Virgin Islands | US$1 | — | 80% | Trading of parts of drilling rigs |

## 26 INVESTMENT IN A SUBSIDIARY (continued)

(i) These entities are limited liability companies.

(ii) The official names of these companies are in Chinese. The English translation of the Company names is for reference only.

## 27 AMOUNT DUE FROM A SUBSIDIARY

The amount due from a subsidiary is unsecured, interest-free and has no fixed repayment terms.

## 28 INTEREST IN A JOINTLY CONTROLLED ENTITY

| | The Group | |
|---|---|---|
| | **2007** | 2006 |
| | **RMB'000** | RMB'000 |
| Share of net assets | **6,006** | — |

Details of the Group's interest in the jointly controlled entity are as follows:

| Name of company | Place and date of establishment | Issued and fully paid-up/ registered capital | Proportion of ownership interest: Group's effective interest | Held by the Company | Held by a subsidiary | Principal activities |
|---|---|---|---|---|---|---|
| Egyptian Petroleum Honghua Rig Manufacturing Shareholder Co. ("HH Egyptian Company") | Egypt 24 April 2007 | US$12,000,000 | 50% | — | 50% | Manufacture and sale of drilling rig, parts and components |

# Notes to the Financial Statements

(Expressed in Renminbi)

## 28 INTEREST IN A JOINTLY CONTROLLED ENTITY (continued)

**Summary financial information on the jointly controlled entity — group's effective interest**

| | The Group | |
|---|---|---|
| | **2007** | 2006 |
| | **RMB'000** | RMB'000 |
| Non-current assets | **18,224** | — |
| Current assets | **99,437** | — |
| Current liabilities | **(16,508)** | — |
| Non-current liabilities | **(95,147)** | — |
| | **6,006** | — |
| Income | **47,264** | — |
| Expenses | **(40,796)** | — |
| Profits for the year | **6,468** | — |

## 29 SHARE CAPITAL

**(a)** Details of the movements in capital of the Company are set out on pages 64.

## 29 SHARE CAPITAL (continued)

### (b) Authorised and issued share capital

| | 2007 | |
|---|---|---|
| | Number of shares | '000 |
| **Authorised:** | | |
| Ordinary shares of HK$0.1 each | 10,000,000,000 | HK$1,000,000 |
| Equivalent to: | | RMB968,739 |
| | | RMB'000 |
| **Ordinary shares, issued and fully paid:** | | |
| At 15 June | 1 | – |
| Arising from the reorganisation | 2,499,999,999 | 233,155 |
| At 31 December | 2,500,000,000 | 233,155 |

The Company was incorporated in the Cayman Islands on 15 June 2007 with an authorised share capital of 3,800,000 shares of HK$0.1 each. One share of HK$0.1 was issued nil paid and allotted to Reid Services Limited and was transferred to Ally Giant on the same day.

On 16 October 2007, a shareholder's resolution was passed to increase the authorised share capital of the Company, from HK$380,000, divided into 3,800,000 ordinary shares, with a par value of HK$0.10, to HK$1,000,000,000, divided into 10,000,000,000 ordinary shares with par value of HK$0.10.

Pursuant to a group reorganisation, on 16 October 2007, the Company entered into a sale and purchase agreement with, Ally Giant, under which agreement the Company acquired one ordinary share (at par value of HK$1.00) of Asia Harbour (being Asia Harbour's entire issued share capital) from Ally Giant. The acquisition was satisfied by (i) crediting as fully paid the aggregate 1 nil paid share in the issued share capital of the Company; and (ii) allotting and issuing 2,499,999,999 fully paid up shares to Ally Giant.

Share capital in the Group's balance sheet as at 31 December 2006 represents the issued capital of Asia Harbour comprising 1 share of HK$1 each. Share capital in the Group's balance sheet as at 31 December 2007 represents the issued capital of the Company, comprising 2,500,000,000 shares of HK$0.1 each.

# Notes to the Financial Statements

(Expressed in Renminbi)

## 29 SHARE CAPITAL (continued)

### (c) Capital reduction

On 7 January 2006, a shareholders' resolution was passed to reduce the registered capital of Honghua Company from RMB21,011,100 to RMB13,944,485. Further to the said shareholders' resolution, Honghua Company entered into an equity repurchase agreement with all the shareholders (the 11 individual shareholders), on 12 January 2006, pursuant to which Honghua Company repurchased all equity interests held by these shareholders at a consideration of RMB55,203,000 which was determined with reference to a valuer's report of the net asset value of Honghua Company as of 30 June 2005, issued by Beijing Zhongkehua Certified Public Accountants Co., Ltd (北京中科華會計師事務所有限公司) plus a premium of approximately 57.27%.

On 25 April 2006, shareholders' resolutions were passed to reduce the registered capital of Honghua Company, from RMB13,944,485 to RMB8,070,305, to further consolidate the control and ownership in Honghua Company by Zhang Mi and 22 other individual shareholders, namely Ren Jie, Liu Zhi, Zheng Yong, Zuo Huixian, Zhang Xu, Wang Jiangyang, Chen Jun, Fan Bing, Zhang Yanyong, Ao Pei, Tian Diyong, Shen Dingjian, Liu Xuetian (deceased), Zhou Bing, Lu Lan, Tian Yu, Li Hanqiang, Liu Yingguo, Liu Lulu, He Guangfu, Zhang Zongyou and Chen Zongliang, pursuant to which they formed the Concert Group. Further to the said shareholders' resolution, Honghua Company entered into an equity buy-out agreement with Huasheng Oil Company, Deng Meng and Yuan Guiqi, on 22 May 2006, pursuant to which Honghua Company repurchased all of the equity interests held by Huasheng Oil Company, Deng Meng and Yuan Guiqi (i.e., approximately 24.615%, 8.755% and 8.755% equity interests, respectively) in Honghua Company, at a consideration of RMB31,928,000, which was determined with reference to a valuation report of the net asset value of Honghua Company as of 31 March 2006, issued by Beijing Zhongkehua Certified Public Accountants Co., Ltd (北京中科華會計師事務所有限公司).

The difference between the share capital redeemed and the consideration was debited to the retained profits and statutory reserve.

### (d) Capital injection

On 17 August 2006, the equity holders of Honghua Company injected capital totalling RMB10,680,000 to Honghua Company. The capital was issued at a consideration of RMB40,150,000. The difference between the consideration and capital injected was included as share premium.

## 29 SHARE CAPITAL (continued)

### (e) Reorganisation

(i) On 15 September 2006, Asia Harbour acquired all the capital of Honghua Company from the controlling shareholders at a consideration of RMB154,758,000. The difference between the historical carrying value of the shares acquired and the acquisition consideration is treated as an equity movement, and recorded in "Other reserve".

On the even date, Asia Harbour injected capital amounting to RMB53,250,000 to Honghua Company. The capital was issued at par.

As a result of the acquisition, Honghua Company became a wholly-owned subsidiary of Asia Harbour. Accordingly, this was reflected as a reduction of capital in the statement of changes in equity for the year ended 31 December 2006.

(ii) The Company acquired the entire interest of the subsidiaries, including Asia Harbour and Honghua Company and became the holding company on 16 October 2007 (see note 29(b)).

## 30 RESERVES

### (a) Statutory reserve

Pursuant to applicable PRC regulations, PRC entity is required to appropriate 5% of its profit after tax (after offsetting prior year losses) to the reserve until such reserve reaches 50% of the registered capital. The transfer to the reserve must be made before distribution of dividends to shareholders. The statutory reserve can be utilised, upon approval by the relevant authorities, to offset accumulated losses or to increase registered capital of the PRC subsidiaries, provided that the balance after such issue is not less than 50% of its registered capital.

### (b) Exchange reserve

The exchange reserve comprises all foreign exchange differences arising from the translation of the financial statements of operations outside the PRC which are dealt with in accordance with the accounting policies as set out in note 3(t).

### (c) Distributable reserve

The aggregate amount of distributable reserves at 31 December 2007 of the companies comprising the Group was RMB886,974,000 (2006: RMB319,158,000).

# Notes to the Financial Statements

(Expressed in Renminbi)

## 30 RESERVES (continued)

### (d) Other reserve

The other reserve of the Group comprises the difference between the nominal value of share of the subsidiaries acquired over the nominal value of the shares issued by the Company in exchange therefore and the contribution of technology licenses by Ally Giant.

(i) On 16 July 2006, the Group acquired additional equity interest from the minority equity holders of Honghua International, a company under common control by the controlling shareholders, for RMB7,045,000. The difference between the carrying value and acquisition consideration is treated as an equity movement and recorded in "Other reserve".

(ii) On 18 July 2006, Honghua Company acquired a 80% equity interest of each of Hongtian Company and Youxin Company legally became subsidiaries of the Group. The relevant assets and liabilities acquired by the Group have been recognised at historical cost. The difference between the historical carrying value of the shares acquired and the acquisition consideration is treated as an equity movement, and recorded in "Other reserve".

(iii) On 17 October 2007, the immediate holding company of the Company, Ally Giant, contributed several technology licences amounting to US$52,768,000 (equivalent to RMB389,691,000) to the Company. The amount is recorded in "Other reserve".

(iv) Pursuant to a group reorganisation, on 16 October 2007, the Company entered into a sale and purchase agreement with Ally Giant, under which agreement the Company acquired one ordinary share (at par value of HK$1.00) of Asia Harbour from Ally Giant. The difference between the historical carrying value of the share acquired and the consideration (see note 29(b)) is recorded in "Other reserve".

### (e) The Company

| | Other reserve RMB'000 | Accumulated losses RMB'000 | Total RMB'000 |
|---|---|---|---|
| At 15 June 2007 | — | — | — |
| Loss for the period | — | (2,471) | (2,471) |
| Arising from reorganisation (note 30(d)(iii)) | 389,691 | — | 389,691 |
| At 31 December 2007 | 389,691 | (2,471) | 387,220 |

## 31 FINANCIAL INSTRUMENTS

Exposure to credit, liquidity, interest rate, currency and business risks arises in the normal course of the Group's business. These risks are limited by the Group's financial management policies and practices described below.

### (a) Credit risk

The Group's credit risk is primarily attributable to trade and other receivables. Management has a credit policy in place and the exposures to these credit risks are monitored on an ongoing basis.

The Group's exposure to credit risk is influenced mainly by the individual characteristics of each customer. The management of the Company has established a credit policy under which credit evaluations are performed on all customers requiring credit. These receivables are due within 30 to 90 days from the date of billing. Debtors with balance that are more than 24 months overdue are requested to settle all outstanding balances before any further credit is granted. Normally, the Group does not obtain collateral from customers.

At 31 December 2007, the Group has a certain concentration of credit risk as 63% (2006: 76%) of the total trade receivables was due from the Group's top five largest customers.

The maximum exposure to credit risk is represented by the carrying amount of each financial asset in the balance sheet after deducting any impairment allowance. The Group does not provide any guarantees which would expose the Group to credit risk.

Further quantitative disclosures in respect of the Group's exposure to credit risk arising from trade and other receivable are set out in note 18.

### (b) Liquidity risk

Individual operating entities within the Group are responsible for their own cash management, including the short term investment of cash surplus and the raising of loans to cover expected cash demands, subject to approval by the Company's management when the borrowings exceed certain predetermined levels of authority.

The Group's policy is to regularly monitor current and expected liquidity requirements and its compliance with lending covenants, to ensure that it maintains sufficient reserves of cash and adequate committed lines of funding from major financial institutions to meet its liquidity requirements in the short and longer term.

# Notes to the Financial Statements

(Expressed in Renminbi)

## 31 FINANCIAL INSTRUMENTS (continued)

### (b) Liquidity risk (continued)

The following table details the remaining contractual maturities at the balance sheet date during which contractual payments, presented on an undiscounted basis, are due to be made. These payments include, among others, interest payments computed using contractual rates under the Group's non-derivative financial liabilities which are due to be paid.

| | 2007 | | | | 2006 | | | |
|---|---|---|---|---|---|---|---|---|
| | Carrying amount | Total contractual undiscounted cash flow | Within 1 year or on demand | More than 1 year | Carrying amount | Total contractual undiscounted cash flow | Within 1 year or on demand | More than 1 year |
| | RMB'000 | RMB'000 | RMB'000 | RMB'000 | RMB'000 | RMB'000 | RMB'000 | RMB'000 |
| Trade and other payables | 1,136,892 | (1,136,892) | (1,136,892) | – | 1,091,647 | (1,091,647) | (1,091,647) | – |
| Interest-bearing borrowings | 871,762 | (895,713) | (877,576) | (18,137) | 366,299 | (393,698) | (370,806) | (22,892) |
| Amounts due to related companies | 46,490 | (46,490) | (46,490) | – | 54,859 | (54,859) | (54,859) | – |
| Loan from ultimate holding company | 405,488 | (405,488) | (405,488) | – | 262,656 | (262,656) | (262,656) | – |
| Loan from shareholders of the holding company | 76,850 | (76,850) | (76,850) | – | – | – | – | – |
| | 2,537,482 | (2,561,433) | (2,543,296) | (18,137) | 1,775,461 | (1,802,860) | (1,779,968) | (22,892) |

### (c) Interest rate risk

The interest rates and maturity information of the Group's bank loans and loans from a financial institution are disclosed in note 22. The Group's policy is to manage its interest rate risk to ensure there are no undue exposures to significant interest rate movements. The Group does not use derivative financial instruments to hedge its fixed rate debt obligations.

The Group has interest-bearing assets carrying at floating rate as set out in the table below. All of the interest-bearing borrowing of the Group are fixed rate instruments and are insensitive to any change in market interest rates. The net exposure subject to the interest rate risk is not material and management does not expect the increase in interest rates at the balance sheet date would significantly affect profit or loss.

## 31 FINANCIAL INSTRUMENTS (continued)

### (c) Interest rate risk (continued)

***Effective interest rates and repricing analysis***

In respect of income-earning financial assets and interest-bearing borrowings, the following table indicates their effective interest rates at the balance sheet date and the periods in which they reprice or the maturity date, if earlier.

| | Year ended 31 December 2006 | | | |
|---|---|---|---|---|
| | Effective interest rate | Total RMB'000 | Within one year RMB'000 | More than one year and less than five years RMB'000 |
| *Repricing date for assets which reprice before maturity* | | | | |
| Restricted bank deposit | 0.72%–2.50% | 107,875 | 107,875 | — |
| Pledged bank deposits | 2.02%–2.27% | 67,746 | 67,746 | — |
| Cash and cash equivalents | 0.72%–1.15% | 158,351 | 158,351 | — |
| | | 333,972 | 333,972 | — |
| *Liabilities which do not reprice before maturity* | | | | |
| Interest-bearing borrowings | 5.28%–9.68% | 366,299 | 345,000 | 21,299 |

| | **Year ended 31 December 2007** | | | |
|---|---|---|---|---|
| | **Effective interest rate** | **Total RMB'000** | **Within one year RMB'000** | **More than one year and less than five years RMB'000** |
| *Repricing date for assets which reprice before maturity* | | | | |
| Pledged bank deposits | **0.72%–5.10%** | **261,109** | **261,109** | **—** |
| Cash and cash equivalents | **0.10%–3.20%** | **195,367** | **195,367** | **—** |
| *Liabilities which do not reprice before maturity* | | | | |
| Interest-bearing borrowings | **5.30%–9.25%** | **871,762** | **856,059** | **15,703** |

# Notes to the Financial Statements

(Expressed in Renminbi)

## 31 FINANCIAL INSTRUMENTS (continued)

### (d) Foreign currency risk

The Group is exposed to foreign currency risk through sales and purchases that are denominated in United States Dollars ("US$"). The movements of US$ will affect the revenue and costs of some production materials, spare parts and equipment purchases. The Group minimises the currency risk by requesting deposits from customers and converting most of these deposits into RMB.

The Group's investments in certain companies incorporated outside the PRC also expose the Group to foreign currency risk resulting from fluctuation of US$.

RMB is not freely convertible into foreign currencies. All foreign exchange transactions involving RMB must take place through the People's Bank of China or other institutions authorised to buy and sell foreign currencies. The exchange rates adopted for the foreign exchange transactions are the rates of exchange quoted by the People's Bank of China that are determined largely by supply and demand.

In addition, an appreciation of RMB against US$ may have the effect of rendering exports from the Group in the PRC more expensive and less competitive than products from other countries.

The following table details the Group's exposure at the balance sheet date to currency risk arising from recognised assets or liabilities denominated in a currency other than the functional currency of the entity to which they relate.

| | The Group | | | |
|---|---|---|---|---|
| | **2007** | | | 2006 |
| | **US$'000** | **EURO'000** | **United Arab Emirates Dirham ("AED")'000** | US$'000 |
| Cash and cash equivalents | **7,084** | **276** | **295** | 8,350 |
| Trade and other receivables | **107,456** | **611** | **138** | 43,031 |
| Interest-bearing borrowings | **(2,153)** | **—** | **—** | (1,750) |
| Trade and other payables | **(18,534)** | **—** | **(172)** | (15,952) |
| Overall net exposure | **93,853** | **887** | **261** | 33,679 |

## 31 FINANCIAL INSTRUMENTS (continued)

### (d) Foreign currency risk (continued)

***Sensitivity analysis***

A 5 percent (2006: 10 percent) strengthening of the RMB against the following currencies at 31 December 2007 would have (decreased)/increased profit by the amounts shown below. This analysis assumes that all other variables, in particular interest rates, remain constant. The analysis is performed on the same basis as the previous year.

| | The Group | |
|---|---|---|
| | **2007** | 2006 |
| | **RMB'000** | RMB'000 |
| **Effect on profit after tax and retained profits** | | |
| US$ | **(23,851)** | (23,221) |
| EURO | **(330)** | — |
| AED | **26** | — |
| | **(24,155)** | (23,221) |

A 5 percent (2006: 10 percent) weakening of the RMB against the above currencies at 31 December 2007 would have had the equal but opposite effect on the above currencies to the amounts shown above, on the basis that all other variables remain constant.

The sensitivity analysis has been determined assuming that the change in foreign exchange rates had occurred at the balance sheet date and had been applied to each of the Group entities' exposure to currency risk for non-derivative financial instruments in existence at that date, and that all other variables, in particular interest rates, remain constant.

The stated changes represent management's assessment of reasonably possible changes in foreign exchange rates over the period until the next annual balance sheet date.

### (e) Fair value

The carrying amounts of significant financial assets and liabilities approximate their respective fair values as at 31 December 2007.

## 31 FINANCIAL INSTRUMENTS (continued)

### (e) Fair value (continued)

The following methods and assumptions were used to estimate the fair value for each of following classes of financial assets and liabilities:

(i) Cash and cash equivalents, restricted bank deposit, pledged bank deposits, trade and other receivables and trade and other payables

The carrying values of these financial assets and liabilities approximate their fair value because of their short maturities.

(ii) Interest-bearing borrowings

The carrying amounts of interest-bearing borrowings approximate their fair value because the borrowing rates were similar to rates currently available for bank loans with similar terms and maturity.

(iii) The amounts due from/to related companies, loan from ultimate holding company and loan from shareholders are interest-free and have no fixed repayment terms. Given these terms, the directors believe that the carrying amounts approximate to their fair values.

### (f) Business risk

The Group's revenue is generated mainly from the sale of drilling rigs and related parts and components. The revenue from the sale of drilling rigs and related parts and components used in the oil and gas exploration and production industry is dependent on the exploration and development capital expenditures of oil and gas producers, which in turn is largely dependent on current prices of, and future trends in, global oil and gas prices. The demand for oil and gas exploration and development related services and the number of worldwide active rigs increase and decrease with fluctuations in the price of oil and gas. Given the Group's heavy reliance on customers in the oil and gas drilling industry, the Group's revenue could be highly sensitive to fluctuations in global oil and gas prices.

### (g) Capital management

The Group's policy is to maintain a strong capital base so as to maintain creditor and market confidence and to sustain future development of the business. The Group defines the capital of the Group as the total shareholders' equity.

Neither the Company, any of its subsidiaries nor the jointly controlled entity is subject to externally imposed capital requirements.

## 32 COMMITMENTS

### Capital commitments

Capital commitments outstanding at 31 December 2007 not provided for in the financial statements were as follows:

| | The Group | |
|---|---|---|
| | **2007** | 2006 |
| | **RMB'000** | RMB'000 |
| Contracted for | **133,828** | 293,275 |
| Authorised but not contracted for | **113,340** | 38,820 |
| | **247,168** | 332,095 |

## 33 MATERIAL RELATED PARTY TRANSACTIONS

In addition to the related party information disclosed elsewhere in the financial statements, the Group entered into the following material related party transactions.

**(a) During the year, the directors are of the view that the following companies are related parties of the Group:**

| Name of party | Relationship |
|---|---|
| Guanghan Hongtai Business Trading Co. Ltd（廣漢市宏泰商貿有限公司）("Hongtai Company") | Hongtai Company is a party which spouses of certain directors and management have equity interest. |
| Luzhou Changjiang Petroleum Engineering Equipment Co. Ltd（瀘州長江石油工程機械有限公司）("Luzhou Changjiang Company") | Luzhou Changjiang Company is a party which the which the father-in-law of a director, Mr. Zhang Mi, has equity interest. |
| Chengdu Haitaike Electric Motor System L.L.C（成都海泰科電氣傳動系統有限責任公司）("Haitaike Company") | Haitaike Company is a party which the brother of a director, Mr. Zhang Mi and a director of a subsidiary have equity interest. |

# Notes to the Financial Statements

(Expressed in Renminbi)

## 33 MATERIAL RELATED PARTY TRANSACTIONS (continued)

**(a) During the year, the directors are of the view that the following companies are related parties of the Group: (continued)**

| Name of party | Relationship |
|---|---|
| Luzhou Tuojiang Hydraulic Pressure Equipment Company Limited (瀘州沱江液壓件有限公司) ("Luzhou Tuojiang Company") | Luzhou Tuojiang Company is a party which the sister's husband of the spouse of a director, Mr. Zhang Mi, has equity interest. |
| NCE Management, Inc. | NCE Management, Inc is a party which certain management of Honghua America have equity interest. |
| Luzhou City Jianming Decorating Design Company (瀘州劍鳴裝飾設計有限公司) ("Luzhou Jianming Company") | Luzhou Jianming Company is a party which the brother of the spouse of a director of a subsidiary is the legal representative. |
| Guanghai Huite Fluid Appendix Co. Ltd. (廣漢市惠特液壓附件有限公司) ("Guanghan Huite Company") | Guanghan Huite Company is a party which the brother of a director of a subsidiary has equity interest. |
| Chengdu Juzhong Technology Co., Ltd. (成都巨中科技有限公司) ("Chengdu Juzhong Company") | Chengdu Juzhong Company is a party which the brother-in-law and brother-in-law's wife of a director of a subsidiary have equity interest. |
| Honghua — Ural Equipment Manufacture Joint Stock Co., Ltd (宏華 — 烏拉爾機械製造股份公司) ("Honghua — Ural") | Honghua — Ural is jointly owned by several directors and management of the Group's subsidiaries and Russian investors. The interest in Honghua — Ural of several directors and management was disposed of on 15 November 2007. |
| Izhdrill — Honghua Co., Ltd (伊日德利爾宏華股份有限公司) ("Izhdrill — Honghua") | Izhdrill — Honghua is a party which is owned by a senior management of a subsidiary and Russian investors. The interest in Izhdrill — Honghua of the senior management was disposal of on 11 October 2007. |
| HH Egyptian Company | HH Egyptian Company is incorporated in Egypt with limited liability on 24 April 2007 and is 50% owned by Asia Harbour. |

## 33 MATERIAL RELATED PARTY TRANSACTIONS (continued)

Particulars of significant transactions between the Group and the above related parties during the relevant period are as follows:

| | The Group | |
|---|---|---|
| | **2007** | 2006 |
| | **RMB'000** | RMB'000 |
| **Purchases of parts and components** | | |
| — Hongtai Company | **41,071** | 34,393 |
| — Luzhou Changjiang Company | **15,702** | 19,219 |
| — Haitaike Company | **43,419** | 32,507 |
| — Luzhou Tuojiang Company | **4,515** | 2,904 |
| — Chengdu Juzhong Company | **668** | 850 |
| | **105,375** | 89,873 |
| **Decoration service received** | | |
| — Luzhou Jianming Company | **674** | 898 |
| **Sub-contracting services received** | | |
| — Guanghan Huite Company | **1,045** | 1,266 |
| | **1,719** | 2,164 |
| **Sale of drilling rigs, parts and components** | | |
| — Honghua — Ural | **—** | 667 |
| — Hongtai Company | **45** | — |
| — HH Egyptian Company | **216,594** | — |

The directors of the Company are of the opinion that the above related party transactions were conducted on normal commercial terms and in the ordinary course of business.

# Notes to the Financial Statements

(Expressed in Renminbi)

## 33 MATERIAL RELATED PARTY TRANSACTIONS (continued)

### (b) Balances with related parties

As at the balance sheet date, the Group had the following balances with related parties:

| | The Group | |
|---|---|---|
| | **2007** | 2006 |
| | **RMB'000** | RMB'000 |
| **Amounts due from related companies** | | |
| — Hongtai Company | **—** | 1,960 |
| — NCE Management, Inc. | **—** | 38 |
| — Haitaike Company | **13,557** | — |
| — Chengdu Juzhong Company | **84** | — |
| — HH Egyptian Company | **27,157** | — |
| | **40,798** | 1,998 |
| Loans from ultimate holding company | **405,488** | 262,656 |
| Loans from shareholders of the holding company | **76,850** | — |
| **Amounts due to related companies** | | |
| — Hongtai Company | **9,694** | 9,516 |
| — Luzhou Changjiang Company | **12,903** | 3,374 |
| — Luzhou Tuojiang Company | **1,383** | 1,180 |
| — Haitaike Company | **19,280** | 25,025 |
| — Luzhou Jianming Company | **230** | — |
| — Guanghan Huite Company | **399** | — |
| — Honghua-Ural | **—** | 15,764 |
| — HH Egyptian Company | **2,601** | — |
| | **46,490** | 54,859 |

The balances with related parties are unsecured, interest-free and have no fixed repayment terms. There was no provision made against these amounts at 31 December 2007 (2006: Nil).

## 33 MATERIAL RELATED PARTY TRANSACTIONS (continued)

### (c) Key management personnel remuneration

Remuneration for key management personnel of the Group, including amounts paid to the Company's directors as disclosed in note 9 and certain of the key management personnel as disclosed in note 10, is as follows:

| | 2007<br>RMB'000 | 2006<br>RMB'000 |
|---|---|---|
| Basic salaries, allowances and other benefits in kind | 3,346 | 1,970 |
| Contributions to defined contribution retirement scheme | 67 | 39 |
| Discretionary bonuses | 5,103 | 2,195 |
| | 8,516 | 4,204 |

Total remuneration is included in "staff costs" (see note 7(b)).

## 34 IMMEDIATE AND ULTIMATE HOLDING COMPANY

The directors consider the immediate holding company and the ultimate holding company as at 31 December 2007 are Ally Giant and Ample Chance International Limited ("Ample Chance") respectively, which are incorporated in the British Virgin Islands. These entities do not produce financial statements available for public use.

## 35 SIGNIFICANT ACCOUNTING ESTIMATES AND JUDGEMENTS

Estimates and judgements are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

The selection of critical accounting policies, the judgements and other uncertainties affecting application of those policies and the sensitivity of reported results to changes in condition and assumptions are factors to be considered when reviewing the financial statements. The principal accounting policies are set forth in note 3. The Group believes the following critical accounting policies involve the most significant judgements and estimates used in the preparation of the financial statements.

# Notes to the Financial Statements

(Expressed in Renminbi)

## 35 SIGNIFICANT ACCOUNTING ESTIMATES AND JUDGEMENTS (continued)

### (a) Impairments

#### *(i) Impairment of trade and other receivables*

Trade and other receivables are reviewed periodically to assess whether impairment losses exist and if they exist, the amounts of the impairment losses are estimated based on historical loss experience for trade and other receivables with similar credit risk. The methodology and assumptions used in estimating future cash flows are reviewed regularly to reduce any difference between the loss estimates and actual amounts.

#### *(ii) Impairment of intangible assets, property, plant and equipment and interest in leasehold land held for own use under operating leases*

If circumstances indicate that the carrying value of intangible assets, property, plant and equipment and interest in leasehold land held for own use under operating leases may not be recoverable, these assets may be considered impaired, and an impairment loss may be recognised in accordance with IAS 36 "Impairment of Assets". The carrying amounts of these assets are reviewed periodically in order to assess whether the recoverable amounts have declined below the carrying amounts. These assets are tested for impairment whenever events or changes in circumstances indicate that their recorded carrying amounts may not be recoverable. When such a decline has occurred, the carrying amount is reduced to recoverable amount. The recoverable amount is the greater of the net selling prices and the value in use. It is difficult to estimate precisely selling prices because quoted market prices for the Group's assets are not readily available. In determining the value in use, expected cash flows generated by the asset are discounted to their present value, which requires significant judgement relating to revenue and amount of operating costs. The Group uses all readily available information in determining an amount that is a reasonable approximation of recoverable amount, including estimates based on reasonable and supportable assumptions and projections of revenue and amount of operating costs.

### (b) Write down of inventories

The Group determines the write-down for obsolescence of inventories. These estimates are made with reference to aged inventories analyses, projections of expected future saleability of goods and management experience and judgement. Based on this review, write down of inventories will be made when the carrying amounts of inventories decline below their estimated net realisable value. Due to changes in market conditions, actual saleability of goods may be different from estimation and profit or loss could be affected by differences in this estimation.

## 35 SIGNIFICANT ACCOUNTING ESTIMATES AND JUDGEMENTS (continued)

### (c) Depreciation and amortisation

Property, plant and equipment are depreciated on a straight-line basis over the estimated useful lives, after taking into account the estimated residual value. Intangible assets are amortised on a straight-line basis over the estimated useful lives. The Group reviews the estimated useful lives of the assets regularly in order to determine the amount of depreciation and amortisation expenses to be recorded during any reporting period. The useful lives are based on the Group's historical experience with similar assets and taking into account anticipated technological changes. The depreciation and amortisation expenses for future periods are adjusted if there are significant changes from previous estimates.

### (d) Warranty provision

The Group makes provisions under the warranties it gives on sale of its drilling rigs taking into account the Group's recent claim experience. Any increase or decrease in the provision would affect profit or loss in future years.

## 36 CONTINGENT LIABILITIES

### Dispute with 64 natural persons

As of 31 December 2005, 728 employees of Oil Drilling Plant (the 'original investors'), through 11 representatives, held collectively, 33.63% of Honghua Company's share capital. These 11 representatives were registered as shareholders of Honghua Company with the competent PRC government authority. On 7 January 2006, Honghua Company passed a shareholders' resolution to reduce its registered capital and buy-out equity interests from these 11 registered shareholders.

Honghua Company entered into a share purchase agreement with the 11 registered shareholders on 12 January 2006, under which, with the written consent of the 11 registered shareholders, it agreed to pay the share purchase price directly to the 728 original investors. The capital reduction process with the competent PRC government authority was completed on 26 April 2006. As of the Latest Practical Date, 664 of the 728 original investors have agreed to the buy-out arrangement and had accepted payment from Honghua Company. The remaining 64 investors, who, collectively, invested RMB651,385, claimed that they were still shareholders and refused to accept the buy-out arrangement and payment from Honghua Company.

# Notes to the Financial Statements

(Expressed in Renminbi)

## 36 CONTINGENT LIABILITIES (continued)

**Dispute with 64 natural persons** (continued)

On 11 December 2007, 57 out of the 64 initiated the legal proceedings at the Intermediate Peoples' Court of Chengdu City, Sichuan Province (Action No.: (2008) Cheng Min Chu Zi No. 53)). The 57 individuals joined as plaintiffs to the legal proceedings against Honghua Company as the 1st defendant, Asia Harbour as the 2nd defendant and 14 individuals including Shi Shuming (3rd defendant); Huang Dequan (4th defendant), Li Yan (5th defendant), Wang Yaoxin (6th defendant), Zhou Tao (7th defendant), Wang Wei (8th defendant), Chen Zhenghua (9th defendant), Yang Xuefeng (10th defendant), Yang Yuanchun (11th defendant), Ni Xiurong (12th defendant), Yu Zhenghua (13th defendant), Xing Manrong (14th defendant), Zhi Rongmu (15th defendant) and Liu Chuanjun (16th defendant) as the 3rd to 16th defendants. There are a total of 16 defendants.

The relief sought by the 57 plaintiffs include:

(1) An adjudication by the court that the 592,250 shares held by the 3rd to 16th defendants were actually owned by the 57 plaintiffs, and all the benefits and rights in such equity interests be restored to the 57 plaintiffs and the names of the 57 plaintiffs be entered into the register of members of Honghua Company;

(2) An adjudication by the court that Honghua Company be ordered to pay to the 57 plaintiffs a total sum of RMB296,125, being the 2003 dividends;

(3) An adjudication that the repurchase of the 592,250 shares of Honghua Company be declared null and void;

(4) An adjudication that Asia Harbour be jointly and severally liable for the above mentioned relief sought by the 57 plaintiffs and the consequential liabilities thereof, and that Asia Harbour together with Honghua Company be ordered to apply to the relevant Administration of Industry and Commerce to register the 57 plaintiffs as shareholders of Honghua Company; and

(5) An adjudication that all the defendants be jointly liable for the legal costs arising from these legal proceedings.

## 36 CONTINGENT LIABILITIES (continued)

**Dispute with 64 natural persons** (continued)

On 13 March 2008, Honghua Company received the Supplemental Statement on Amending, Adding and Waiving the Statement of Claims (the "Supplemental Statement") submitted by the 57 plaintiffs. The plaintiffs added the following new claims:

(a) An adjudication that the 1st defendant, 3rd to 16th defendants be jointly liable for the damages of shareholders' right and interests, calculated until the date when the judgment is executed in full, including shareholders' rights for 3,760,379 bonus shares calculated until 30 September 2007, pre-emptive rights, and dividend from 2004 to 2006 in a total amount of RMB1,510,237.50;

(b) An adjudication that the 1st defendant, 3rd to 16th defendants be jointly liable for the damages and costs of RMB228,000 incurred by the plaintiffs arising from these legal proceedings; and

(c) An adjudication that the merger and acquisition of Honghua Company by Asia Harbour be declared null and void and that Asia Harbour be jointly liable for all the claims against Honghua Company and other defendants.

Ally Giant, Ample Chance, Wealth Afflux Limited, Mowbray Worldwide Limited, Ecotech Enterprises Corporation, Otama Company Limited, Vast & Fast Corporation, Cavendish Global Corporation, Airtech Investments Limited, Ally Smooth Investments Limited, Charm Moral International Limited, Beauty Clear Holding Limited, Brondesbury Enterprises Limited, Oriental Starz Limited, Tech Express Enterprises Inc, Dobson Global Inc, Darius Enterprises Limited, Believe Power International Limited, Benefit Way International Limited, Birdview Limited and the shareholders of the above companies have executed a deed of indemnity in respect of dispute and risk dated 15 February 2008 in favour of the Group under which they agree to jointly and severally indemnify any members of the Group for any potential damages that the Company may suffer as a result of the legal proceedings initiated by the 57 plaintiffs.

The directors, based on the PRC legal advisor's opinion, considered that these 64 natural persons investors had never been properly registered as shareholders of Honghua Company with the competent PRC government authority, there is no legal basis under the PRC law for them to be regarded as shareholders of Honghua Company, and the directors consider that sufficient provision in legal costs in respect of the dispute has been made.

# Notes to the Financial Statements

(Expressed in Renminbi)

## 37 SUBSEQUENT EVENTS

### (a) Share option scheme

Pursuant to the written resolution of the shareholders of the Company passed on 21 January 2008, the Company has adopted the Pre-IPO Share Option Scheme and conditionally adopted the Share Option Scheme.

The amount payable by the grantee of an option to the Company on acceptance of the offer for the grant of an option is HK$1.00. The aggregate number of shares which may be issued upon exercise of all outstanding options granted and yet to be exercised under the Share Option Scheme and any other share option schemes of the Company must not exceed 30% of the share in issue from time to time.

The maximum number of shares which may be issued upon exercise of all options granted under the Pre-IPO Share Option Scheme is 125,000,000 shares and no options of the Pre-IPO Share Option Scheme would be granted after 7 March 2008.

For the Share Option Scheme, it is expected that the Company may grant options in respect of up to 333,336,000 shares (or such members of shares as shall result from a sub-division or a consolidation of such 333,336,000 share from time to time) to the participants under the Share Option Scheme. The options granted under the Pre-IPO Share Option Scheme and the Share Option Scheme are non-transferable.

### (b) Listing on the Main Board of the Stock Exchange

On 7 March 2008, the Company's shares were listed on the Main Board of the Stock Exchange following the completion of the public offer and placing of 833,360,000 shares of the Company dated 25 February 2008 with a gross proceed of HK$3,191,768,800.

(Expressed in Renminbi)

## 38 POSSIBLE IMPACT OF AMENDMENTS, NEW STANDARDS AND INTERPRETATIONS ISSUED BUT NOT YET EFFECTIVE FOR THE YEAR ENDED 31 DECEMBER 2007

Up to the date of issue of these financial statements, the IASB has issued a number of amendments, new standards and interpretations which are not yet effective for the year ended 31 December 2007 and which have not been adopted in these financial statements.

Of these developments, the following relate to matters that may be relevant to the Group's operations and financial statements:

| | | **Effective or available for early adoption for accounting periods beginning on or after** |
|---|---|---|
| Amendments to IFRS 2 | Share-based payment — Vesting conditions and cancellations | 1 January 2009 |
| Amendments to IAS 27 | Consolidated and separate financial statements | 1 July 2009 |
| IFRS 8 | Operating Segments | 1 January 2009 |
| IAS 1 (Revised) | Presentation of financial statement | 1 January 2009 |
| IAS 23 (revised) | Borrowing costs | 1 January 2009 |

The directors have confirmed that the Group is in the process of making an assessment of what the impact of these amendments, new standards and new interpretations is expected to be in the period of initial application. So far it has concluded that the adoption of them is unlikely to have a significant impact on the Group's results of operations and financial position.

# Four-Year Financial Highlights

| | **2007 RMB'000** | 2006 RMB'000 | 2005 RMB'000 | 2004 RMB'000 |
|---|---|---|---|---|
| **Consolidated Income Statement** | | | | |
| Revenue | **3,164,022** | 2,335,948 | 501,570 | 539,265 |
| Cost of sales | **(2,083,888)** | (1,558,121) | (392,993) | (440,028) |
| **Gross profit** | **1,080,134** | 777,827 | 108,577 | 99,237 |
| Other operating revenue | **22,999** | 4,620 | 3,187 | 2,214 |
| Other operating expenses | **(768)** | (917) | (648) | (572) |
| Selling expenses | **(210,319)** | (84,176) | (22,971) | (17,818) |
| General and administrative expenses | **(186,546)** | (110,185) | (42,436) | (29,039) |
| Other net income | **22,475** | 3,085 | 1,427 | 440 |
| **Profit from operations** | **727,975** | 590,254 | 47,136 | 54,462 |
| Net financing costs | **(49,927)** | (23,141) | (4,132) | (3,858) |
| Share of profits from a jointly controlled entity | **6,468** | | | |
| **Profit before taxation** | **684,516** | 567,113 | 43,004 | 50,604 |
| Income tax expenses | **(67,511)** | (103,203) | (10,749) | (10,488) |
| **Profit for the year** | **617,005** | 463,910 | 32,255 | 40,116 |
| Attributable to: | | | | |
| Equity shareholders of the Company | **583,235** | 412,814 | 18,454 | 32,168 |
| Minority interests | **33,770** | 51,096 | 13,801 | 7,948 |
| **Figures per share** | | | | |
| Basic earnings per share (RMB Cents) | **23.3** | 16.5 | 0.7 | 1.3 |
| Dividends declared during the year | **—** | 19,533 | 1,638 | 2,164 |

| | **2007 RMB'000** | 2006 RMB'000 | 2005 RMB'000 | 2004 RMB'000 |
|---|---|---|---|---|
| **Consolidated Balance Sheet** | | | | |
| Total non-current assets | **794,951** | 286,659 | 146,634 | 77,713 |
| Total current assets | **3,136,002** | 1,895,735 | 1,022,722 | 306,125 |
| Total assets | **3,930,953** | 2,182,394 | 1,169,356 | 383,838 |
| Total current liabilities | **2,555,556** | 1,818,785 | 1,024,510 | 277,307 |
| Total non-current liabilities | **19,686** | 25,558 | — | — |
| Total liabilities | **2,575,242** | 1,844,343 | 1,024,510 | 277,307 |
| Total equity | **1,355,711** | 338,051 | 144,846 | 106,531 |

# Four-Year Financial Highlights

| | **2007** | 2006 | 2005 | 2004 |
|---|---|---|---|---|
| Profitability | | | | |
| Gross Margin | **34.1%** | 33.3% | 21.6% | 18.4% |
| EBITDA Margin | **24.0%** | 25.9% | 11.1% | 11.0% |
| Net Margin | **18.4%** | 17.7% | 3.7% | 6.0% |
| Return | | | | |
| Return on Average Equity | **73.3%** | 203.9% | 19.9% | N/A |
| Return on Average Asset | **19.1%** | 24.6% | 2.4% | N/A |
| Liquidity | | | | |
| Current Ratio | **1.23** | 1.04 | 1.00 | 1.10 |
| Quick Ratio | **0.82** | 0.66 | 0.71 | 0.81 |
| Turnover | | | | |
| Turnover of average trade and bill receivables | **101** | 59 | 117 | 93 |
| Turnover of average trade and bill payables | **107** | 81 | 154 | 81 |
| Turnover of average inventory | **151** | 116 | 176 | 66 |
| Gearing | | | | |
| Total Debt/Total Asset | **22.2%** | 16.8% | 2.7% | 14.3% |
| EBIT/Interest Expense | **18.7** | 64.6 | 21.3 | 13.3 |

Note:

**Profitability**

| | | |
|---|---|---|
| Gross Margin | = | Gross Profit/Revenue |
| EBITDA | = | Profit From Operations + Share of profits from a jointly controlled Entity + Depreciation + Amortisation |
| EBITDA Margin | = | EBITDA/Revenue |
| Net Margin | = | Profit Attributable to Equity Shareholders of the Company/Revenue |

**Return**

| | | |
|---|---|---|
| Return on Average Asset | = | Profit Attributable to Equity Shareholders of the Company/Average Assets |
| Return on Average Equity | = | Profit Attributable to Equity Shareholders of the Company/Average Equity Attributable to Equity Shareholders of the Company |

**Liquidity**

| | | |
|---|---|---|
| Current Ratio | = | Current Asset/Current Liability |
| Quick Ratio | = | (Current Asset-Inventory)/Current Liability |

**Turnover**

| | | |
|---|---|---|
| Turnover of average trade and bill receivables | = | 365.25*Average Trade and Bill Receivables/Revenue |
| Turnover of average trade and bill payables | = | 365.25*Average Trade and Bill Payables/Cost of Sales |
| Turnover of average inventory | = | 365.25*Average Inventory/Cost of Sales |

**Gearing**

| | | |
|---|---|---|
| Total Debt/Total Asset | = | (Long Term Interest-bearing Loan + Short Term Interest-bearing Loan)/Total Assets |
| **EBIT/Interest Expense** | = | ( Profit From Operations + Share of Profits from a jointly controlled Entity)/Interest Expenses |

# Definitions

| | |
|---|---|
| "Ally Smooth" | Ally Smooth Investments Limited (聯順投資有限公司), a company incorporated in the BVI with limited liability on July 5, 2006 |
| "Ample Chance" | Ample Chance International Limited (宏機國際有限公司), a company incorporated in the BVI with limited liability on July 13, 2006 |
| "Articles of Association" | the Articles of Association of the Company, approved at extraordinary shareholders' meetings of the Company on January 21, 2008 |
| "Asia Harbour" | Asia Harbour International Limited (宏海國際有限公司), a company incorporated in Hong Kong with limited liability on July 8, 2006 and a wholly-owned subsidiary of the Company |
| "Beauty Clear" | Beauty Clear Holdings Limited (俊朗控股有限公司), a company incorporated in the BVI with limited liability on July 21, 2006 |
| "Believe Power" | Believe Power International Limited (信力國際有限公司), a company incorporated in the BVI with limited liability on July 21, 2006 |
| "Benefit Way" | Benefit Way International Limited (益通國際有限公司), a company incorporated in the BVI with limited liability on July 7, 2006 |
| "Board of Directors" or "Board" | the Board of Directors of our Company |
| "BVI" | the British Virgin Islands |
| "Cayman Companies Law" | the Companies Law (2007 Revision) of the Cayman Islands |
| "Charm Moral" | Charm Moral International Limited (德美國際有限公司), a company incorporated in the BVI with limited liability on July 18, 2006 |
| "CNOOC" | China National Offshore Oil Corporation (中國海洋石油總公司), a state-owned enterprise established in the PRC on February 15, 1982 |
| "CNOOC Group" | CNOOC and its subsidiaries |
| "Companies Ordinance" | the Companies Ordinance (Chapter 32 of the Laws of Hong Kong) |

# Definitions

| | |
|---|---|
| "Company" or "our Company" | Honghua Group Limited, (宏華集團有限公司) an exempted company incorporated in the Cayman Islands with limited liability on June 15, 2007 |
| "Concert Group" | several shareholders of Honghua Company forming a concert group as set out in the "Company History and Reorganisation-Ownership Continuity and Control" section of this Prospectus, namely, Zhang Mi (張弭), Ren Jie (任杰), Liu Zhi (劉智), Zheng Yong (鄭勇), Zuo Huixian (左輝先), Zhang Xu (張旭), Wang Jiangyang (王江陽), Chen Jun (陳俊), Fan Bing (范兵), Zhang Yanyong (張彥永), Ao Pei (敖沛), Tian Diyong (田弟勇), Shen Dingjian (沈定建), Liu Xuetian (劉學田) (deceased), Zhou Bing (周兵), Lu Lan (呂蘭), Tian Yu (田雨), Li Hanqiang (李漢強), Liu Yingguo (劉映國), Liu Lulu (劉露璐), He Guangfu (何光福), Zhang Zongyou (張宗友) and Chen Zongliang (陳宗良), out of which He Guangfu (何光福), Zhang Zongyou (張宗友) and Chen Zongliang (陳宗良) transferred an aggregate of approximately 9.132% equity interests in Honghua Company to the other members of the Concert Group. The transfers were completed on February 17,2006 |
| "Controlling Shareholder(s)" | has the meaning ascribed thereto under the Listing Rules being, for the time being, Ally Giant, Ample Chance, Ally Smooth, Charm Moral, Beauty Clear, Believe Power, Benefit Way, Wealth Afflux Limited, Mowbray Worldwide Limited, Ecotech Enterprises Corporation, Vast & Fast Corporation, Cavendish Global Corporation, Brondesbury Enterprises Limited, Dobson Global Inc, Darius Enterprises Limited, Zhang Mi (張弭), Ren Jie (任杰), Liu Zhi (劉智), Zheng Yong (鄭勇), Zuo Huixian (左輝先), Zhang Xu (張旭), Wang Jiangyang (王江陽), Chen Jun (陳俊), Fan Bing (范兵), Zhang Yanyong (張彥永), Ao Pei (敖沛), Tian Diyong (田弟勇), Shen Dingjian (沈定建), Liu Xuetian (劉學田) (deceased), Zhou Bing (周兵), Lu Lan (呂蘭), Tian Yu (田雨), Li Hanqiang (李漢強), Liu Yingguo (劉映國) and Liu Lulu (劉露璐). Contracts executed by the Controlling Shareholders after Liu Xuetian's death were executed by his legal successors |
| "COOS" | China Ocean Oilfields Services (Hong Kong) Limited (中國近海石油服務(香港)有限公司), a company incorporated in Hong Kong with limited liability on April 2, 1982 |
| "CNPC" | China National Petroleum Corporation (中國石油天然氣集團公司) |

# Definitions

| | |
|---|---|
| "Great Wall" | Great Wall Drilling Company (中油長城鑽井有限責任公司), a subsidiary of CNPC |
| "Golden Coast Company" | Honghua Golden Coast Equipment FZE (宏華金海岸設備有限公司), formerly known as Golden Coast Equipment FZE (金海岸設備公司), a company incorporated in the United Arab Emirates with limited liability on November 28, 2006 and a wholly-owned subsidiary of Honghua International |
| "Group" or "we" or "us" | the Company and its subsidiaries, and, for the period before the Company became the holding company for such subsidiaries, the entities which carried on the business of the Group |
| "HH Egyptian Company" | Egyptian Petroleum HH Rig Manufacturing Shareholder Co., a company incorporated in Egypt with limited liability on April 24, 2007 and a 50%-owned subsidiary of Asia Harbour |
| "HK$" or "HK dollars" | Hong Kong dollars, the lawful currency of Hong Kong |
| "Honghua America" | Honghua America, LLC, formerly known as New Continental Equipment Co., LLC and as New Continental Equipment Co., Ltd, a limited partnership formed in the State of Texas on October 11, 2004, and converted into a limited liability company on December 19, 2006, and a 80%-owned subsidiary of Honghua Company |
| "Honghua Company" | Sichuan Honghua Petroleum Equipment Co., Ltd. (四川宏華石油設備有限公司), formerly known as Chuanyou Guanghan Honghua Co., Ltd. (川油廣漢宏華有限公司), a limited liability company established in the PRC on December 31, 1997,and a wholly-owned subsidiary of Asia Harbour |
| "Honghua Industrial" | Chuanyou Guanghan Honghua Industrial Development Company (川油廣漢宏華實業開發公司), a collectively-owned enterprise established in the PRC on June 17, 1993 |
| "Honghua International" | Honghua International Co., Ltd. (四川宏華國際科貿有限公司), formerly known as Sichuan Honghua Trading Co., Ltd. (田川宏華貿易有限公司), a limited liability company established in the PRC on January 13, 2004, and an 80%-owned subsidiary of Honghua Company |

# Definitions

| | |
|---|---|
| "Hong Kong" or "HK" | the Hong Kong Special Administrative Region of the PRC |
| "Hongtai Company" | Guanghan Hongtai Business Trading Co., Ltd (廣漢市宏泰商貿有限公司), a limited liability company established in the PRC on June 21, 2002 |
| "Hongtian Company" | Chengdu Hongtian Electronic Drive Engineering Co., Ltd. (成都宏天電傳工程有限公司), a limited liability company established in the PRC on June 6, 2001, and an 80%-owned subsidiary of Honghua Company |
| "Listing Rules" | the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (as amended from time to time) |
| "Lucky Wish" | Lucky Wish International Limited, a company incorporated in the BVI with limited liability on February 2, 2005 and wholly-owned by Liu Zhi on trust for Honghua International |
| "Nabors Global" | Nabors Global Holdings Limited, an exempted company organized under the laws of Bermuda on February 25, 2005 |
| "Nabors Group" | Nabors Industries and its subsidiaries |
| "Nabors Industries" | Nabors Industries Ltd., an exempted company organized under the laws of Bermuda on December 11, 2001, whose shares are listed on the New York Stock Exchange |
| "Nabors International" | Nabors Drilling International II Limited, an exempted company organized under the laws of Bermuda on March 12, 2003 |
| "Nabors Management" | Nabors International Management Limited, an exempted company organized under the laws of Bermuda on December 23, 2004 |
| "National Bureau of Statistics" | National Bureau of Statistics of the PRC (中國國家統計局) |
| "PetroChina" | PetroChina Company Limited (中國石油天然氣股份有限公司) |
| PRC" or "China" | the People's Republic of China and, except where the context requires and only for the purpose of this Prospectus, references in this Prospectus to the PRC or China do not apply to Taiwan or the Hong Kong and Macau Special Administrative Regions |

# Definitions

| | |
|---|---|
| "RMB" or "Renminbi" | Renminbi, the lawful currency of the PRC |
| "Russia" | The Russian Federation |
| "SAFE" | the PRC State Administration of Foreign Exchange (國家外滙管理局) |
| "Securities and Futures Commission" or "SFC" | the Securities and Futures Commission of Hong Kong |
| "SFO" | the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong) |
| "Share(s)" | ordinary shares issued by the Company, with a nominal value of HK$0.10 each |
| "Shareholder(s)" | holder(s) of our Share(s) |
| "Sinopec" | China Petroleum & Chemical Corporation (中國石油化工股份有限公司) |
| "sq.m." | square meters |
| "Stock Exchange" | The Stock Exchange of Hong Kong Limited |
| "Substantial Shareholder(s)" | has the meaning ascribed to it under the Listing Rules |
| "UAE" | the United Arab Emirates |
| "United Kingdom" or "UK" | the United Kingdom of Great Britain and Northern Ireland |
| "United States", "USA" or "U.S." | the United States of America, including its territories and possessions |
| "US$" or "U.S. dollars" or "USD" | United States dollars, the lawful currency of the United States |
| "Youxin Company" | Sichuan Honghua Youxin Petroleum Machinery Co., Ltd. (四川宏華友信石油機械有限公司), formerly known as Guanghan Youxin Co., Ltd. (廣漢市友信有限責任公司), a limited liability company established in the PRC on August 7, 1998, and an 80%- owned subsidiary of Honghua Company |