1 Background of the Company

China Southern Airlines Company Limited (the "Company") and its subsidiary companies (the "Group") are principally engaged in the provision of domestic, Hong Kong regional and international passenger and cargo and mail airline services, with flights operating primarily from the Guangzhou Baiyun International Airport, which is both the main hub of the Group's route network and the location of its corporate headquarters.

The Company was established in the People's Republic of China (the "PRC", "China" or the "State") on 25 March, 1995 as a joint stock limited company as part of the Reorganisation (the "Reorganisation") of Southern Airlines (Group) (the "SA Group"), a state-owned enterprise which is under the supervision of the Civil Aviation Administration of China (the "CAAC"), a ministry-level enterprise under the direct supervision of the State Council of the PRC responsible for the administration and development of the airline industry in the PRC. Pursuant to the Reorganisation, the Company assumed, as from the effective date on 1 January, 1995, the airline and airline-related businesses together with the relevant assets and liabilities from the SA Group in consideration of which 2,200,000,000 domestic shares with a par value of RMB1.00 each were allocated by the Company on 25 March, 1995 to the SA Group. On the same date, the SA Group became the holding company of the Company.

In July 1997, the Company successfully listed its H Shares and American Depositary Shares ("ADS") (each ADS representing 50 H Shares) on the Stock Exchange of Hong Kong Limited and the New York Stock Exchange, respectively.

2 Principal accounting policies

The principal accounting policies adopted in the preparation of the accounts, which conform with International Accounting Standards ("IAS"), are set out below:

(a) Statement of compliance

The accounts of the Group and the Company have been prepared in accordance with IAS issued by the International Accounting Standards Committee ("IASC"), interpretations issued by the Standing Interpretations Committee of the IASC and the disclosure requirements of the Hong Kong Companies Ordinance.

(b) Basis of preparation

The accounts of the Group and the Company are prepared on the historical cost basis as modified by the revaluation of certain fixed assets, investments in subsidiary and associated companies. The accounting policies have been consistently applied by the Group and the Company and they are consistent with those used in the previous year.

(c) Basis of consolidation

The consolidated accounts of the Group include the accounts of the Company and all of its subsidiaries made up to 31 December each year. Subsidiaries are those enterprises controlled by the Group. Control exists when the Group has the power, directly or indirectly, to govern the financial and operating policies of an enterprise so as to obtain benefits from its activities. The accounts of subsidiaries are included in the consolidated accounts from the date that control effectively commences until the date that control effectively ceases.

The results of subsidiary are included in the consolidated profit and loss account and the share attributable to minority shareholders is deducted from or added to the consolidated loss/profit after taxation. Losses attributable to minority shareholders of partly owned subsidiaries are accounted for based on the respective equity owned by the minority shareholders up to the amount of the capital contribution and reserves attributable to the minority shareholders. Thereafter, all further losses are assumed by the Company.

All significant intercompany balances and transactions have been eliminated on consolidation.

2 Principal accounting policies (cont'd)

(d) Financial assets and liabilities

Adjustments are made for financial assets, if their carrying amount exceeds the value realisable in the foreseeable future, except for investments, the accounting policies for which are disclosed below. Financial liabilities are stated at their carrying amount.

(e) Investments

(i) *Investment in subsidiaries*

Investments in subsidiaries in the Company's balance sheet are stated at cost or revalued amount, less provisions for permanent diminution in value as determined by the directors.

(ii) *Investments in associated companies*

An associated company is a company, not being a subsidiary, in which the Group holds, for long term interest, not less than 20% and not more than 50% of its equity and exercises significant influence in its management.

The consolidated profit and loss account includes the Group's share of the results of its associated companies for the year. In the consolidated balance sheet, the investments in associated companies are stated at the Group's attributable share of net assets. When the Group's share of losses exceeds the carrying amount of the associated company, the carrying amount is reduced to nil and recognition of further losses is discontinued except to the extent that the Group has incurred obligations in respect of the associated company.

The results of associated companies are included in the Company's profit and loss account to the extent of dividends received and receivable, providing such dividends are in respect of a period ending on or before that of the Company and the Company's right to receive the dividend are established before 31 December each year. In the Company's balance sheet, investments in associated companies are stated at cost or revalued amount, less provisions for permanent diminution in value as determined by the directors.

(iii) *Other investments*

Other investments, which are held for long term purposes, are stated at cost, less provisions for permanent diminution in value as determined by the directors.

(f) Fixed assets and depreciation

Fixed assets are stated at cost or revalued amount less accumulated depreciation and impairment losses (refer to accounting policy m). Revaluations are performed periodically to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet date.

2 Principal accounting policies (cont'd)

(f) Fixed assets and depreciation (cont'd)

Depreciation is provided to write off the cost, or revalued amount where appropriate, of the fixed assets over their estimated useful lives on a straight line basis, after taking into account their estimated residual values, as follows:

	Depreciable life	Residual value
Buildings	15 to 40 years	Nil
Owned & leased aircraft	8 to 15 years	28.75%
Other flight equipment		
Jet engines	8 to 15 years	3%
Others, including rotable spares	8 to 15 years	Nil
Machinery and equipment	5 to 10 years	3%
Vehicles	6 years	3%

Land use rights are amortised on a straight line basis over the period of grant or 50 years, whichever is shorter.

No depreciation is provided in respect of construction in progress.

(g) Leased assets

Flight equipment under finance leases is stated at outright purchase price, which approximates the present value of minimum lease payments, and is amortised on a straight line basis over the shorter of the lease term or estimated useful life of the asset to residual values. In cases where title to the asset will be acquired by the Group at the end of the lease, the outright purchase price of the asset is amortised on a straight line basis over the estimated useful life of the asset to its residual value.

Amounts payable in respect of finance leases are apportioned between interest charges and reductions of obligations based on the interest rates implicit in the leases. Interest charges are included in the profit and loss account to provide a constant periodic rate of charge over the lease term.

Gains on aircraft sale and leaseback transactions which result in finance leases are deferred and amortised over the terms of the related leases. Gains on other aircraft sale and leaseback transactions are recognised as income immediately if the transactions are established at fair value. Any excess of the sales price over fair value is deferred and amortised over the period the assets are expected to be used.

Operating lease payments are charged to the profit and loss account on a straight line basis over the terms of the related leases.

(h) Construction in progress

Construction in progress represents office buildings, various infrastructure projects under construction and equipment pending installation, and is stated at cost. Cost comprises direct costs of construction as well as interest charges during the periods of construction and installation. Capitalisation of these costs ceases and the construction in progress is transferred to fixed assets when the asset is substantially ready for its intended use, notwithstanding any delays in the issue of the relevant commissioning certificates by the relevant PRC authorities.

(i) Inventories

Inventories, which consist primarily of expendable spare parts and supplies, are stated at cost less provision for obsolescence, and are expensed when used in operations. Cost represents the average unit cost. Provision for obsolescence is established, over the estimated useful life of the related aircraft and engines, for spare parts expected to be on hand at the date the aircraft retired from service.

2 Principal accounting policies (cont'd)

(j) Trade receivables

Trade receivables are stated at cost less provisions for bad and doubtful accounts. Provisions for bad and doubtful accounts are established based on evaluation of the recoverability of these accounts at the balance sheet date.

(k) Deferred expenditure

Custom duties and other costs in relation to modifying, introducing and certifying aircraft are deferred and amortised over the terms of the related leases.

(l) Cash and cash equivalents

Cash and cash equivalents consist of cash in hand and balances with banks and other financial institutions with an original maturity within three months. For the purpose of the consolidated cash flow statement, cash and cash equivalents are presented net of bank overdrafts, if any.

(m) Impairment loss

The carrying amounts of the Group's assets, other than inventories (refer to accounting policy i) and deferred tax assets (refer to accounting policy t) 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 the recoverable amount. The recoverable amount is the greater of the net selling price and the value in use. In determining the value in use, expected future cash flows generated by the asset are discounted to their present value. The amount of the reduction is recognised as an expense in the profit and loss account.

The Group assesses at each balance sheet date whether there is any indication that an impairment loss recognised for an asset in prior years may no longer exist. An impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount. A subsequent increase in the recoverable amount of an asset, when the circumstances and events that led to the write-down or write-off cease to exist, is recognised as income. The reversal is reduced by the amount that would have been recognised as depreciation had the write-down or write-off not occurred.

(n) Deferred credits

In connection with the acquisition of certain aircraft and engines, the Group receives various credits. Such credits are deferred until the aircraft and engines are delivered, at which time they are either applied as a reduction of the cost of acquiring the aircraft and engines, resulting in a reduction of future depreciation, or amortised as a reduction of rental expense for aircraft and engines under operating leases.

(o) Revenue recognition

Passenger, cargo and mail revenues are recognised when the transportation is provided. Ticket sales for transportation not yet provided are included in current liabilities as sales in advance of carriage. Revenues from airline-related business are recognised when services are rendered. Revenue is stated net of sales tax and contributions to the CAAC Infrastructure Development Fund.

Interest income is recognised as it accrues unless collectibility is in doubt. Dividend income is recognised when the Group's right to receive the dividend is established.

Operating lease income is recognised on a straight line basis over the terms of the respective leases.

2 Principal accounting policies (cont'd)

(p) Traffic commissions

Traffic commissions are expensed when the transportation is provided and the related revenue is recognised. Traffic commissions for transportation not yet provided are recorded on the balance sheet as a prepaid expense.

(q) Maintenance and overhaul costs

Routine maintenance and repairs and overhauls in respect of owned aircraft and aircraft held under finance leases are expensed in the profit and loss account as and when incurred. In respect of aircraft held under operating leases, a provision is made over the lease term for the estimated cost of scheduled overhauls required to be performed on the related aircraft prior to their return to the lessors.

(r) Translation of foreign currencies

Foreign currency transactions during the year are translated into Renminbi at the applicable rates of exchange prevailing on the transaction dates.

Foreign currency monetary balances at the balance sheet date are translated into Renminbi at the exchange rates quoted by the People's Bank of China ruling at that date. Exchange differences are dealt with in the profit and loss account.

(s) Borrowing costs

Borrowing costs are expensed in the profit and loss account as and when incurred, except to the extent that they are capitalised as being directly attributable to the acquisition or construction of an asset which necessarily takes a substantial period of time to get ready for its intended use.

(t) Deferred taxation

Deferred tax is provided using the balance sheet liability method on all temporary differences between the carrying amounts for financial reporting purposes and the amounts used for taxation purposes, except differences relating to the initial recognition of assets or liabilities which affect neither accounting nor taxable profit/loss.

The tax value of losses expected to be available for utilisation against future taxable income is recognised as a deferred tax asset and offset against the deferred tax liability attributable to the same legal tax unit and jurisdiction. Net deferred tax assets are reduced to the extent that it is no longer probable that the related tax benefit will be realised.

(u) Retirement benefits

Contributions to retirement schemes and additional retirement benefits paid to retired employees are charged to the profit and loss account as and when incurred.

(v) Frequent flyer award programs

The Group maintains two frequent flyer award programs, namely, the China Southern Airlines Sky Pearl Club and the Egret Mileage Plus, which provide travel awards to members based on accumulated mileage. The estimated incremental cost to provide free travel is recognised as an expense and accrued as a current liability as members accumulate mileage.

As members redeem awards or their entitlements expire, the incremental cost liability is reduced accordingly to reflect the acquittal of the outstanding obligations.

2 Principal accounting policies (cont'd)

(w) Provisions

A provision is recognised in the balance sheet when the Group has a legal or constructive obligation as a result of a past event, and it is probable that an outflow of economic benefits will be required to settle the obligations.

(x) Related parties

For the purposes of these accounts, parties are considered to be related to the Group if the Group has the ability, directly or indirectly, to control the party or exercise significant influence over the party in making financial and operating decisions, or vice versa, or where the Group and the party are subject to common control or common significant influence. Related parties may be individuals or entities.

(y) Use of estimates

The preparation of the accounts of the Group and the Company in accordance with IAS requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the accounts and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

3 Turnover

Turnover comprises revenues from airline and airline-related business and is stated net of sales tax and contributions to the CAAC Infrastructure Development Fund. An analysis of turnover is as follows:

	2000 RMB'000	1999 RMB'000
Traffic revenue		
Passenger	**13,254,714**	11,819,160
Cargo and mail	**1,451,445**	1,005,886
	14,706,159	12,825,046
Other operating revenue		
Commission income	**134,252**	134,828
General aviation income	**53,161**	49,150
Ground services fees	**63,111**	49,918
Air catering	**23,654**	23,351
Aircraft lease income	**110,635**	119,400
Other	**87,346**	97,971
	472,159	474,618
	15,178,318	13,299,664