



Wafer Systems Limited

威發系統有限公司*

(Incorporated in the Cayman Islands with limited liability)

(Stock Code: 8198)

INTERIM REPORT FOR THE SIX MONTHS ENDED 30 JUNE 2004

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As at the date of this report, the executive director of the Company is Mr. Chan Sek Keung, Ringo, the non-executive directors are Ms. Clara Ho, Mr. Alasdair Gordon Nagle and Mr. Kwan Kit Tong and the independent non-executive directors are Mr. Pang Hing Chung, Alfred and Mr. Tsoi Tai Wai, David.

This report, for which the directors (the “Directors”) of Wafer Systems Limited (the “Company”) collectively and individually accept full responsibility, includes particulars given in compliance with the Rules Governing the Listing of Securities on GEM (the “GEM Listing Rules”) for the purpose of giving information with regard to the Company. The Directors, having made all responsible enquiries, confirm that, to the best of their knowledge and belief: (i) the information contained in this report is accurate and complete in all material respects and not misleading; (ii) there are no other matters the omission of which would make any statement in this report misleading; and (iii) all opinions expressed in this report have been arrived at after due and careful consideration and are founded on bases and assumptions that are fair and reasonable.

* For identification purpose only

TO OUR SHAREHOLDERS

The board of Directors (the “Board”) is pleased to announce the unaudited consolidated results of the Company and its subsidiaries (collectively, the “Group”) for the six months ended 30 June 2004 (the “Review Period”) together with the comparative unaudited figures for the corresponding period in 2003.

In the first half of 2004, the Group continued to execute its business strategy and aligned closely with the evolving needs of its customers. While serving the traditional market segments which the Group is strong at, such as the telecom service providers and multi-national corporations (“MNCs”), the Group managed to go deeper, such as into the automobile manufacturing sector amongst the MNCs in China, during the Review Period.

BUSINESS OVERVIEW AND REVIEW

Financial Highlights

	Q2/2004 HK\$'000	Q1/2004 HK\$'000	Change	Q2/2003 HK\$'000	Change
Turnover	55,917	40,493	+38%	36,085	+55%
Operating profit (loss)	2,106	(596)	N/A	1,006	+109%
Net profit (loss)	1,501	(987)		50	
Basic EPS (HK cents)	0.52	(0.34)		0.02	
Contracts on hand at quarter end	92,700	37,000	+151%	13,800	+572%

Financial Review

The Group’s business in the 2004 second quarter rebounded with sales increased 38% from approximately HK\$40.5 million for the quarter ended 31 March 2004 to approximately HK\$55.9 million for the quarter ended 30 June 2004. At the same time, the Group’s bottom line improved significantly from a loss of approximately HK\$1.0 million for the quarter ended 31 March 2004 to a profit of approximately HK\$1.5 million for the quarter ended 30 June 2004.

During the Review Period, the Group recorded a turnover of approximately HK\$96.4 million (2003: HK\$94.2 million), a slight 2% increase from that recorded in the corresponding period in 2003. Net profit attributable to shareholders for the Review Period decreased by approximately 52% to approximately HK\$514,000 (2003: HK\$1.1 million).

Mainland China continued to be the Group’s major market during the Review Period, accounting for approximately 92% (2003: 90%) of the total turnover with the remaining 8% (2003: 10%) generated in Hong Kong. Turnover generated from the Group’s Network Infrastructure business remained at about the same level as the corresponding period in last year amounting to approximately HK\$83.2 million. The turnover of the Group’s Professional Services business amounted to approximately HK\$12.1 million, while the Group’s Network Software business enjoyed encouraging growth of some 282% to approximately HK\$1.1 million during the Review Period.

Interim Dividend

The Board does not recommend the payment of an interim dividend for the six months ended 30 June 2004 (2003: Nil).

Business Review

With well-defined marketing strategy, the Group placed extra efforts into the further penetration of both the MNCs and telecommunication markets by leveraging its next generation network (“NGN”) capabilities. By providing network infrastructure and security solutions to leading operators, such as China Telecom Corporation, the Group has expanded its telecommunications clientele. Penetrating further into the MNCs market segment, the Group now goes to industrial sectors of such market segments. The Group has won contracts from Volkswagen Automotive Co., Ltd., DaimlerChrysler (Mercedes Benz and Chrysler), Toyota Motor Corporation and SAIC GM Wuling Automobile Co., Ltd. and KONE Corporation, paving the way for gaining a strong position in the industrial sector.

Professional Services are at the core of the Group offering. During the Review Period, the Group’s professional services met the evolving needs of MNCs customers and large local corporations in Mainland China, such as Sybase Software (China) Co., Ltd. and EDS (China) Co., Ltd. as well as new customers in the sector of domestic enterprises like Shanghai Posts & Telecommunications Equipment Co. Ltd. and China Telecom Corporation. Besides, the Group also offers network optimization and security solutions to a host of local and international customers, including Schneider Electric (Hong Kong) Limited, QAD Asia Limited, Bookham Technology plc., Hong Kong Interbank Clearing Ltd., and the Sogo department store outlets in both Mainland China and Hong Kong.

In line with the Group’s commitment to research and development, the Group is constantly sharpening its network software to improve their competitiveness. These suites of software include business support systems (“BSS”), operation support systems (“OSS”) and network security solutions, among others. Additionally, the Group has also built up a strategic alliance with the China Division of Cisco Systems Inc. and has also developed good working relations with their Asia Pacific research and development team, with a view to accelerate its development pace in relation to NGN software and solutions, so as to further consolidate its position as a NGN pioneer in the industry.

Prospects

The Group kicked off its business for the third quarter of 2004 with a very healthy backlog order on hand. As at 30 June 2004, total value of the backlog order on hand was approximately HK\$92.7 million, comparing with backlog orders of approximately HK\$37.0 million and HK\$13.8 million, as at 31 March 2004 and 30 June 2003, respectively.

The advent of the NGN is hailed as a milestone in the history of the telecommunications industry. In view of this, the Group has been laying the appropriate groundwork for NGN developments over the years. By providing customers with a portfolio of synergistic businesses including Network Infrastructure, Professional Services and Network Software, the Group has established a strong foothold in the telecommunication industry and MNCs markets. To fully capture the business opportunities arising from the increasing awareness of the NGN trend among telecommunication and MNCs customers, the Group will continue to sharpen its competitiveness in the next half of 2004.

Internet Protocol (“IP”) telephony is another main focus of the Group in the coming quarters. The Group is now negotiating with a number of potential customers to offer them with sophisticated systems and services. A number of new contracts are expected to be concluded in the second half of the year.

Good foundations for the Group’s future growth have been laid in the most functional areas. With the large backlog of orders on hand and the traditionally busier months impending, the Group remains dedicated to achieving the goals of maximizing profitability and value for its investors.

COMPARISON OF BUSINESS OBJECTIVES WITH ACTUAL BUSINESS PROGRESS

The following is a comparison of actual business progress during the Review Period with the business objectives for the same period as set out in the prospectus of the Company dated 10 May 2002 (the “Prospectus”). The Group reviews its business objectives and strategies on an ongoing basis and makes adjustments as necessary.

Business objectives for the Review Period as set out in the Prospectus

Actual business progress in the Review Period

Business Development

Establish one additional sales and marketing presence in the Asia Pacific region

The Group was doing this in collaboration with its partners in the region.

Product Development and Service Launches

Network Infrastructure

Further enhance the research and development of IP Multimedia Collaboration Solutions

Enhancement of the IP Multimedia Collaboration Solutions continued during the Review Period.

Promote the latest version of IP Multimedia Collaboration Solutions

Promotion of the latest version of IP Multimedia Collaboration Solutions continues as planned.

Further increase its market share by promoting Infrastructure Solutions and Network Security Solutions, as well as Multimedia Solutions by adopting self-developed software and integrating with video conferencing equipment.

This was in progress as planned.

Professional Services

Further increase its market share by promoting Customer Services, Expert Services and Outsourcing Services

Revenue from this segment stayed at about the same level.

Network Software

Continue the research and development of the NextG IP Billing Software, the Network Management Software and the OSS/BSS Software.

The Group continued the research and development of the NextG Billing Software, etc. under the NGN OSS solutions.

Further increase its market share by promoting the NextG IP Billing Software, the Network Management Software and the OSS/BSS Software.

The Group continued to actively promote its NGN OSS solution.

Sales and Marketing

Promote self-developed software in Asia Pacific Region and further enhance the sales network in the PRC and Southeast Asia.

The Group has been promoting its self-developed software in collaboration with its partners in the region.

Increase efforts in brand building of the Group for its three business segments through comprehensive marketing campaigns in the PRC.

Increased efforts have been put into these areas.

Use of Proceeds from Initial Public Offer

The net proceeds raised from the new issue of shares by way of placing were approximately HK\$19.2 million, and were utilized in the following areas:

	Use of Proceeds as stated in the Prospectus		Actual amount utilized up to 30 June 2004 (in HK\$ million)
	Total (in HK\$ million)	Up to 30 June 2004 (in HK\$ million)	
Research and development*	6.0	4.9	7.0
Expansion of geographical establishments**	4.0	3.3	0.8
Establishment of network monitoring center	3.0	2.5	2.2
Sales and marketing***	2.0	1.6	1.1
Working capital	4.0	4.0	4.0
Total	19.0	16.3	15.1

The remaining proceeds of approximately HK\$ 4.1 million were placed with licensed banks in Hong Kong and Mainland China.

* *The higher than projected spending on R&D was due to the speeding up of researches on NGN.*

** *The lower than projected spending was due to the postponement of expansion plans.*

*** *The lower than projected spending was due to postponement of additional geographical establishment.*

MANAGEMENT DISCUSSION & ANALYSIS

Liquidity, Financial Resources and Capital Structure

During the Review Period, the Group continued its conservative policies in cash and financial management. Surplus funds were placed on interest-bearing deposits with banks. The Group generally financed its operations and serviced its debts with its internal resources, short-terms bank loans and convertible bonds.

As at 30 June 2004, the Group had net current assets of approximately HK\$43.4 million (31 December 2003: HK\$45.7 million), including bank balances and cash of approximately HK\$27.8 million (31 December 2003: HK\$45.2 million), total short terms bank loans of approximately HK\$31.5 million (31 December 2003: HK\$33.1 million) and convertible bonds maturing within one year of approximately HK\$7.5 million (31 December 2003: HK\$9.3 million). The current ratio fell slightly from 1.67 as at 31 December 2003 to about 1.63 as at 30 June 2004. In addition, the Group had total banking facilities of approximately HK\$78.5 million (31 December 2003: HK\$67.0 million) as at 30 June 2004, of which approximately HK\$45.5 million (31 December 2003: HK\$43.0 million) had been utilized.

The Group recorded no non-current liabilities (31 December 2003: HK\$2.8 million) as at 30 June 2004.

As at 30 June 2004, all assets and liabilities of the Group were denominated in U.S. dollars, Hong Kong dollars and Renminbi.

Acquisitions, Disposals and Significant Investment

The Group had not made any significant acquisitions, disposals and investments during the Review Period.

Segmental Information

The segmental information of the Group is set out in Note 3 of the “Financial Information” in this report.

Employee Information

As at 30 June 2004, the Group had 130 employees (30 June 2003: 131 employees) comprising 22 employees (30 June 2003: 23 employees) based in Hong Kong and 108 employees (30 June 2003: 108 employees) based in Mainland China. The Group continues to provide remuneration packages to employees in accordance with market practices and past performance. In addition to basic remuneration, the Group also provides other benefits such as a mandatory provident fund, medical scheme, share option scheme and staff training programs to employees.

Charges on Group Assets

As at 30 June 2004, the Group did not have any significant charges on its assets.

Gearing Ratio

As at 30 June 2004, the Group’s gearing ratio, total liabilities over total assets, reduced to approximately to 55.7% from approximately 56.5% as at 31 December 2003.

Foreign Exchange Exposure

During the Review Period, the Group earned revenue and incurred costs and expenses mainly in U.S. dollars, Hong Kong dollars and Renminbi. As the exchange rates of such currencies have been stable, no hedging or other alternatives have been implemented.

Order Book & Prospects for New Business

As at 30 June 2004, the Group had contracts on hand for sales amounting to approximately HK\$92.7 million (30 June 2003: HK\$13.8 million) which would be booked as revenue upon delivery and implementation.

Contingent Liabilities

Except for those commitments and contingent liabilities set out in the Notes 12 to 13 in the Financial Information section of this Report, the Group had no significant contingent liabilities as at 30 June 2004.

Future plans for Investments or Capital Assets and Sources of Funding

With the exception of those plan set out in the Prospectus, there are no plans for any significant investments in capital assets and sources of funding.

FINANCIAL INFORMATION

Condensed Consolidated Income Statement

	Notes	(Unaudited) For the three months ended 30 June		(Unaudited) For the six months ended 30 June	
		2004	2003	2004	2003
		HK\$'000	HK\$'000	HK\$'000	HK\$'000
Turnover	2	55,917	36,085	96,410	94,198
Other operating income		36	49	59	88
Changes in materials and equipment		(41,740)	(26,224)	(72,415)	(69,743)
Staff costs		(4,191)	(3,964)	(8,110)	(8,121)
Depreciation and amortization		(1,290)	(1,434)	(2,602)	(2,819)
Other operating expenses		6,626	(3,506)	(11,832)	(10,754)
		<u>2,106</u>	<u>1,006</u>	<u>1,510</u>	<u>2,849</u>
Profit from operations	4	2,106	1,006	1,510	2,849
Finance costs		(585)	(956)	(967)	(1,784)
		<u>1,521</u>	<u>50</u>	<u>543</u>	<u>1,065</u>
Profit before taxation		1,521	50	543	1,065
Taxation	5	(45)	–	(45)	–
		<u>1,476</u>	<u>50</u>	<u>498</u>	<u>1,065</u>
Profit after taxation		1,476	50	498	1,065
Minority interest		25	–	16	–
		<u>1,501</u>	<u>50</u>	<u>514</u>	<u>1,065</u>
Net profit attributable to shareholders		1,501	50	514	1,065
Earnings per share					
– Basic (cents)	6	0.52	0.02	0.18	0.37
– Diluted (cents)	6	0.52	N/A	0.18	N/A

Condensed Consolidated Balance Sheet

		(Unaudited) As at 30 June 2004 HK\$'000	(Audited) As at 31 December 2003 HK\$'000
	<i>Notes</i>		
Non-current assets			
Property, plant and equipment	7	4,441	4,606
Software product development costs		6,980	6,795
		<u>11,421</u>	<u>11,401</u>
Current assets			
Inventories		13,851	10,623
Trade and other receivables	8	70,462	56,490
Pledged bank deposits		–	1,042
Bank balances and cash		27,834	45,167
		<u>112,147</u>	<u>113,322</u>
Current liabilities			
Trade and other payables	9	29,252	24,842
Taxation		477	481
Convertible bonds maturing within one year	10	7,534	9,280
Short-term bank loans		10,935	14,953
Trust receipt and import loans		19,465	18,103
Bank overdrafts		1,112	–
		<u>68,775</u>	<u>67,659</u>
Net current assets		<u>43,372</u>	<u>45,663</u>
Total assets less current liabilities		<u>54,793</u>	<u>57,064</u>
Non-current liabilities			
Convertible bonds maturing after one year	10	–	2,804
Minority interest		–	–
Net assets		<u>54,774</u>	<u>54,260</u>
Capital and reserves			
Share capital	11	2,900	2,900
Reserves		51,874	51,360
Shareholders' funds		<u>54,774</u>	<u>54,260</u>

Condensed Consolidated Cash Flow Statement

	(Unaudited) Six months ended 30 June 2004 HK\$'000	(Unaudited) Six months ended 30 June 2003 HK\$'000
Net cash (used in) generated from operating activities	(9,694)	10,576
Net cash (used in) generated from investing activities	(1,580)	1,476
Net cash used in financing activities	(6,059)	(3,975)
Net (decrease) increase in cash and cash equivalents	(17,333)	8,077
Cash and cash equivalents at the beginning of period	45,167	14,412
Cash and cash equivalents at the end of period	<u>27,834</u>	<u>22,489</u>
Analysis of the balances of cash and cash equivalents		
Bank balances and cash	27,834	22,489
Bank overdrafts	(1,112)	–
	<u>26,722</u>	<u>22,489</u>

Condensed Consolidated Statement of Changes in Equity (Unaudited)

	Share capital HK\$'000	Share premium HK\$'000	Statutory surplus reserve fund HK\$'000	Enterprise expansion fund HK\$'000	Staff welfare fund HK\$'000	Deficit HK\$'000	Total HK\$'000
As at 1 January 2003	2,823	55,824	1,003	502	502	(7,328)	53,326
Exercise of warrants	77						77
Profit for the six months ended 30 June 2003						1,065	1,065
As at 30 June 2003	<u>2,900</u>	<u>55,824</u>	<u>1,003</u>	<u>502</u>	<u>502</u>	<u>(6,263)</u>	<u>54,468</u>
As at 1 January 2004	2,900	55,824	1,003	502	502	(6,471)	54,260
Profit for the six months ended 30 June 2004						514	514
As at 30 June 2004	<u>2,900</u>	<u>55,824</u>	<u>1,003</u>	<u>502</u>	<u>502</u>	<u>(5,957)</u>	<u>54,774</u>

NOTES TO THE CONDENSED FINANCIAL STATEMENTS

(1) Basis of Presentation

The condensed financial statements have been prepared in accordance with Hong Kong Financial Reporting Standard – Statement of Standard Accounting Practice No. 25 “Interim Financial Reporting” issued by the Hong Kong Society of Accountants and the applicable disclosure requirements of the Rules Governing the Listing of Securities on the Growth Enterprise Market of the Stock Exchange of Hong Kong Limited.

The principal accounting policies and basis of preparation adopted for the preparation of these condensed financial statements are consistent with those adopted by the Group in its annual financial statements for the year ended 31 December 2003.

The condensed financial statements are unaudited but have been reviewed by the audit committee of the Company (the “Audit Committee”).

(2) Turnover and revenue

An analysis of the Group’s turnover and revenue recognized for the three and the six months ended 30 June 2004 together with the comparative figures for the corresponding period in 2003 are as follows:

	For the three months ended 30 June		For the six months ended 30 June	
	2004 HK\$’000	2003 HK\$’000	2004 HK\$’000	2003 HK\$’000
Network infrastructure	49,826	30,716	83,154	81,034
Professional services	4,946	5,069	12,111	12,864
Network software	1,145	300	1,145	300
Total turnover	55,917	36,085	96,410	94,198
Interest income	36	49	59	88
Total revenue	55,953	36,134	96,469	94,286

(3) Segment Information

a. Business Segment

An analysis of the Group’s turnover and results by business segment is as follows:

	(Unaudited) For the six months ended 30 June 2004		(Unaudited) For the six months ended 30 June 2003	
	Turnover HK\$’000	Results HK\$’000	Turnover HK\$’000	Results HK\$’000
Network infrastructure	83,154	1,625	81,034	2,575
Professional services	12,111	502	12,864	1,386
Network software	1,145	(515)	300	(866)
	96,410	1,612	94,198	3,095
Other operating income		59		88
Central administrative expenses		(161)		(334)
Profit from operations		1,510		2,849
Finance costs		(967)		(1,784)
Profit before taxation		543		1,065
Taxation		(45)		0
Profit after taxation		498		1,065
Minority interest		16		0
Net profit attributable to shareholders		514		1,065

b. Geographical segment

An analysis of the Group's turnover by geographical location is as follows:

	(Unaudited) For the six months ended 30 June	
	2004 HK\$'000	2003 HK\$'000
Hong Kong	7,659	9,412
PRC	88,751	84,786
	<u>96,410</u>	<u>94,198</u>

(4) Profit from operations

Profit from operations has been arrived at after charging:

	For the three months ended 30 June		For the six months ended 30 June	
	2004	2003	2004	2003
Amortization of software product development costs	483	565	965	1,153
Depreciation of property, plant and equipment	807	869	1,637	1,666
Staff costs (including directors' remuneration)	4,191	3,964	8,110	8,121
Loss on disposal of investments in securities	-	360	-	360
Loss on disposal of property, plant and equipment	10	-	10	-

(5) Taxation

Taxation charges consisted of:

	For the three months ended 30 June		For the six months ended 30 June	
	2004 HK\$'000	2003 HK\$'000	2004 HK\$'000	2003 HK\$'000
Current taxation:				
Hong Kong profits tax	-	-	-	-
PRC income tax	45	-	45	-
	<u>45</u>	<u>-</u>	<u>45</u>	<u>-</u>

No provision for Hong Kong profits tax has been made for the three and six months ended 30 June 2004 as the Group had no assessable profit arising in or derived from Hong Kong (2003: Nil).

Pursuant to the relevant laws and regulations in the PRC, the Company's PRC subsidiaries are entitled to exemption from PRC income tax for two or three years commencing from their first profit-making year of operation and thereafter, these PRC subsidiaries will be entitled to a 50% relief from PRC income tax for the following three years. During the Review Period, one of the Company's PRC subsidiaries is within its tax exemption period, the rest are within their 50% tax relief period.

No deferred tax asset has been recognized in respect of the unutilized tax losses due to the unpredictability of future profit streams.

(6) Earnings per share

The calculation of basic earnings per share for the three months and the six months ended 30 June 2004 is based on the unaudited net profit attributable to shareholders of approximately HK\$1,501,000 (2003: HK\$50,000) and approximately HK\$514,000 (2003: HK\$1,065,000), respectively, and on the weighted average number of approximately 289,945,000 (2003: 285,980,000) shares and approximately 289,945,000 (2003: 284,134,000) shares respectively in issue during these periods.

The calculation of the diluted earnings per share for the three months and the six months ended 30 June 2004 is based on the net profit attributable to shareholders of approximately HK\$1,501,000 and approximately HK\$514,000, respectively, and on the weighted average number of approximately 290,029,000 shares and approximately 290,309,000 shares respectively.

Diluted earnings per share has not been presented for the three months and six months ended 30 June 2003 since the effect is anti-dilutive.

(7) **Property, plant and equipment**

Movements in property, plant and equipment were:

	Computer equipment <i>HK\$'000</i>	Furniture, fixtures and office equipment <i>HK\$'000</i>	Motor vehicle <i>HK\$'000</i>	Tools <i>HK\$'000</i>	Total <i>HK\$'000</i>
Cost					
At 1 January 2004	7,891	1,779	438	4,602	14,710
Additions	1,127	(21)	–	421	1,527
Disposals	(26)	(99)	–	(174)	(299)
At 30 June 2004	8,992	1,659	438	4,849	15,938
Accumulated depreciation					
At 1 January 2004	5,767	1,328	254	2,755	10,104
Additions	824	167	55	591	1,637
Disposals	(21)	(99)	–	(124)	(244)
At 30 June 2004	6,570	1,396	309	3,222	11,497
Net book value					
At 30 June 2004	2,422	263	129	1,627	4,441
At 31 December 2003	2,124	451	184	1,847	4,606

(8) **Trade and other receivables**

	As at 30 June 2004 <i>HK\$'000</i>	31 December 2003 <i>HK\$'000</i>
Trade receivables	60,034	44,132
Other receivables	6,764	8,155
Prepaid maintenance charges	3,664	4,203
	70,462	56,490

There was no change on the Group's credit policies since 31 December 2003.

The aged analysis of trade receivables is as follows:

	As at 30 June 2004 <i>HK\$'000</i>	31 December 2003 <i>HK\$'000</i>
Age		
0 to 90 days	44,323	30,710
91 to 180 days	5,756	4,313
181 to 365 days	4,266	9,942
over 365 days	7,643	227
	61,988	45,192
<i>Less:</i> allowance for bad and doubtful debts	(1,954)	(1,060)
	60,034	44,132

(9) **Trade and other payables**

	As at	
	30 June 2004 HK\$'000	31 December 2003 HK\$'000
Trade payables	23,562	14,772
Other payables	5,690	10,070
	<u>29,252</u>	<u>24,842</u>

The aged analysis of trade payables is as follows:

	As at	
	30 June 2004 HK\$'000	31 December 2003 HK\$'000
Age		
0 to 90 days	21,296	11,726
91 to 180 days	1,056	28
over 180 days	1,210	3,018
	<u>23,562</u>	<u>14,772</u>

(10) **Convertible bonds**

	As at	
	30 June 2004 HK\$'000	31 December 2003 HK\$'000
Within 1 year	7,534	9,280
Between 1 to 2 years	-	2,804
	<u>7,534</u>	<u>12,084</u>

In January 2004, the Company redeemed a convertible bond at its face value of HK\$4,800,000 on its maturity date.

(11) **Share Capital**

	Number of shares	Nominal value HK\$'000
<i>Authorized</i>		
- ordinary shares of HK\$0.01 each	<u>500,000,000</u>	<u>5,000</u>
<i>Issued and fully paid</i>		
- at 1 January 2004 and 30 June 2004	<u>289,944,745</u>	<u>2,900</u>

(12) **Operating lease commitments**

As at 30 June 2004, the Group had operating lease commitments of approximately HK\$3,636,000 (31 December 2003: HK\$4,043,000), out of which approximately HK\$2,441,000 was payable within 1 year (31 December 2003: HK\$2,540,000).

(13) **Contingent liabilities**

As at 30 June 2004, the Company has given corporate guarantees totaling approximately HK\$67,600,000 (31 December 2003: HK\$2,000,000) to banks to secure the credit facilities granted to its subsidiaries.

DIRECTORS' AND CHIEF EXECUTIVE'S INTERESTS OR SHORT POSITION IN SHARES AND UNDERLYING SHARES OF THE COMPANY

As at 30 June 2004, the interests and short positions of the Directors, the chief executive of the Company and their respective associates in the shares, underlying shares and debentures of the Company and its associated corporations (within the meaning of Part XV of the Securities and Futures Ordinance (“SFO”)), as recorded in the register required to be kept by the company pursuant to Section 352 of the SFO or as otherwise notified to the Company and the Exchange pursuant to the required standard of dealings by Directors as referred to in Rule 5.46 of the GEM Listing Rules, were as follows:

(a) Long positions in shares in the Company

Name of Director	Number of shares held						Total interest in shares	Approximate percentage of the Company's issued share capital
	Personal interest	Capacity	Family interest	Corporate interest	Capacity	Other interest		
Mr. Chan Sek Keung, Ringo	4,368,000	Beneficial owner	–	56,400,000 <i>(Note)</i>	Interest of a controlled corporation	–	60,768,000	20.96%

Note: Such shares in the Company are held by Woodstock Management Limited (“Woodstock”), a company wholly owned by Mr. Chan Sek Keung, Ringo, who is deemed, by virtue of the SFO, to be interested in these shares.

(b) Long positions in underlying shares in the Company (Directors' rights to acquire shares)

Name of Director	Capacity	Date of grant	Number of unlisted pre-IPO share option outstanding as at 1 January 2004	Number of unlisted pre-IPO share option outstanding as at 30 June 2004	Number of unlisted post-IPO share option outstanding as at 1 January 2004	Number of unlisted post-IPO share option outstanding as at 30 June 2004	Aggregate interests	Exercise period of share options	Exercise price of share options (HK\$)	Approximate percentage of the Company's issued share capital
Mr. Chan Sek Keung, Ringo	Beneficial owner	30 April 2002	3,000,000	3,000,000	-	-	4,200,000	17 November 2002 to 29 April 2012	0.55	
Mr. Pang Hing Chung, Alfred	Beneficial owner	20 February 2003	-	-	1,200,000	1,200,000		20 February 2004 to 19 February 2013	0.138	1.45%
Mr. Tsoi Tai Wai, David	Beneficial owner	20 February 2003	750,000	750,000	-	-	1,500,000	17 November 2002 to 29 April 2012	0.55	0.52%
Mr. Alasdair Gordon Nagle	Beneficial owner	20 February 2003	-	-	750,000	750,000		20 February 2004 to 19 February 2013	0.138	0.26%
Ms. Clara Ho	Beneficial owner	20 February 2003	-	-	375,000	375,000		20 February 2004 to 19 February 2013	0.138	0.13%
Mr. Kwan Kit Tong	Beneficial owner	20 February 2003	-	-	375,000	375,000		20 February 2004 to 19 February 2013	0.138	0.13%

Note: Each of the Directors' interests represent their respective long positions in the underlying shares in the Company by virtue of options granted to the Directors pursuant to a pre-IPO share option scheme and a post-IPO share option scheme both adopted by the Company on 20 April 2002 (further details are set out under the section headed "Share Option Schemes").

Other than as disclosed above, none of the Directors, the chief executive and their respective associates, had any interests or short positions in any shares, underlying shares or debentures of the Company or any of its associated corporations as at 30 June 2004.

REQUIRED STANDARD OF SECURITIES DEALINGS BY DIRECTORS

During the six months ended 30 June 2004, the Company had adopted a code of conduct for directors' securities transactions on terms no less exacting than the required standard of dealings set out in Rules 5.48 to 5.67 of the GEM Listing Rules.

Having made specific enquiry with all the Directors, the Directors of the Company confirmed that they had complied with the required standard of dealings and the code of conducts for directors' securities transactions during the six months ended 30 June 2004.

SUBSTANTIAL SHAREHOLDERS AND OTHER SHAREHOLDERS WHOSE INTEREST RECORDED UNDER SECTION 336 OF THE SFO

As at 30 June 2004, the following persons or corporations, in addition to the Director stated under the section headed "Directors' and chief executive's interests or short position in shares and underlying shares of the Company" had interests in the shares and underlying shares in the Company as recorded in the register of interests required to be kept by the Company pursuant to Section 336 of the SFO.

(a) Long positions in share in the Company

Name of Shareholder	Capacity	Type of interests	Number of shares	Approximate percentage of the Company's issued share capital
The Applied Research Council ("ARC") (Note 1)	Beneficial Owner	Corporate	48,460,000	16.71%
HSBC Private Equity Technology (Asia) Limited (Note 2)	Investment Manager	Corporate	48,460,000	16.71%
HSBC Private Equity (Asia) Limited (Note 2)	Interest of a controlled corporation	Corporate	48,460,000	16.71%
North 22 Nominees Limited	Beneficial Owner	Corporate	36,900,000	12.73%
Mr. Ng Lai Yick (Note 3)	Beneficial owner Interest of a controlled corporation	Personal Corporate	3,134,744 36,900,000	1.08% 12.73%
QPL International Holdings Limited ("QPL") (Note 4)	Beneficial Owner	Corporate	35,456,745	12.23%
Mr. Li Tung Lok (Note 4)	Interest of a controlled corporation	Corporate	35,456,745	12.23%
Madam Su Ching Wah (Note 4)	Interest of spouse	Family	35,456,745	12.23%

Notes:

- (1) ARC is the beneficial owner of these shares. In addition to these shares, ARC also holds two convertible bonds issued by the Company with a face value of HK\$7,660,000 in aggregate. If these convertible bonds were fully converted on their respective maturity dates, ARC would hold an additional 14,543,383 shares in the Company.
- (2) HSBC Private Equity Technology (Asia) Limited is deemed, by virtue of the SFO, to be interested in these shares as it is the investment manager of ARC.

HSBC Private Equity (Asia) Limited is deemed, by virtue of the SFO, to be interested in these shares as HSBC Private Equity Technology (Asia) Limited is its wholly-owned subsidiary.
- (3) Mr. Ng Lai Yick is deemed, by virtue of the SFO, to be interested in the 36,900,000 shares held by North 22 Nominees Limited as the company is wholly-owned by him.
- (4) Mr. Li Tung Lok is the controlling shareholder of QPL and is deemed, by virtue of the SFO, to be interested in the 35,456,745 shares held by QPL.

Madam Su Ching Wah is the spouse of Mr. Li Tung Lok and is deemed, by virtue of the SFO, to be interested in the 35,456,745 shares held by QPL.

(b) Long positions in underlying shares in the Company

Name of Shareholder	Capacity	Amount of convertible bonds of the Company issued	Number of underlying Shares
ARC (<i>Note 1</i>)	Beneficial owner	HK\$7,660,000	14,543,383
HSBC Private Equity Technology (Asia) Limited (<i>Note 2</i>)	Investment manager	HK\$7,660,000	14,543,383
HSBC Private Equity (Asia) Limited (<i>Note 2</i>)	Interest of a controlled corporation	HK\$7,660,000	14,543,383

Notes:

- (1) Pursuant to an agreement dated 26 April 2002 entered into among ARC, the Group and Woodstock, ARC would subscribe for five convertible bonds to be issued by the Company with respective face values of HK\$4,188,100, HK\$3,400,000, HK\$4,800,000, HK\$4,660,000 and HK\$3,000,000. As at 30 June 2004, the Company had redeemed three convertible bonds of face value of HK\$4,188,100, HK\$3,400,000 and HK\$4,800,000 respectively on their maturity date leading to ARC's underlying interests in Company's shares being decreased from 38,063,603 shares to 14,543,383 shares.
- (2) HSBC Private Equity Technology (Asia) Limited is deemed, by virtue of the SFO, to be interested in 14,543,383 underlying shares held by ARC as the Company is the investment manager of ARC.

HSBC Private Equity (Asia) Limited is deemed, by virtue of the SFO, to be interested in 14,543,383 underlying shares held by ARC as HSBC Private Equity Technology (Asia) Limited is its wholly-owned subsidiary.

Other than as disclosed above, the Company has not been notified of any other relevant interests or short positions in the shares or underlying shares in the Company as at 30 June 2004.

SHARE OPTION SCHEMES

The Company, in a general meeting held on 20 April 2002, adopted both a pre-IPO share option scheme (the "Pre-IPO Share Option Scheme") and a Post-IPO share option scheme (the "Post-IPO Share Option Scheme").

Save as disclosed below, no options granted pursuant to either the Pre-IPO Share Option Scheme or the Post-IPO Share Option Schemes had lapsed or had been exercised during the Review Period.

(a) **Pre-IPO Share Option Scheme**

One single grant of 11,913,000 shares in aggregate was made to various participants on 30 April 2002 under this scheme. As at 30 June 2004, options comprising an aggregate of 9,853,000 shares were outstanding, as detailed below:

	Exercise price per share <i>HK\$</i>	Number of share options		
		Outstanding as at 1.1.2004	Cancelled during Review Period	Outstanding as at 30.6.2004
Type of Participants:				
Directors	0.55	3,750,000	–	3,750,000
Advisor	0.55	750,000	–	750,000
Employees	0.55	5,473,000	120,000 (<i>Note</i>)	5,353,000
		<u>9,973,000</u>	<u>120,000</u>	<u>9,853,000</u>

Note: These options were cancelled according to the rules of this scheme due to the employees having left the Group.

Pre-IPO share options are exercisable as to (i) a maximum of 25% of the total number of options granted six months after 17 May 2002 (the “Date of Listing”); (ii) a maximum additional 6.25% of the total number of options granted after the expiry of each 3-month period twelve months after the Date of Listing; and (iii) the remaining options on or after the third anniversary of the Date of Listing until the end of the option period or lapse of an option.

The above outstanding options may be exercised, in accordance with the terms of the Pre-IPO Share Option Scheme, before 30 April 2012.

(b) **Post-IPO Share Option Schemes**

There have been a total of 4 Post-IPO share options grants. The number of share options granted were 5,277,000 shares on 12 July 2002, 7,859,000 shares on 20 February 2003, 385,000 shares on 10 October 2003 and 2,844,000 shares on 23 February 2004.

A summary of the Post-IPO Share Option Scheme movements during the Review Period and as at 30 June, 2004 is as follows:

Date of grant	Type of Participants	Exercisable Period	Exercise Price per share HK\$	Number of share options			
				Outstanding as at 1.1.2004	Granted during Review Period	Cancelled during Review Period (Note 1)	Outstanding as at 30.6.2004
12.7.2002	Employees	12.7.2003 to 11.7.2012	0.384	3,419,000	–	175,000	3,244,000
20.2.2003	Directors	20.2.2004 to 19.2.2013	0.138	3,825,000	–	–	3,825,000
	Advisors	20.2.2004 to 19.2.2013	0.138	300,000	–	–	300,000
	Employees	20.2.2004 to 19.2.2013	0.138	3,351,000	–	165,000	3,186,000
				7,476,000	–	165,000	7,311,000
10.10.2003	Employees	10.10.2004 to 9.10.2013	0.142	385,000	–	–	385,000
23.2.2004	Employees	23.2.2005 to 22.2.2014 (Note 2)	0.165	–	2,844,000	70,000	2,774,000
				11,280,000	2,844,000	410,000	13,714,000

Notes:

- (1) These options were cancelled according to the rules of this scheme due to the employees having left the Group.
- (2) The closing price of the share of the Company immediately before the date on which the options were granted was HK\$0.155.

Post-IPO share options are exercisable starting from the first anniversary of the grant date at stepped annual increment of 25% of the total options granted, for a period not later than 10 years from the date of grant.

The above outstanding options may be exercised within the exercisable period in accordance with the terms of the Post-IPO Share Option Scheme.

Valuation of Share Options

The Directors consider that it is inappropriate to state the value of the options granted under the above share option schemes of the Company both adopted on 20 April 2002 (together, the “Schemes”) due to the following reasons:

- (i) the calculation of the value of the options will be based on a number of undetermined but crucial variables such as the subscription price payable for the shares in the Company, the number of options to be granted under the Schemes during their duration, the exercise period, interest rate, expected volatility and other relevant variables. In particular, the duration of the Schemes of 10 years will make these volatile variables very difficult to ascertain with accuracy;
- (ii) the generally accepted pricing models of options normally value options which are transferable but the options granted to a grantee under the Schemes are personal to the grantee which are non-transferable and non-assignable and hence calculation of the value of the options granted under the Schemes using such pricing models may not be appropriate; and
- (iii) the Directors are of the view that the calculation on speculative assumptions would not be meaningful and would be misleading to shareholders of the Company.

COMPETITION AND CONFLICT OF INTERESTS

Each of the Directors and the management shareholders of the Company and their respective associates (as defined in the GEM Listing Rules) has confirmed that none of them had any business or interest in companies that competes or may compete with the business of the Group or any other conflict of interests with the interests of the Group.

SPONSOR’S INTERESTS

As confirmed by the Company’s sponsor, CSC Asia Limited (the “Sponsor”), as at 30 June 2004, neither the Sponsor nor its directors, employees and associates (as referred in Note 3 to rule 6.35 of the GEM Listing Rules) had any interest in the securities of the Company or any member of the Group or any right to subscribe for or to nominate persons to subscribe for the securities of the Company, or any members of the Group.

At the time of and subsequent to the listing of shares in the Company on GEM, the Sponsor received and will receive fees under a sponsor’s agreement dated 10 May 2002 between the Company and the Sponsor in connection with services rendered and to be rendered by the Sponsor pursuant to rules 6.01 and 17.81 of the GEM Listing Rules.

AUDIT COMMITTEE

The Company established the Audit Committee on 29 October 2001 with written terms of reference in compliance with rules 5.28 to 5.30 of the GEM Listing Rules and with reference to the guidelines published by the Hong Kong Society of Accountants.

The Audit Committee consists of two independent non-executive Directors, namely, Mr. Tsoi Tai Wai, David and Mr. Pang Hing Chung, Alfred and the executive Director, Mr. Chan Sek Keung, Ringo. Mr. Tsoi is the Chairman of the Audit Committee.

The Audit Committee has reviewed the draft of this report and has provided advice and comments thereon.

BOARD PRACTICES AND PROCEDURES

The Company has complied with the board practices and procedures as set out in Rules 5.34 to 5.45 of the GEM Listing Rules during the Review Period.

PURCHASE, REDEMPTION OR SALE OF LISTED SECURITIES OF THE COMPANY

During the Review Period, neither the Company nor any of its subsidiaries purchased, sold or redeemed any of the Company's listed securities.

By Order of the Board
Wafer Systems Limited
CHAN Sek Keung, Ringo
Chairman and Chief Executive Officer

Hong Kong, 12 August 2004