

The following is the text of a report, prepared for the purpose of incorporation in this Prospectus, received from our auditors and reporting accountants, Ernst & Young, Certified Public Accountants, Hong Kong. As described in “Appendix X — Documents Delivered and Available for Inspection”, a copy of the Accountants’ Report is available for inspection.



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December 3, 2004

The Directors  
Air China Limited  
China International Capital Corporation (Hong Kong) Limited  
Merrill Lynch Far East Limited  
Merrill Lynch International

Dear Sirs,

We set out below our report on the financial information regarding Air China Limited (the “Company”), its subsidiaries and joint ventures (hereinafter collectively referred to as the “Group”) for each of the three years ended December 31, 2001, 2002 and 2003 and the six-month period ended June 30, 2004 (the “Relevant Periods”) and the six-month period ended June 30, 2003 (the “June 30, 2003 Financial Information”), prepared on the basis set out in Section 2 below for inclusion in the prospectus of the Company dated December 3, 2004 (the “Prospectus”).

The Company was incorporated on September 30, 2004 in Beijing, the People’s Republic of China (the “PRC”), as a joint stock limited company as part of the restructuring (the “Restructuring”) of China National Aviation Holding Company (“CNAHC”), a state-owned enterprise under the supervision of the State Council, as described in Section 1 below. Pursuant to the Restructuring, CNAHC, through its wholly-owned subsidiaries, effected the transfer of the following to the Company upon its incorporation:

- (1) the assets, liabilities and undertakings which principally relate to the business of the provision of airline operations (the “Relevant Businesses”); and
- (2) the shareholding interests in certain subsidiaries, joint ventures and associates which principally carry on the business of the provision of airline operations, aircraft engineering services, air catering services, airport ground handling services and other airline-related businesses (the “Relevant Companies”).

In consideration for CNAHC transferring the Relevant Businesses and the Relevant Companies to the Company, the Company issued 6,500 million ordinary shares. The shares issued to CNAHC and its subsidiary have a par value of RMB1.00 each and represented the entire registered and issued share capital of the Company upon its incorporation.

Prior to the formation of the Company, the Relevant Businesses and the Relevant Companies were held by two subsidiaries of CNAHC, namely, Air China International Corporation (中國國際航空公司) and China National Aviation Company Limited (“CNAC”), a Hong Kong incorporated company with its shares publicly traded on The Stock Exchange of Hong Kong Limited (the “Hong Kong Stock Exchange”). Air China International Corporation is a state-

owned enterprise established in the PRC on July 1, 1988 and was subject to the supervision and regulation of the General Administration of Civil Aviation of China, formerly known as the Civil Aviation Administration of China (“CAAC”), a regulatory authority of the civil aviation industry in the PRC. Pursuant to the documents issued by the State Council and the Ministry of Finance dated July 14, 2002 and August 9, 2002, respectively, the PRC government approved the formation of CNAHC, a state-owned enterprise under the supervision of the State Council, which then held, inter alia, a 100% direct interest in Air China International Corporation, a 100% direct interest in China Southwest Airlines (“CSWA”), a 100% direct interest in CNAC (PRC), which owned CNAC Zhejiang Airlines (“ZJA”) and approximately a 69% indirect interest in CNAC. In 2003, CNAHC undertook further reorganisation measures to merge the business operations of CSWA and ZJA into Air China International Corporation, following which CSWA and ZJA became branches of Air China International Corporation. Further details of the Restructuring are set out in the “Our Restructuring” section of the Prospectus.

The registered office of the Company is located at 9th Floor, Blue Sky Mansion, 28 Tianzhu Road, Zone A, Tianzhu Airport Industrial Zone, Shunyi District, Beijing 101312, China.

No financial statements of the Company have been prepared since the date of its incorporation on September 30, 2004.

For the purpose of the Restructuring, the directors of the Company have prepared the combined financial statements of the Group for the Relevant Periods. We have audited the combined financial statements in accordance with Statements of Auditing Standards (“SAS”) issued by the Hong Kong Institute of Certified Public Accountants (“HKICPA”).

Except for the companies indicated in Section 1 and the audited combined financial statements, no audited financial statements were prepared by CNAHC and other companies comprising the Group for the Relevant Periods because there is no statutory audit requirement in the countries/jurisdictions in which the companies are incorporated/established.

*Procedures Performed in Respect of the Relevant Periods*

For the purpose of this report, we have examined the audited combined financial statements of the Group for the Relevant Periods in accordance with SAS and have carried out such additional procedures as we considered necessary in accordance with the Auditing Guideline “Prospectuses and the Reporting Accountant” issued by the HKICPA and Statements of Investment Circular Reporting Standards issued by the Auditing Practices Board in the United Kingdom. We have planned and performed our work so as to obtain reasonable assurance that the financial information upon which our opinion is given is free from material misstatement.

*Procedures Performed in Respect of the June 30, 2003 Financial Information*

For the purpose of this report, we have performed a review of the June 30, 2003 Financial Information, in accordance with SAS 700 “Engagements to review interim financial reports” issued by the HKICPA. A review consists principally of making enquiries of management and applying analytical procedures to the financial information and based thereon, assessing whether the accounting policies and presentation have been consistently applied unless otherwise disclosed. A review excludes audit procedures such as tests of controls and verification of assets and liabilities and transactions. It is substantially less in scope and provides a lower level of assurance than our audit or examination procedures described in the preceding paragraph and, accordingly, we do not express an opinion on the June 30, 2003 Financial Information.

Our work has not been carried out in accordance with auditing standards generally accepted in the United States of America and, accordingly, should not be relied upon as if it had been carried out in accordance with those standards.

The financial information set out in this report has been prepared based on the audited combined financial statements or management accounts of the Group as if the Restructuring had been completed as at the beginning of the Relevant Periods. No adjustments were considered necessary to restate the audited combined financial statements and management accounts of the Group to conform to the accounting policies referred to in Section 3, which are in compliance with International Financial Reporting Standards (“IFRS”) as promulgated by the International Accounting Standards Board (“IASB”).

The combined financial statements and management accounts of the Group are the responsibility of the directors of the respective companies who approve their issuance or preparation. The directors of the Company are responsible for the contents of the Prospectus in which this report is included. It is our responsibility to compile the financial information, together with the notes thereto, based on the audited combined financial statements or management accounts of the Group and to form an independent opinion and a review conclusion on such information in respect of the Relevant Periods and for the six-month period ended June 30, 2003, respectively, and to report our opinion and review conclusion to you.

*Opinion in Respect of the Relevant Periods*

In our opinion, the financial information gives, for the purpose of this report, a true and fair view of the combined results and combined cash flows of the Group for each of the Relevant Periods and of the state of affairs of the Group as at December 31, 2001, 2002 and 2003, and June 30, 2004.

*Review Conclusion in Respect of the June 30, 2003 Financial Information*

On the basis of our review, for the purpose of this report, we are not aware of any material modification that should be made to the combined results and combined cash flows of the Group as set out in the June 30, 2003 Financial Information.

**1. RESTRUCTURING**

As a result of a group restructuring of CNAHC in preparation for the listing of the Company’s H Shares on the Hong Kong Stock Exchange and the Official List of the UK Listing Authority, the Company was incorporated on September 30, 2004. Pursuant to the Restructuring, CNAHC, together with its wholly-owned subsidiaries, effected the transfer of the Relevant Businesses and interests in the Relevant Companies to the Company upon its incorporation and 5,054,276,915 Domestic Shares (in the form of State legal person shares) and 1,445,723,085 non-H Foreign Shares with a par value of RMB 1.00 each were issued by the Company to CNAHC and China National Aviation Corporation (Group) Limited (“CNACG” and which is a Hong Kong incorporated company wholly owned by CNAHC) in exchange for the transfer of the Relevant Businesses and interests in the Relevant Companies to the Company. In the opinion of the directors, the Company is wholly owned by CNAHC which is the Company’s ultimate holding company.

Prior to the Restructuring, CNAHC was indirectly engaged in the Relevant Businesses through its subsidiaries and the Relevant Companies. As a result of the Restructuring, the Group and its associates become the only entities through which CNAHC conducts the respective airline operations, aircraft engineering services, airport ground handling services, air catering services and other airline-related businesses.

The Company was incorporated in Beijing, the PRC, on September 30, 2004 as a joint stock limited company and, pursuant to the Restructuring, the Company became the holding company of the following principal subsidiaries, joint ventures and associates. In addition, except for the interests in Hong Kong Dragon Airlines Limited (“Dragonair”), which were acquired from independent third parties in 1996 and 1997, all of the entities in the Group were owned by CNAHC or companies now comprising the CNAHC group upon their incorporation/establishment:

Company name	Notes	Place and date of incorporation/establishment	Nominal value of registered and paid-up capital (in thousands)	Percentage of equity interest attributable to the Group				Principal activities
				December 31,		June 30,		
				2001	2002	2003	2004	
<b>Subsidiaries</b>								
China National Aviation Company Limited (中航興業有限公司) .....	(1)	Hong Kong February 3, 1997	HK\$ 331,268	70.5	68.7	69	69	Investment holding
Air Macau Company Limited (“Air Macau”) (澳門航空股份有限公司).....	(2)	Macau September 13, 1994	MOP 400,000	51	35	35.2	35.2	Airline operator
Air China Group Import and Export Trading Co. (國航集團進出口貿易公司)	(3)	PRC August 30, 1993	RMB 90,000	100	100	100	100	Import and export trading
浙江航空服務有限公司 .....	(4)	PRC ** November 27, 1995	RMB 20,000	100	100	100	100	Provision of airline catering and shuttle bus services
Beijing Aviation Passenger Service Corporation (北京航空旅客服務公司).....	(5)	PRC December 17, 1992	RMB 3,000	100	100	100	100	Provision of passenger transportation services
Air China Shantou Industrial Development Company (中國國際航空汕頭實業發展公司) .....	(6)	PRC January 21, 1993	RMB 12,000	51	51	51	51	Manufacture and retail of aircraft supplies
China National Aviation Air Passenger and Cargo Services Agency Company (中國民航客貨運輸銷售代理公司) .....	(7)	PRC September 20, 1987	RMB 6,980	100	100	100	100	Provision of travel agency and freight forwarding services
四川西南航空信息服務中心 .....	(8)	PRC ** December 30, 1995	RMB 1,000	100	100	100	100	Provision of information system consultancy services

**APPENDIX I**
**ACCOUNTANTS' REPORT**

Company name	Notes	Place and date of incorporation/ establishment	Nominal value of registered and paid-up capital (in thousands)	Percentage of equity interest attributable to the Group				Principal activities
				December 31,		June 30,		
				2001	2002	2003	2004	
Beijing Air China Engineering Technology Development Centre (北京國航工程技術發展中心) .....	(9)	PRC January 28, 1996	RMB 1,500	100	100	100	100	Provision of engineering consultancy services
Beijing Civil Aviation Blue Sky Air Travel Services Company (北京民航藍天空運服務公司) .....	(10)	PRC August 30, 1985	RMB 5,530	100	100	100	100	Provision of travel agency services
Sichuan Southwest Air Equipment and Supplies Centre (四川西南航空物資設備供應中心) ....	(11)	PRC November 1, 1995	RMB 1,000	100	100	100	100	Provision of wholesale and retail services
Air China Development Corporation (Hong Kong) Limited (國航香港發展有限公司)	(12)	Hong Kong March 20, 2000	HK\$ 500	95	95	95	95	Provision of air ticketing services
Air China Cargo Co., Ltd. (中國國際貨運航空有限公司) .....	(13)	PRC November 14, 2003	RMB2,200,000	N/A	N/A	51	51	Provision of cargo carriage services
<b>Joint ventures</b>								
Aircraft Maintenance and Engineering Corporation, Beijing ("AMECO") (北京飛機維修工程有限公司) .....	(14)	PRC August 1, 1989	US\$ 87,530	60	60	60	60	Provision of aircraft overhaul and maintenance services
Beijing Air Catering Co., Ltd. ("BACL") (北京航空食品有限公司).....	(15)	PRC November 16, 1987	US\$ 8,000	60	60	60	60	Provision of airline catering services
Southwest Air Catering Company Limited ("SWACL") (西南航空食品有限公司)...	(16)	PRC July 29, 1993	RMB 20,000	75	75	75	75	Provision of airline catering services
<b>Associates</b>								
Shenzhen Airlines, Co., Ltd. ("Shenzhen Airlines") (深圳航空有限責任公司).....	(17)	PRC October 11, 1989	RMB 300,000	25	25	25	25	Airline operator
Dragonair (港龍航空有限公司) .....	(18)	Hong Kong May 24, 1985	HK\$ 500,000	30.5	29.7	29.9	29.9	Airline operator
Sichuan SNECMA Aeroengine Maintenance Co., Ltd. (四川斯奈克瑪航空發動機維修有限公司)	(19)	PRC July 1, 1999	US\$ 21,000	40.3	40.3	40.3	40.3	Provision of maintenance and repair services for aircraft engines

## APPENDIX I

## ACCOUNTANTS' REPORT

Company name	Notes	Place and date of incorporation/ establishment	Nominal value of registered and paid-up capital (in thousands)	Percentage of equity interest attributable to the Group				Principal activities
				December 31,			June 30,	
				2001	2002	2003	2004	
Chengdu Falcon Aircraft Engineering Service Co., Ltd. (成都富凱飛機工程服務有限公司).....	(20)	PRC July 6, 2001	RMB 16,474	35.6	35.6	35.6	35.6	Provision of maintenance and repair services for aircraft engines
Yunan Airport Aircraft Maintenance Services Co., Ltd. (雲南空港飛機維修服務公司)	(21)	PRC June 9, 2003	RMB 10,000	N/A	N/A	40	40	Provision of maintenance and repair services
Macau Aircraft Repair and Conversion Company Limited (澳門飛機維修工程有限公司) .....	(22)	Macau July 12, 2001	MOP 100	25	17.2	17.3	17.3	Provision of aircraft repair and conversion services
Jardine Airport Services Limited (怡中航空服務有限公司).....	(23)	Hong Kong November 29, 1988	HK\$ 10	35.3	34.4	34.5	34.5	Provision of airport ground handling services
Menzies Macau Airport Services Limited ("Menzies") (明捷澳門機場服務有限公司) .....	(24)	Macau December 14, 1994	MOP 10,000	25.5	23.1	23.2	23.2	Provision of airport ground handling services
CAAC Data Communications Co., Ltd. (民航數據通信有限責任公司) .....	(25)	PRC June 20, 1996	RMB 10,800	23.2	23.2	23.2	23.2	Provision of aviation data communication services
CAAC Cares Chongqing Co., Ltd. (重慶民航凱亞信息技術有限公司).....	(26)	PRC May 17, 2000	RMB 9,800	24.5	24.5	24.5	24.5	Provision of airline-related information system services
成都民航西南凱亞有限責任公司 .....	(27)	PRC November 29, 1999	RMB 2,000	35	35	35	35	Provision of airline-related information system services
(Chengdu CAAC Southwest Cares Co., Ltd.)	**							
Tradeport Hong Kong Limited (香港商貿港有限公司) .....	(28)	Hong Kong November 20, 2000	HK\$ 1	17.6	17.2	17.3	17.3	Provision of services for developing and operating logistics centre
China National Aviation Finance Co., Ltd. (“CNAF”) (中國航空集團財務有限責任公司).....	(29)	PRC October 27, 1993	RMB 325,270	42.5	42.5	42.5	42.5	Provision of financial services

## Notes:

- (1) This company is publicly listed on the Hong Kong Stock Exchange and its financial year end is December 31. The statutory financial statements for the three years ended December 31, 2003 were audited by PricewaterhouseCoopers, Certified Public Accountants. The company's registered office is located at 5th Floor, CNAC House, 12 Tung Fai Road, Hong Kong International Airport, Lantau, Hong Kong.
- (2) The financial year end of this company is December 31. The statutory financial statements for the three years ended December 31, 2003 were audited by KPMG, Certified Public Accountants. The decrease in effective interest in 2002 is because CNAHC transferred its 51% interest in Air Macau, held by its wholly-owned subsidiary, to CNAC, a non wholly-owned subsidiary, resulting in a deemed dilution of approximately 16%. The company's registered office is located at Avenida da Praia Grande, n°693, Edificio Tai Wah, 12° andar, Macau.
- (3) The financial year end of this company is December 31. The audited financial statements for the year ended December 31, 2001 and the two years ended December 31, 2003 were audited by 北京中倫信會計師事務所有限責任公司 (Beijing Zhonglunxin Certified Public Accountants Co., Ltd.) and 中鵬會計師事務所有限公司 (Zhongpeng Accounting Firm Co., Ltd.), respectively. The company's registered office is located at 北京市朝陽區首都機場四號北路國航進出口公司大樓 (Air China Group Import and Export Company Tower, 4 North Road, Beijing Capital International Airport, Chaoyang District, Beijing, China)\*.
- (4) The financial year end of this company is December 31. The statutory financial statements for the two years ended December 31, 2002 and the year ended December 31, 2003 were audited by 浙江天平會計師事務所有限責任公司 (Zhejiang Tianping Certified Public Accountants Co., Ltd.) and 浙江中滙會計師事務所有限公司 (Zhejiang Zhonghui Certified Public Accountants Co., Ltd.), respectively. The company's registered office is located at 杭州市笕橋機場內 (Jianqiao Airport, Hangzhou, China)\*.
- (5) The financial year end of this company is December 31. The audited financial statements for the two years ended December 31, 2002 and the year ended December 31, 2003 were audited by 北京中澤晟會計師事務所有限責任公司 (Beijing Zhongzesheng Certified Public Accountants Co., Ltd.) and 北京天華會計師事務所 (Beijing TIN WHA CPAs), respectively. The company's registered office is located at 北京市朝陽區首都國際機場營運部大樓 (Operating Department Tower, Beijing Capital International Airport, Chaoyang District, Beijing, China)\*.
- (6) The financial year end of this company is December 31. No audited financial statements were issued for the year ended December 31, 2001. The audited financial statements for the two years ended December 31, 2003 were audited by 汕頭市鮫島會計師事務所有限公司 (Shantou Tuodao Certified Public Accountants Co., Ltd.). The company's registered office is located at 金砂東路中信大廈12樓 (12th Floor, Zhongxin Tower, East Jinsha Road, China)\*.
- (7) The financial year end of this company is December 31. The statutory financial statements for the two years ended December 31, 2002 and the year ended December 31, 2003 were audited by 北京市華頌會計師事務所有限公司 (Beijing Huasong Certified Public Accountants Co., Ltd.) and 北京興洲會計師事務所有限責任公司 (Beijing Xingzhou CPA Co., Ltd.), respectively. The company's registered office is located at 北京市朝陽區首都機場貨運路老貨運樓南側 (South Old Cargo Building, Cargo Road, Beijing Capital International Airport, Chaoyang District, Beijing, China)\*.
- (8) The financial year end of this company is December 31. The audited financial statements for the three years ended December 31, 2003 were audited by 四川正則會計師事務所有限責任公司 (Sichuan Zeca Accountants Firm). The company's registered office is located at 成都市雙流國際機場內 (Shuangliu International Airport, Chengdu, China)\*.
- (9) The financial year end of this company is December 31. No audited financial statements were issued for the year ended December 31, 2001. The audited financial statements for the two years ended December 31, 2003 were audited by 北京方誠會計師事務所有限責任公司 (Beijing Fangcheng Certified Public Accountants Co., Limited) and 北京興洲會計師事務所有限責任公司 (Beijing Xingzhou CPA Co., Ltd.), respectively. The company's registered office is located at 北京市朝陽區首都國際機場北蘋果園商業樓 (Business Tower, North Pingguoyuan, Beijing Capital International Airport, Chaoyang District, Beijing, China)\*.
- (10) The financial year end of this company is December 31. The audited financial statements for the three years ended December 31, 2003 were audited by 中鵬會計師事務所有限公司 (Zhongpeng Accounting Firm Co., Ltd.). The company's registered office is located at 北京市東城區東四大街394號 (394 Dongs North Road, Dongcheng District, Beijing, China)\*.

- (11) The financial year end of this company is December 31. The statutory financial statements for the year ended December 31, 2001 and the two years ended December 31, 2003 were audited by 四川華文會計師事務所有限公司 (Sichuan Huawen Accounting Office) and 四川正則會計師事務所有限責任公司 (Sichuan Zeca Accountants Firm), respectively. The company's registered office is located at 成都市雙流國際機場內 (Shuangliu International Airport, Chengdu, China)\*.
- (12) The financial year end of this company is December 31. The statutory financial statements for the three years ended December 31, 2003 were audited by Deloitte Touche Tohmatsu, Certified Public Accountants. The company's registered office is located at 2nd Floor, CNAC Group Building, 10 Queen's Road, Central, Hong Kong.
- (13) The financial year end of this company is December 31. Since this company was established on November 14, 2003 and commenced its operations in 2004, no statutory financial statements were prepared up to the date of this report. The company's registered office is located at 北京市順義區天竺空港工業區A區 (Area A, Tianzhu Konggang Industrial Estate, Shunyi District, Beijing, China)\*.
- (14) The financial year end of this company is December 31. The statutory financial statements for the three years ended December 31, 2003 were audited by 北京京都會計師事務所有限責任公司 (Beijing Jingdu Certified Public Accountants Co., Ltd.). The company's registered office is located at 北京市首都國際機場 (Beijing Capital International Airport, China)\*.
- (15) The financial year end of this company is December 31. The statutory financial statements for the three years ended December 31, 2003 were audited by 北京京都會計師事務所有限責任公司 (Beijing Jingdu Certified Public Accountants Co., Ltd.). The company's registered office is located at 北京市首都國際機場 (Beijing Capital International Airport, China)\*.
- (16) The financial year end of this company is December 31. The statutory financial statements for the three years ended December 31, 2003 were audited by 四川宏信會計師事務所有限公司 (Sichuan Hongxin Certified Public Accountants Co., Ltd.). The company's registered office is located at 四川成都市西南航空港經濟開發區機場路 (Airport Road, Economics & Developing Estate, Southwest Airport, Chengdu, Sichuan Province, China)\*.
- (17) The financial year end of this company is December 31. The statutory financial statements for the three years ended December 31, 2003 were audited by 深圳鵬城會計師事務所 (Shenzhen Pengcheng Certified Public Accountants Co., Ltd.). The company's registered office is located at 深圳市寶安區黃田國際機場深航辦公大樓 (Office Block, Shenzhen Airlines, Huangtian International Airport, Baoan District, Shenzhen, China)\*.
- (18) The financial year end of this company is December 31. The statutory financial statements for the three years ended December 31, 2003 were audited by PricewaterhouseCoopers, Certified Public Accountants. The company's registered office is located at 35th Floor, Two Pacific Place, 88 Queensway, Hong Kong.
- (19) The financial year end of this company is December 31. The statutory financial statements for the three years ended December 31, 2003 were audited by 華實會計師事務所 (Sino-Reality Certified Public Accountants). The company's registered office is located at 成都市雙流國際機場內 (Shuangliu International Airport, Chengdu, China)\*.
- (20) The financial year end of this company is December 31. The statutory financial statements for the three years ended December 31, 2003 were audited by 四川標準會計師事務所有限公司 (Sichuan Standard Certified Public Accountants Co., Ltd.), 四川安銳會計師事務所有限公司 (Sichuan Anrui Certified Public Accountants Co., Ltd.) and 四川金典會計師事務所有限公司 (Sichuan Jindian Certified Public Accountants Co., Ltd.), respectively. The company's registered office is located at 成都高新區高朋大道十一號科技工業園F-58號 (No. F-58 Technological & Industrial Park, 11 Gaopeng Road, High Technological Developing District, Chengdu, Sichuan Province, China)\*.
- (21) The financial year end of this company is December 31. The first statutory financial statements for the year ended December 31, 2003 were audited by 雲南興華會計師事務所有限公司 (Yunnan Xinhua Certified Public Accountants Co., Ltd.). The company's registered office is located at 昆明市春城路284號 (284 Chuncheng Road, Kunming, China)\*.
- (22) No audited financial statements were issued for each of the three years ended December 31, 2003. The company's registered office is located at 2nd Floor, MASC Ogden Headquarters Macau International Airport Pac On, Taipa, Macau.
- (23) The financial year end of this company is December 31. The statutory financial statements for the three years ended December 31, 2003 were audited by PricewaterhouseCoopers, Certified Public Accountants. The company's registered office is located at 25th Floor, Devon House, Taikoo Place, 979 King's Road, Quarry Bay, Hong Kong.
- (24) The financial year end of this company is December 31. The statutory financial statements for the three years ended December 31, 2003 were audited by Deloitte Touche Tohmatsu, Certified Public Accountants. The company's registered office is located at Menzies Macau Headquarters, Macau International Airport Pac On, Taipa, Macau.



- (25) The financial year end of this company is December 31. The audited financial statements for the two years ended December 31, 2002 and the year ended December 31, 2003 were audited by 北京高商會計師事務所有限公司 (Beijing Gaoshang Certified Public Accountants Co., Ltd.) and 北京中天恒會計師事務所有限責任公司 (Beijing Zhongtianheng Certified Public Accountants Co., Ltd.), respectively. The company's registered office is located at 北京市東城區東四西大街155號 (155 Dongsu West Road, Dongcheng District, Beijing, China)\*.
- (26) The financial year end of this company is December 31. The audited financial statements for the two years ended December 31, 2003 were audited by 重慶諦威會計師事務所有限公司 (Chongqing Diwei Certified Public Accountants Co., Ltd.) and 重慶中瑞會計事務所有限公司 (Chongqing Zhongrui Certified Public Accountants Co., Ltd.), respectively. The company's registered office is located at 重慶市九龍坡區石橋鋪渝州路8號 (8 Yuzhou Road, Shiqiao Pu, Jiulongpo District, Chongqing, China)\*.
- (27) The financial year end of this company is December 31. The audited financial statements for the three years ended December 31, 2003 were audited by 四川華文會計師事務所有限公司 (Sichuan Huawen Accounting Office). The company's registered office is located at 四川省成都市武侯區人民南路四段航空路一號二層 (2nd Floor, Aviation Road, 4th Section, 1 South Renmin Road, Wuhou District, Chengdu, Sichuan Province, China)\*.
- (28) The financial year end of this company is December 31. The statutory financial statements for the three years ended December 31, 2003 were audited by PricewaterhouseCoopers, Certified Public Accountants. The company's registered office is located at 30th Floor, Jardine House, One Connaught Place, Hong Kong.
- (29) The financial year end of this company is December 31. The audited financial statements for the two years ended December 31, 2002 and the year ended December 31, 2003 were audited by 北京興華會計師事務所有限責任公司 (Beijing Xinhua Certified Public Accountants Co., Ltd.) and 北京天華會計師事務所 (Beijing TIN WHA CPAs), respectively. The company's registered office is located at 北京市朝陽區東三環北路甲2號京信大廈6層 (6th Floor Jingxin Tower, Jia 2, East 3rd Ring North Road, Chaoyang District, Beijing, China)\*.

\* The English addresses are a direct translation of the company's registered office addresses in Chinese.

\*\* The English names are a direct translation of the company's Chinese names.

## **2. BASIS OF PRESENTATION**

As discussed in Section 1 above, the Relevant Businesses were operated by subsidiaries of CNAHC and interests in the Relevant Companies were owned directly or indirectly by CNAHC prior to the Restructuring. Accordingly, the Restructuring has been accounted for as a reorganisation of companies under common control in a manner similar to a pooling-of-interests. As a result, the accompanying combined balance sheets have been prepared to present the Group's assets and liabilities as if the Restructuring had been completed as at the beginning of the Relevant Periods. The accompanying combined results and combined cash flows include the Group's results of operations and cash flows as if the Relevant Businesses and interests in the Relevant Companies had been transferred to the Group at the beginning of the Relevant Periods.

The combined results in Section 4 and combined balance sheets in Section 5 have been prepared in accordance with IFRS, which comprise standards and interpretations approved by the IASB, and International Accounting Standards ("IAS") and Standing Interpretations Committee interpretations approved by the International Accounting Standards Committee that remain in effect.

The Group is principally engaged in the provision of airline operations, aircraft engineering services, air catering services, airport ground handling services and other airline-related businesses.

## **3. PRINCIPAL ACCOUNTING POLICIES**

The combined financial statements of the Group have been prepared in accordance with IFRS, which comprise standards and interpretations approved by the IASB, and International Accounting Standards and Standing Interpretations Committee interpretations approved by the

International Accounting Standards Committee that remain in effect, except for the following standards that have been early adopted as at the beginning of the Relevant Periods:

- IFRS 1 (amended 2004), *First Time Adoption of International Financial Reporting Standards*;
- IFRS 3, *Business Combinations*;
- IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*;
- IAS 1 (amended 2004), *Presentation of Financial Statements*;
- IAS 2 (revised 2003), *Inventories*;
- IAS 7 (amended 2003), *Cash Flow Statements*;
- IAS 8 (revised 2003), *Accounting Policies, Changes in Accounting Estimates and Errors*;
- IAS 10 (amended 2004), *Events after the Balance Sheet Date*;
- IAS 12 (amended 2004), *Income Taxes*;
- IAS 14 (amended 2004), *Segmental Reporting*;
- IAS 17 (amended 2004), *Leases*;
- IAS 18 (amended 2004), *Revenue*;
- IAS 19 (amended 2004), *Employee Benefits*;
- IAS 20 (revised 2003), *Accounting for Government Grants and Disclosure of Government Assistance*;
- IAS 21 (revised 2003), *The Effects of Changes in Foreign Exchange Rates*;
- IAS 23 (amended 2003), *Borrowing Costs*;
- IAS 27 (amended 2004), *Consolidated and Separate Financial Statements*;
- IAS 28 (amended 2004), *Investments in Associates*;
- IAS 31 (amended 2004), *Interests in Joint Ventures*;
- IAS 32 (amended 2004), *Financial Instruments: Disclosure and Presentation*;
- IAS 33 (amended 2004), *Earnings Per Share*;
- IAS 36 (amended 2004), *Impairment of Assets*;
- IAS 37 (amended 2004), *Provisions, Contingent Liabilities and Contingent Assets*;
- IAS 38 (amended 2004), *Intangible Assets*; and
- IAS 39 (amended 2004), *Financial Instruments: Recognition and Measurement*.

Except for the audited financial statements of Air Macau, Menzies and the audited combined financial statements of the Group for the Relevant Periods, the above basis of accounting differs from that used in the audited financial statements and management accounts of other companies comprising the Group, which were prepared in accordance with the accounting principles and the financial regulations applicable to State-owned enterprises or Sino-foreign or domestic joint

ventures established in the PRC (“PRC GAAP”) or generally accepted accounting principles in Hong Kong (“HK GAAP”).

The combined financial statements have been prepared on a historical cost basis, except for the measurement at fair value of financial instruments in accordance with IAS 39 (amended 2004).

**(a) Basis of consolidation**

The Group’s combined financial statements incorporate the financial statements of the Company and its subsidiaries after elimination of intercompany transactions.

Subsidiaries are consolidated from the date on which control is transferred to the Group and cease to be consolidated from the date on which control is transferred out of the Group. This control is normally evidenced when the Group owns, either directly or indirectly, more than 50% of the voting rights of a company’s share or registered capital, is able to govern the financial and operating policies of an enterprise so as to benefit from its activities, and when there is no evidence that control is intended to be temporary.

Minority interests represent the interests in the Company’s subsidiaries, not held by the Group and are presented in the combined balance sheet within equity, separately from the parent shareholders’ equity.

**(b) Foreign currencies**

The Group’s functional and reporting currency is Renminbi (“RMB”), except for overseas subsidiaries, which use their local currencies.

Foreign currency transactions are recorded at the applicable exchange rates ruling at the transaction dates as quoted by the People’s Bank of China. Monetary assets and liabilities denominated in foreign currencies at the balance sheet date are translated at the applicable exchange rates ruling at that date as quoted by the People’s Bank of China. All exchange differences are dealt with in the income statement.

On consolidation, the financial statements of overseas subsidiaries are translated into RMB. The income statements of the subsidiaries are translated into RMB at the weighted average exchange rates for the year, and the balance sheets are translated into RMB at the exchange rates ruling at the balance sheet date. The resulting translation differences are included in the exchange fluctuation reserve.

For the purpose of the combined cash flow statement, the cash flows of the overseas subsidiary are translated into RMB at the exchange rates ruling at the dates of the cash flows. Frequently recurring cash flows of overseas subsidiaries, which arise throughout the year, are translated into RMB at the weighted average exchange rates for the year.

**(c) Interests in joint ventures**

The Group’s interests in its joint ventures are accounted for by proportionate consolidation, which involves recognising a proportionate share of the joint venture’s assets, liabilities, income and expenses with similar items in the combined financial statements on a line-by-line basis.

**(d) Investments in associates**

The Group’s investments in its associates are accounted for under the equity method of accounting. An associate is an entity in which the Group has significant influence and which is

neither a subsidiary nor a joint venture of the Group. The investments in associates are carried in the balance sheet at cost plus post-acquisition changes in the Group's share of net assets of the associates, less any impairment in value. The income statement reflects the Group's share of the results of operations of the associates. The Group's investments in its associates include goodwill (net of accumulated amortisation and impairment) on acquisition, which is treated in accordance with the accounting policy for goodwill stated below.

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

Property, plant and equipment, other than construction in progress ("CIP"), are stated at cost less accumulated depreciation and provision for any impairment in value.

The cost of an asset comprises its purchase price and any directly attributable costs of bringing the asset to its working condition and location for its intended use. Expenditure incurred after assets have been put into operation, such as repairs and maintenance, is normally charged to the income statement in the period in which it is incurred. In situations where it can be clearly demonstrated that the expenditure has resulted in an increase in the future economic benefits expected to be obtained from the use of the asset, the expenditure is capitalised as an additional cost of that asset.

Depreciation is calculated on the straight-line basis over the expected useful life of the asset, after taking into account its estimated residual value, as follows:

	<u>Depreciation life</u>	<u>Residual value</u>
Aircraft and flight equipment . . . . .	10 to 20 years	Nil - 5%
Buildings . . . . .	15 to 35 years	5%
Machinery, transportation equipment and office equipment . .	4 to 20 years	5%

CIP represents office buildings and various infrastructure projects under construction and equipment pending installation in the aircraft and is stated at cost less any impairment loss, and is not depreciated. Cost comprises the direct costs of construction, the cost of equipment as well as finance charges from borrowings used to finance these assets during the construction or installation period. CIP is reclassified to the appropriate categories of property, plant and equipment when completed and ready for use.

The carrying values of property, plant and equipment are reviewed for impairment when events or changes in circumstances indicate that the carrying values may not be recoverable. If any such indication exists and where the carrying values exceed the estimated recoverable amounts, the assets or cash-generating units are written down to their recoverable amounts. The recoverable amount of property, plant and equipment is the greater of 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 the time value of money and the risks specific to the asset. For an asset that does not generate largely independent cash inflows, the recoverable amount is determined for the cash-generating unit to which the asset belongs. Impairment losses are recognised in the income statement.

***(f) Lease prepayments***

Lease prepayments represent acquisition costs of land use rights less accumulated amortisation and impairment losses.

**(g) Goodwill**

Goodwill represents the excess of cost over the fair value of net tangible and identifiable intangible assets of acquired businesses. The Group early adopted IFRS 3, *Business Combinations*, and applied the requirements of IFRS 3 to goodwill existing at or acquired after, and to business combinations occurring from, the beginning of the Relevant Periods. In accordance with IFRS 3, the Group ceased amortising goodwill as of January 1, 2001.

IAS 36 (amended 2004) requires that goodwill be tested for impairment at the cash-generating units on an annual basis and whenever there is an indication that a unit may be impaired, by comparing the carrying amount of the unit, including the goodwill, with the recoverable amount of the unit. An impairment loss shall be recognised for a cash-generating unit if the recoverable amount of the unit is less than the carrying amount of the unit. The impairment loss shall be allocated to reduce the carrying amount of the assets of the unit (group of units) in the following order: (i) first, to reduce the carrying amount of any goodwill allocated to the cash-generating unit (group of units); and (ii) then, to the other assets of the unit pro rata on the basis of the carrying amount of each asset in the unit. In allocating an impairment loss, the Group shall not reduce the carrying amount of an asset below the highest of: (i) its fair value less costs to sell (if determinable); (ii) its value in use (if determinable); and (iii) zero.

**(h) Advance payments for aircraft and related equipment**

Advance contract payments to aircraft manufacturers to secure deliveries of aircraft and related equipment in future years, including attributable finance costs, are included in assets. The advances are accounted for as part of the cost of property, plant and equipment upon delivery of the aircraft.

**(i) Investments**

All investments are initially recognised at cost, being the fair value of the consideration given and including acquisition charges associated with the investments.

After initial recognition, investments, except those investments which do not have a quoted market price in an active market and whose fair value cannot be reliably measured, are classified as held for trading and available-for-sale and measured at fair value. Gains or losses on investments held for trading and available-for-sale are recognised in the income statement. Investments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured are stated at cost less impairment.

**(j) Leases**

Finance leases which transfer to the Group substantially all the risks and benefits of ownership of the leased item are capitalised at the inception of the lease at the fair value of the leased properties or, if lower, at the present value of the minimum lease payments. Lease payments are apportioned between the finance charges and reduction of the lease liability so as to achieve a constant rate of interest on the remaining balance of the liability. Finance charges are charged directly against income. Capitalised leased assets are depreciated over the estimated economic useful lives of the assets.

Leases where the lessor retains substantially all the risks and benefits of ownership of the asset are classified as operating leases. Operating lease payments are recognised as an expense in the income statement on the straight-line basis over the lease terms.

***(k) Inventories***

Inventories, which consist primarily of expendable spare parts and supplies, are stated at cost less any provision for obsolescence, and are expensed when consumed in operations. Cost is determined on the weighted average basis.

Work in progress represents material cost, labour cost and overhead cost capitalised for the provision of aircraft engineering services and is stated at the lower of cost, calculated on a weighted average basis, and net realisable value. Net realisable value is determined on the basis of anticipated sales proceeds less estimated selling expenses.

***(l) Cash and cash equivalents***

Cash and cash equivalents comprise cash at bank and in hand and short-term deposits, which are not restricted as to use. For the purpose of the combined cash flow statement, cash and cash equivalents consist of cash at bank and in hand and short-term deposits with an original maturity of three months or less, net of outstanding bank overdrafts.

***(m) Manufacturers' credits***

In connection with the acquisition of certain aircraft and related equipment, the Group receives various credits from the manufacturers. Such credits are deferred until the aircraft and related equipment are delivered, at which time they are applied as a reduction of the cost of acquiring the aircraft and related equipment.

***(n) Employee benefits***

***(i) Pension obligations***

The full-time employees of the Group are covered by various government-sponsored pension plans under which the employees are entitled to a monthly pension based on certain formulae. Certain government agencies are responsible for the pension liability to these retired employees. The Group contributes on a monthly basis to these pension plans. Under these plans, the Group has no legal or constructive obligation for retirement benefits beyond the contributions made. Contributions to these plans are expensed as incurred.

***(ii) Termination and early retirement benefits***

Termination benefits are payable whenever an employee's employment is voluntary terminated before the normal retirement date or whenever an employee accepts voluntary redundancy in exchange for these benefits. The Group recognises termination benefits when it is demonstrably committed to either terminating the employment of current employees according to a detailed formal plan without possibility of withdrawal or to providing termination benefits as a result of an offer made to encourage voluntary redundancy.

*(iii) Housing benefits*

In prior periods, the Group sold staff quarters to its employees, subject to a number of eligibility requirements, at below market prices. When staff quarters are identified as being subject to sale under these arrangements, the carrying value of the staff quarters is written down to the net recoverable amount. Upon sale, any difference between sales proceeds and the carrying amount of the staff quarters is charged to the income statement. The above staff quarters' allocation scheme was phased out during the Relevant Periods in accordance with the policies of the PRC government. In 1998, the State Council of the PRC issued a circular, which stipulated that the sale of quarters to employees at preferential prices should be withdrawn. In 2000, the State Council further issued a circular stating that cash subsidies should be made to the employees following the withdrawal of allocation of staff quarters. However, the specific timetable and procedures to implement these policies were to be determined by the individual provincial or municipal government based on the particular situation of the province or municipality.

Based on the relevant detailed local government regulations promulgated, certain entities within the Group have adopted cash housing subsidy plans, whereby, for those eligible employees who have not been allocated with any quarter or who have not been allocated with quarters up to the prescribed standards before the staff quarters' allocation scheme was terminated, the Group will pay them one-off cash housing subsidies based on their years of service, positions and other criteria. These cash housing subsidies are charged to the income statement in the year in which it was determined that the payment of such subsidies is probable and the amounts can be reasonably estimated.

In addition, all full-time employees of the Group are entitled to participate in various government-sponsored housing funds. The Group contributes on a monthly basis to these funds based on certain percentages of the salaries of the employees. The Group's liability in respect of these funds is limited to the contributions payable in each period.

*(o) Provisions*

Provisions are recognised when the Group has a present obligation (legal or constructive) as a result of a past event and it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation provided that reliable estimate can be made of the amount of the obligation. If the effect of the time value of money is material, provisions are determined by discounting the expected future cash flows at a pre-tax rate that reflects current market assessments of the time value of money and, where appropriate, the risks specific to the liability. Where discounting is used, the increase in the provision due to the passage of time is recognised as an interest expense.

*(p) Maintenance and overhaul costs*

In respect of aircraft and engines under operating leases, the Group has the responsibility to fulfil certain return conditions under the relevant operating leases. In order to fulfil these return conditions, major overhauls are required to be conducted on a regular basis. Accordingly, estimated costs of major overhauls for aircraft and engines under operating leases are accrued and charged to the income statement over the estimated period between overhauls using the ratios of actual flying hours/cycles and estimated flying hours/cycles between overhauls. The costs of major

overhauls comprise mainly labour and materials. Differences between the estimated costs and the actual costs of overhauls are included in the income statement in the period of overhaul.

In respect of aircraft and engines owned by the Group or held under finance lease, costs of major overhauls are charged to the income statement as and when incurred.

All other routine repair and maintenance costs incurred in restoring such property, plant and equipment to their normal working condition are charged to the income statement as and when incurred.

*(q) Revenue recognition*

Revenue is recognised when it is probable that the economic benefits will flow to the Group and the revenue can be reliably measured on the following bases:

*(i) Provision of airline and airline-related services*

Passenger revenue is recognised either when transportation is provided or when a ticket expires unused rather than when a ticket is sold. Unused tickets generally expire one year from the date the ticket was sold, or for partially used tickets, the date of first flight. Ticket sales for transportation not yet provided are included in current liabilities as air traffic liabilities. In addition, the Group has code-sharing agreements with other airlines under which a carrier's flights can be marketed under the two-letter airline designator code of another carrier. Revenues earned under these arrangements are allocated between the code share partners based on existing contractual agreements and airline industry standard pro-ratio formulae and are recognised as passenger revenue when the transportation is provided.

Cargo and mail revenues are recognised when the transportation is provided.

Revenue from airline-related services is recognised when services are rendered.

Revenue was stated net of business tax and contributions to the CAAC Infrastructure Development Fund prior to January 1, 2004. From 2004, contributions to the CAAC Infrastructure Development Fund is included in other flight operation expenses to reflect the change in the levy basis in accordance with the related new policy promulgated by the PRC government.

*(ii) Sale of goods*

Revenue is recognised when the significant risks and rewards of ownership have been transferred to the buyer, provided that the Group maintains neither managerial involvement to the degree usually associated with ownership, nor effective control over the goods sold.

*(iii) Trading of investments*

Revenue is recognised on a trade date basis.

*(iv) Interest income*

Revenue is recognised on a time proportion basis taking into account the principal outstanding and the effective rate of interest applicable.



*(v) Dividends*

Revenue is recognised when the owners' right to receive the payment has been established.

*(vi) Rental income and aircraft and related equipment lease income*

Revenue is recognised on a time proportion basis over the terms of the respective leases.

*(r) Frequent flyer programme*

For Air China Companion Club member accounts that have sufficient mileage credits to claim the lowest level of free travel, the Group records a liability for the estimated incremental costs associated with providing travel awards that are expected to be redeemed. Incremental costs include the cost of incremental fuel, meals and insurance but do not include any cost for aircraft ownership, maintenance, labour or overhead allocation. The liability is adjusted periodically based on awards earned, awards redeemed, changes in the incremental costs and changes in the Air China Companion Club programme, and is included on the balance sheet as a current liability.

*(s) Government grants*

Government grants are recognised at their fair values when it is probable that the grant will be received and all attaching conditions will be complied with. When the grant relates to an expense item, it is recognised as income over the periods necessary to match the grant on a systematic basis to the costs that it is intended to compensate. Where the grant relates to an asset, the fair value is credited to a deferred income account and is released to the income statement over the expected useful life of the relevant asset by equal annual instalments.

*(t) Borrowing costs*

Borrowing costs directly attributable to the acquisition of aircraft, construction or production of qualifying assets, i.e. assets that necessarily take a substantial period of time to get ready for their intended use, are capitalised as part of the costs of those assets. The capitalisation of aircraft borrowing costs ceases when the aircraft is placed into revenue earning services and the capitalisation of other assets' borrowing costs ceases when the assets are substantially ready for their intended use or sale.

Where funds have been borrowed generally, and used for the purpose of obtaining qualifying assets, a capitalisation rate ranging between 5.58% and 6.54% has been applied to the expenditure on the individual asset.

All other borrowing costs are charged to the income statement in the period in which they are incurred.

*(u) Income tax*

Deferred income tax is provided, using the liability method, on all temporary differences at the balance sheet date between the tax bases of assets and liabilities and their carrying amounts for

financial reporting purposes. Deferred income tax liabilities are recognised for all taxable temporary differences:

- except where the deferred income tax liability arises from the initial recognition of an asset or liability in a transaction that is not a business combination and, at the time of the transaction, affects neither the accounting profit nor taxable profit or loss; and
- in respect of taxable temporary differences associated with investments in subsidiaries, associates and interests in joint ventures, except where the timing of the reversal of the temporary difference can be controlled and it is probable that the temporary difference will not reverse in the foreseeable future.

Deferred income tax assets are recognised for all deductible temporary differences, carryforward of unused tax assets and unused tax losses, to the extent that it is probable that taxable profit will be available against which the deductible temporary differences, carryforward of unused tax assets and unused tax losses can be utilised:

- except where the deferred income tax asset relating to the deductible temporary difference arises from the initial recognition of an asset or liability in a transaction that is not a business combination and, at the time of the transaction, affects neither the accounting profit nor taxable profit or loss; and
- in respect of deductible temporary differences associated with investments in subsidiaries, associates and interests in joint ventures, deferred tax assets are only recognised to the extent that it is probable that the temporary differences will be reversed in the foreseeable future and taxable profit will be available against which the temporary difference can be utilised.

The carrying amount of deferred income tax assets is reviewed at each balance sheet date and reduced to the extent that it is no longer probable that sufficient taxable profit will be available to allow all or part of the deferred income tax asset to be utilised. Deferred income tax assets and liabilities are measured at the tax rates that are expected to apply to the period when the asset is realised or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted at the balance sheet date.

**(v) *Derivative financial instruments***

The Group uses derivative financial instruments to hedge its exposure to fuel prices. In accordance with IAS 39, such derivative financial instruments are carried in the balance sheet at fair value as financial assets or financial liabilities.

For the purposes of hedge accounting, hedges are classified as either fair value hedges where they hedge the exposure to changes in the fair value of a recognised asset or liability; or cash flow hedges where they hedge exposure to variability in cash flows that is either attributable to a particular risk associated with a recognised asset or liability or a forecasted transaction.

Changes in the fair value of derivatives that are designated and qualify as fair value hedges and that are highly effective are recorded in the income statement, along with any changes in the fair value of the hedge assets or liabilities that are attributable to the hedged risk. In relation to fair value hedges (interest rate swaps) which meet the conditions for special hedge accounting, any gain or loss from remeasuring the hedging instrument at fair value is recognised immediately in the income statement. Any gain or loss on the hedged item attributable to the hedged risk is

adjusted against the carrying amount of the hedged item and recognised in the income statement. Where the adjustment is to the carrying amount of a hedged interest-bearing financial instrument, the adjustment is amortised to the profit and loss such that it is fully amortised by maturity. In relation to cash flow hedges (forward foreign currency contracts) to hedge firm commitments which meet the conditions for special hedge accounting, the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge is recognised directly in equity and the ineffective portion is recognised in profit or loss.

When the hedged firm commitment results in the recognition of an asset or a liability, then, at the time the asset or liability is recognised, the associated gains or losses that had previously been recognised in equity are included in the initial measurement of the acquisition cost or other carrying amount of the asset or liability.

For all other cash flow hedges, the gains or losses that are recognised in equity are transferred to the income statement in the same period in which the hedged firm commitment affects the profit and loss, for example when the future sale actually occurs.

For derivatives that do not qualify for special hedge accounting, any gains or losses arising from changes in fair value are taken directly to the income statement for the period. Hedge accounting is discontinued when the hedging instrument expires or is sold, terminated or exercised, or no longer qualifies for special hedge accounting. At that point in time, any cumulative gain or loss on the hedging instrument recognised in equity is kept in equity until the forecasted transaction occurs. If a hedged transaction is no longer expected to occur, the net cumulative gain or loss recognised in equity is transferred to the income statement for the period.

*(w) Use of estimates*

The preparation of the financial statements of the Group in accordance with IFRS 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 financial statements and the reported amount of revenues and expenses during the reporting period. Actual results could differ from those estimates.

*(x) Related parties*

Parties are considered to be related if one party has the ability, directly or indirectly, to control the other party or exercise significant influence over the other party in making financial and operating decisions. Parties are also considered to be related if they are subject to common control or common significant influence. Related parties may be individuals or corporate entities.

*(y) Recoverable amount of non-current assets*

At each reporting date, the Group assesses whether there is any indication that an asset may be impaired. Where an indicator of impairment exists, the Group makes a formal estimate of the recoverable amount. Where the carrying amount of an asset exceeds its recoverable amount, the asset is considered impaired and is written down to its recoverable amount. Recoverable amount is the higher of an asset's or cash-generating unit's fair value less costs to sell and its value in use and is determined for an individual asset, unless the asset does not generate cash inflows that are largely independent of those from other assets or groups of assets.

**(z) Trade and other receivables**

Trade receivables, which generally have 30 to 90 day terms, are recognised and carried at original invoice amount less an allowance for any uncollectible amounts. An estimate for doubtful debts is made when collection of the full amount is no longer probable. Bad debts are written off when identified.

**(aa) Interest-bearing loans and borrowings**

All loans and borrowings are initially recognised at cost, being the fair value of the consideration received net of issue costs associated with the borrowing.

**(bb) Derecognition of financial instruments**

The derecognition of a financial instrument takes place when the Group no longer controls the contractual rights that comprise the financial instrument, which is normally the case when the instrument is sold, or all the cash flows attributable to the instrument are passed through to an independent third party.

**(cc) Impact of recently issued accounting standards**

IFRS 2, *Share-based payment*, is applicable for accounting periods beginning on or after January 1, 2005 and requires the Group to recognise share-based payment transactions in its financial statements, including transactions with employees or other parties to be settled in cash, other assets, or equity instruments of the entity. For equity-settled share-based payment transactions, IFRS 2 requires an entity to measure the goods or services received, and the corresponding increase in equity, directly, at the fair value of the goods or services received, unless that fair value cannot be estimated reliably. If the Group cannot estimate reliably the fair value of the goods or services received, the Group is required to measure their value, and the corresponding increase in equity, indirectly, by reference to the fair value of the equity instruments granted. For cash-settled share-based payment transactions, IFRS 2 requires an entity to measure the goods or services acquired and the liability incurred at the fair value of the liability. Until the liability is settled, the Group is required to remeasure the fair value of the liability at each reporting date and at the date of settlement, with any changes in value recognised in profit or loss for the period. For share-based payment transactions in which the terms of the arrangement provide either the Group or the supplier of goods or services with a choice of whether the Group settles the transaction in cash or by issuing equity instruments, the Group is required to account for that transaction, or the components of that transaction, as a cash-settled share-based payment transaction if, and to the extent that, the Group has incurred a liability to settle in cash (or other assets), or as an equity-settled share-based payment transaction if, and to the extent that, no such liability has been incurred. The provisions of IFRS 2 will apply for grants of shares, share options or other equity instruments that were granted after November 7, 2002 and had not yet vested at the beginning on or after January 1, 2005. The Group does not expect IFRS 2 to have a material effect on its results of operations and financial position.

IAS 16 (amended 2004), *Property, plant and equipment*, replaces IAS 16 (revised 1998), *Property, plant and equipment*, and is applicable for accounting periods beginning on or after January 1, 2005. There are a number of differences between the amended standard and the previous version. These include that the amended standard requires an entity to evaluate under the general recognition principle all property, plant and equipment costs at the time they are incurred.

Those costs include costs incurred initially to acquire or construct an item of property, plant and equipment and costs incurred subsequently to add to, replace part of, or service an item. The previous version of IAS 16 contained specific recognition principles for accounting for subsequent costs. Further, the amended standard requires that the cost of an item of property, plant and equipment includes the costs of its dismantlement, removal or restoration, and the obligation for which an entity incurs as a consequence of installing the item. Its cost also includes the costs of its dismantlement, removal or restoration, and the obligation for which an entity incurs as a consequence of using the item during a particular period for purposes other than to produce inventories during that period. The previous version included within its scope only the costs incurred as a consequence of installing the item. In addition, under the amended standard an entity is required to determine the depreciation charge separately for each significant part of an item of property, plant and equipment, a requirement which was not clearly set out in the previous version. Also, under the amended standard, an entity is required to measure the residual value of an item of property, plant and equipment as the amount that it estimates it would currently receive for the asset if the asset was already of the age and in the condition expected at the end of its useful life. The previous version of IAS 16 did not specify whether the residual value was to be this amount or the amount, inclusive of the effects of inflation, that an entity expected to receive in the future on the asset's actual retirement date. The Group does not expect the adoption of new policies arising from the amended standard, when implemented, will have a material effect on its results of operations and financial position.

IAS 24 (revised 2003), *Related Party Disclosures*, replaces IAS 24 *Related Party Disclosures (reformatted in 1994)* and is applicable for accounting periods beginning on or after January 1, 2005. The main objective of such revision was to provide additional guidance and clarity in the scope of IAS 24, for the definitions and the disclosures for related parties. The wording of IAS 24's objective was amended to clarify that the Group's financial statements should contain the disclosures necessary to draw attention to the possibility that the financial position and the income statement may have been affected by the existence of related parties and by transactions and outstanding balances with them. Since IAS 24 is a standard for disclosure requirements only, there is no material effect on the Group's results of operations and financial position upon adoption.

## 4. RESULTS

The following is a summary of the combined results of the Group for the Relevant Periods and prepared on the basis set out in Section 2 above:

	Notes	Year ended December 31,			Six-month period ended June 30,	
		2001	2002	2003	2003	2004
		RMB'000	RMB'000	RMB'000	RMB'000	RMB'000
					(Unaudited)	
<b>Air traffic revenues</b> .....	(a)	21,348,257	23,846,712	23,422,660	8,692,303	14,698,304
<b>Other operating revenues</b> .....	(b)	1,388,195	1,136,965	1,218,745	533,607	612,716
		<u>22,736,452</u>	<u>24,983,677</u>	<u>24,641,405</u>	<u>9,225,910</u>	<u>15,311,020</u>
<b>Operating expenses</b>						
Jet fuel .....		(4,786,775)	(4,978,719)	(5,425,059)	(2,382,985)	(3,784,928)
Take-off, landing and depot charges .....		(2,948,143)	(3,359,565)	(3,449,769)	(1,506,635)	(2,114,327)
Depreciation .....		(3,242,618)	(3,251,571)	(3,377,472)	(1,667,350)	(1,715,396)
Aircraft maintenance, repair and overhaul .....		(1,555,883)	(2,384,865)	(2,149,353)	(922,588)	(1,280,572)
Employee compensation costs .....	(d)	(1,643,885)	(2,030,526)	(2,379,102)	(1,096,055)	(1,310,596)
Air catering charges .....		(856,048)	(919,180)	(842,743)	(360,075)	(534,948)
Aircraft and jet engines operating lease expenses .....		(547,371)	(711,979)	(910,134)	(420,746)	(514,528)
Other operating lease expenses .....		(149,114)	(143,431)	(181,984)	(84,312)	(88,252)
Other flight operation expenses .....		(1,934,291)	(2,237,430)	(2,112,432)	(898,548)	(1,221,978)
Selling and marketing expenses .....		(1,156,643)	(1,220,086)	(1,057,630)	(495,772)	(666,170)
General and administrative expenses .....		(629,576)	(461,946)	(471,463)	(226,500)	(252,800)
<b>Total operating expenses</b> .....		<u>(19,450,347)</u>	<u>(21,699,298)</u>	<u>(22,357,141)</u>	<u>(10,061,566)</u>	<u>(13,484,495)</u>
<b>Profit/(loss) from operations</b> .....	(c)	<u>3,286,105</u>	<u>3,284,379</u>	<u>2,284,264</u>	<u>(835,656)</u>	<u>1,826,525</u>
<b>Finance costs</b> .....	(e)	<u>(2,029,212)</u>	<u>(2,777,087)</u>	<u>(2,349,078)</u>	<u>(984,953)</u>	<u>(789,371)</u>
<b>Dilution gain on investment in a subsidiary</b> .....	(f)	<u>—</u>	<u>106,040</u>	<u>—</u>	<u>—</u>	<u>—</u>
<b>Share of profits less losses from associates</b> .....		<u>352,829</u>	<u>426,494</u>	<u>243,093</u>	<u>(110,864)</u>	<u>223,692</u>
<b>Profit/(loss) before tax</b> .....		<u>1,609,722</u>	<u>1,039,826</u>	<u>178,279</u>	<u>(1,931,473)</u>	<u>1,260,846</u>
<b>Tax</b> .....	(i)	<u>(552,660)</u>	<u>(369,073)</u>	<u>(89,781)</u>	<u>535,263</u>	<u>(391,438)</u>
<b>Profit/(loss) after tax and before minority interests</b> .....		<u>1,057,062</u>	<u>670,753</u>	<u>88,498</u>	<u>(1,396,210)</u>	<u>869,408</u>
<b>Minority interests</b> .....		<u>(108,774)</u>	<u>(171,143)</u>	<u>71,106</u>	<u>143,688</u>	<u>(81,056)</u>
<b>Net profit/(loss) from operating activities attributable to shareholders</b> .....		<u>948,288</u>	<u>499,610</u>	<u>159,604</u>	<u>(1,252,522)</u>	<u>788,352</u>
<b>Distributions</b> .....	(j)	<u>157,993</u>	<u>227,608</u>	<u>342,843</u>	<u>136,606</u>	<u>40,969</u>
<b>Earnings/(loss) per share — Basic</b> .....	(l)	<u>14.6 cents</u>	<u>7.7 cents</u>	<u>2.5 cents</u>	<u>(19.3) cents</u>	<u>12.1 cents</u>

Notes:

## (a) Air traffic revenues

Air traffic revenues comprise revenues from the airline business and is stated net of business tax and contributions to the CAAC Infrastructure Development Fund (“CAAC Infrastructure Development Fund”). The CAAC Infrastructure Development Fund, which was netted against

gross air traffic revenues for the three years ended December 31, 2003, was included in other flight operation expenses for the six-month period ended June 30, 2004 to reflect the change in the levy basis in accordance with the related new policy promulgated by the PRC government. An analysis of air traffic revenues is as follows:

	Year ended December 31,			Six-month period ended June 30,	
	2001	2002	2003	2003	2004
	RMB'000	RMB'000	RMB'000	RMB'000	RMB'000
Passenger . . . . .	18,049,930	19,815,177	19,030,187	6,809,949	12,151,881
Cargo and mail . . . . .	3,298,327	4,031,535	4,392,473	1,882,354	2,546,423
	<u>21,348,257</u>	<u>23,846,712</u>	<u>23,422,660</u>	<u>8,692,303</u>	<u>14,698,304</u>

- (i) Pursuant to various PRC business tax rules and regulations, the Group is required to pay business tax to the local tax bureaus at the following rates:

<u>Type of revenues</u>	<u>Applicable business tax rates</u>
Air traffic revenues . . . . .	3% of air traffic revenues. All inbound international and Hong Kong and Macau regional flights are exempt from business tax.
Other revenues . . . . .	3% of commission income and ground services income, and 3% to 5% of other revenues.

PRC business tax incurred for each of the three years ended December 31, 2001, 2002 and 2003, and for the six-month periods ended June 30, 2003 and 2004, netted against revenues, amounted to approximately RMB501 million, RMB543 million, RMB240 million, RMB173 million (unaudited) and RMB375 million, respectively.

For the period from May 1, 2003 to December 31, 2003, PRC business tax for all domestic, international and regional passenger traffic revenues of the Group was waived by the PRC government in order to subsidise for the airlines' loss of revenue due to the outbreak of Severe Acute Respiratory Syndrome ("SARS") in the region.

- (ii) In addition, the Group was required to pay contributions to the CAAC Infrastructure Development Fund which was calculated at the rates of 5% and 2% on the domestic and international/Hong Kong and Macau regional air traffic revenues, respectively, for each of the three years ended December 31, 2003.

For the period from May 1, 2003 to December 31, 2003, CAAC Infrastructure Development Fund for all domestic, international and regional passenger, cargo and mail traffic revenues of the Group was waived by the PRC government in order to subsidise for the airlines' loss of revenue due to the outbreak of SARS in the region.

For the period from January 1, 2004 to March 31, 2004, the CAAC Infrastructure Development Fund was suspended by the PRC government. As such, no CAAC Infrastructure Development Fund was charged to the income statement of the Group for the three-month period ended March 31, 2004. Effective April 1, 2004, the Group is required to pay contributions to the CAAC Infrastructure Development Fund calculated on the basis of the usage of domestic routes and domestic segments of international routes, geographic area and length of routes and aircraft weight.

Contributions to the CAAC Infrastructure Development Fund payable by the Group for each of the three years ended December 31, 2003, and for the six-month periods ended June 30, 2003 and 2004 amounted to approximately RMB761 million, RMB813 million, RMB247 million, RMB247 million (unaudited) and RMB112 million, respectively.

*(b) Other operating revenues*

	Year ended December 31,			Six-month period ended June 30,	
	2001	2002	2003	2003	2004
	RMB'000	RMB'000	RMB'000	RMB'000	RMB'000
				(Unaudited)	
Aircraft and related equipment					
lease income . . . . .	469,955	27,950	33,519	5,077	4,670
Air catering income . . . . .	115,314	120,068	102,133	49,733	64,945
Aircraft engineering income . . . . .	195,314	152,868	285,493	82,836	128,798
Ground services income . . . . .	162,253	180,464	251,266	117,254	129,527
Government grants:					
(i) Recognition of deferred income (Section 5(q)) . . . . .	57,894	57,894	57,894	28,947	28,947
(ii) Fixed cash subsidy . . . . .	50,000	50,000	50,000	25,000	25,000
(iii) Others . . . . .	—	1,029	1,525	760	771
Gains on disposal of property, plant and equipment, net . . . . .	—	161,717	17,048	33,928	—
General aviation income . . . . .	145,679	160,050	152,574	75,143	88,916
Cargo handling service income . . . . .	69,251	80,472	90,021	38,445	51,548
Rental income . . . . .	17,465	18,688	19,081	10,364	13,934
Training service income . . . . .	14,907	15,717	17,915	7,666	9,937
Import and export service income . . . . .	14,043	16,769	23,589	8,196	13,099
Sale of materials . . . . .	4,441	34,143	20,699	3,076	2,300
Service charges on return of unused flight tickets . . . . .	20,214	24,137	51,678	25,774	29,835
Others . . . . .	51,465	34,999	44,310	21,408	20,489
	<u>1,388,195</u>	<u>1,136,965</u>	<u>1,218,745</u>	<u>533,607</u>	<u>612,716</u>



*(c) Profit/(loss) from operations*

The Group's profit/(loss) from operations is arrived at after charging/(crediting):

	Year ended December 31,			Six-month period ended June 30,	
	2001	2002	2003	2003	2004
	RMB'000	RMB'000	RMB'000	RMB'000 (Unaudited)	RMB'000
Employee compensation costs (Section 4(d)) . . . . .	1,643,885	2,030,526	2,379,102	1,096,055	1,310,596
Depreciation:					
Owned assets . . . . .	2,030,483	2,238,489	2,445,494	1,201,361	1,256,341
Assets held under finance leases . . . . .	1,212,135	1,013,082	931,978	465,989	459,055
Repair and maintenance costs	2,278,163	3,147,730	2,804,507	1,207,481	1,574,290
Minimum lease payments under operating leases:					
Aircraft and jet engines . . .	547,371	711,979	910,134	420,746	514,528
Land and buildings . . . . .	149,114	143,431	181,984	84,312	88,252
(Gains)/losses on disposal of property, plant and equipment, net . . . . .	181,243	(161,717)	(17,048)	(33,928)	15,948
Provision for doubtful debts . .	5,122	2,427	12,144	9,055	1,447
Provision against inventories, net . . . . .	56,722	14,742	24,090	23,910	11,277
Auditors' remuneration . . . . .	<u>1,348</u>	<u>1,640</u>	<u>1,614</u>	<u>760</u>	<u>1,054</u>

*(d) Employee compensation costs*

	Year ended December 31,			Six-month period ended June 30,	
	2001	2002	2003	2003	2004
	RMB'000	RMB'000	RMB'000	RMB'000 (Unaudited)	RMB'000
Employee compensation costs (including directors', supervisors' and management's emoluments):					
Wages, salaries and social security costs . . . . .	1,500,575	1,819,087	2,200,916	1,014,700	1,213,608
Retirement benefit costs (Section 4(h)) . . . . .	<u>143,310</u>	<u>211,439</u>	<u>178,186</u>	<u>81,355</u>	<u>96,988</u>
	<u>1,643,885</u>	<u>2,030,526</u>	<u>2,379,102</u>	<u>1,096,055</u>	<u>1,310,596</u>

The Group had 25,576, 26,149, 26,881, 26,008 and 26,935 employees as at December 31, 2001, 2002, 2003 and June 30, 2003 and June 30, 2004, respectively.

*(e) Finance costs*

	Year ended December 31,			Six-month period ended June 30,	
	2001	2002	2003	2003	2004
	RMB'000	RMB'000	RMB'000	RMB'000 (Unaudited)	RMB'000
Interest expense . . . . .	2,889,116	2,559,633	2,248,996	1,152,954	917,080
Less: Interest capitalised . . . . .	(16,410)	(11,460)	(7,830)	(3,915)	(2,610)
	<u>2,872,706</u>	<u>2,548,173</u>	<u>2,241,166</u>	<u>1,149,039</u>	<u>914,470</u>
Less: Interest income . . . . .	(69,749)	(44,450)	(18,803)	(14,838)	(6,032)
Exchange (gains)/losses, net . . .	(871,942)	360,700	297,042	(36,748)	(42,297)
(Gains)/losses on fuel derivatives, net . . . . .	104,826	(85,243)	(169,921)	(112,117)	(76,641)
Dividend income on long-term investments . . . . .	(6,629)	(2,093)	(406)	(383)	(129)
	<u>2,029,212</u>	<u>2,777,087</u>	<u>2,349,078</u>	<u>984,953</u>	<u>789,371</u>

The interest capitalisation rate represented the cost of capital from raising the related borrowings ranged from 5.58% to 6.54% per annum.

*(f) Dilution gain on investment in a subsidiary*

In 2002, CNACG transferred its entire 51% shareholding interest in Air Macau (the shareholding interest of Air Macau is considered as if it had been directly held by the Company as of January 1, 2001 in accordance with the basis set out in Section 2 of this report) to CNAC, which was then a 70% owned subsidiary of CNACG, for an aggregate consideration of HK\$665,000,000 (equivalent to approximately RMB704,900,000) (the "Disposal"). Subsequent to the Disposal, the Group's effective shareholding interest in Air Macau was reduced from 51% to approximately 35% and, accordingly, a gain on deemed disposal of approximately RMB106,040,000 arose.

*(g) Directors', supervisors' and senior management's emoluments*

Details of the directors' and supervisors' remuneration are as follows:

	Year ended December 31,			Six-month period ended June 30,	
	2001	2002	2003	2003	2004
	RMB'000	RMB'000	RMB'000	RMB'000 (Unaudited)	RMB'000
Fees . . . . .	—	—	—	—	—
Basic salaries, housing benefits, other allowances and benefits in kind . . . . .	3,853	4,546	4,390	2,270	2,104
Bonuses . . . . .	177	197	508	131	95
Pension scheme contributions . . . . .	39	53	45	29	19
	<u>4,069</u>	<u>4,796</u>	<u>4,943</u>	<u>2,430</u>	<u>2,218</u>

**APPENDIX I**
**ACCOUNTANTS' REPORT**

The number of directors and supervisors whose remuneration fell within the following bands is as follows:

	Year ended December 31,			Six-month period ended June 30,	
	2001	2002	2003	2003	2004
	Number of directors and supervisors	Number of directors and supervisors	Number of directors and supervisors	Number of directors and supervisors (Unaudited)	Number of directors and supervisors
Nil to HK\$1,000,000 (RMB1,060,000 equivalent)	12	12	12	13	13
HK\$1,000,001 to HK\$1,500,000 (RMB1,590,000 equivalent)	—	—	—	1	1
HK\$1,500,001 to HK\$2,000,000 (RMB2,120,000 equivalent)	2	1	1	—	—
HK\$2,000,001 to HK\$2,500,000 (RMB2,650,000 equivalent)	—	1	1	—	—
	<u>14</u>	<u>14</u>	<u>14</u>	<u>14</u>	<u>14</u>

An analysis of the five individuals whose remuneration was the highest in the Group is as follows:

Director . . . . .	1	1	1	1	1
Supervisor . . . . .	1	1	1	1	1
Employees . . . . .	3	3	3	3	3

The emoluments paid to non-director, non-supervisor, highest paid individuals are as follows:

	Year ended December 31,			Six-month period ended June 30,	
	2001	2002	2003	2003	2004
	RMB'000	RMB'000	RMB'000	RMB'000	RMB'000
Basic salaries, housing benefits, other allowances and benefits in kind (note) . . . . .	4,540	47,908	4,240	2,062	2,265
Bonuses . . . . .	474	90	30	—	—
Pension scheme contributions . . . . .	300	135	180	94	105
	<u>5,314</u>	<u>48,133</u>	<u>4,450</u>	<u>2,156</u>	<u>2,370</u>

Note: On April 4, 2002, Messrs. Wang Guixiang and Xin Wei, employees of the Group who were former directors of CNAC, in aggregate, exercised options for 84,126,000 shares in CNAC at an exercise price of HK\$1.04 per share. The difference between the aggregate value of CNAC's shares issued upon the exercise of these options at

the exercise price of HK\$1.04 per share and the market price of CNAC's shares on April 4, 2002 of HK\$1.56 per share amounting to approximately HK\$43,746,000 has been included in benefits in kind above. The share options of CNAC have not been recorded in the Group's financial statements.

The remuneration of these remaining highest paid individuals for each of the Relevant Periods fell within the following bands:

	Year ended December 31,			Six-month period ended June 30,	
	2001	2002	2003	2003	2004
	Number of individuals	Number of individuals	Number of individuals	Number of individuals (Unaudited)	Number of individuals
Nil to HK\$1,000,000 (RMB1,060,000 equivalent) . . .	—	—	—	3	3
HK\$1,000,001 to HK\$1,500,000 (RMB1,590,000 equivalent) . . .	2	—	3	—	—
HK\$1,500,001 to HK\$2,000,000 (RMB2,120,000 equivalent) . . .	—	1	—	—	—
HK\$2,000,001 to HK\$2,500,000 (RMB2,650,000 equivalent) . . .	1	—	—	—	—
HK\$19,500,001 to HK\$20,000,000 (RMB21,200,000 equivalent) . .	—	1	—	—	—
HK\$23,500,001 to HK\$24,000,000 (RMB25,440,000 equivalent) . .	—	1	—	—	—
	<u>3</u>	<u>3</u>	<u>3</u>	<u>3</u>	<u>3</u>

During the Relevant Periods, no emoluments were paid by the Group to the directors or supervisors or any of the five highest paid individuals as an inducement to join or upon joining the Group or as compensation for loss of office. No directors or supervisors waived or agreed to waive any emoluments during the Relevant Periods.

**(h) Retirement benefits**

All of the Group's full-time employees in the PRC are covered by a government-regulated defined contribution retirement scheme, and are entitled to an annual pension determined by their basic salaries upon their retirement. The PRC government is responsible for the pension liabilities to these retired employees. The Group is required to make annual contributions to the government-regulated defined contribution retirement scheme at rates ranging from 15% to 20% of the employees' basic salaries during the Relevant Periods and has no further obligation for post-retirement benefits in respect of the above. This defined contribution plan continues to be available to the Group's employees after the Restructuring. The related pension costs are expensed as incurred.

Prior to the Restructuring, the Group also paid certain supplementary pension benefits (the "Supplementary Pension Benefits") to its employees who retired before the formation of the Company. Pursuant to the Restructuring, CNAHC has agreed to assume past payments and future

liabilities in respect of the Supplementary Pension Benefits for those employees who retired before the formation of the Company for nil consideration. The Group's employees who retire after the formation of the Company are not entitled to the Supplementary Pension Benefits. CNAHC has agreed to indemnify the Group against losses from any claims for the Supplementary Pension Benefits.

As described above, during the Relevant Periods, all pension payments relating to the Supplementary Pension Benefits were borne by CNAHC. Had the Supplementary Pension Benefits borne by CNAHC as described above been borne by the Group itself, the Group would have incurred additional pension benefits payments as detailed below:

	Year ended December 31,			Six-month period ended June 30,	
	2001	2002	2003	2003	2004
	RMB'000 (Unaudited)	RMB'000 (Unaudited)	RMB'000 (Unaudited)	RMB'000 (Unaudited)	RMB'000 (Unaudited)
Notional Supplementary Pension Benefits payments .....	<u>28,914</u>	<u>40,652</u>	<u>53,928</u>	<u>26,964</u>	<u>26,398</u>

The aforesaid notional amounts are disclosed for information purposes only and have not been recorded in the Group's audited combined financial statements and the financial information included in this report.

Further, the Group implemented an early retirement plan for certain employees in addition to the benefits under the government-regulated defined contribution retirement scheme and the Supplementary Pension Benefits described above. The benefits of the early retirement plan are calculated based on factors including the remaining number of years of services from date of early retirement to normal retirement date and the salary amount on the date of early retirement of the employees. The costs of early retirement benefits were recognised in the period when employees opted for early retirement. Where the effect of discounting is material, the amount recognised for early retirement benefits is the present value at the balance sheet date of the future cash flows expected to be required to settle the obligation. The increase in the discounted present value amount arising from the passage of time is included in finance cost in the income statement.

The expenses attributed to the PRC government-regulated defined contribution retirement scheme and the early retirement benefits for each of the Relevant Periods are as follows:

	Year ended December 31,			Six-month period ended June 30,	
	2001	2002	2003	2003	2004
	RMB'000	RMB'000	RMB'000	RMB'000 (Unaudited)	RMB'000
Contributions to PRC government-regulated defined contribution retirement scheme .....	78,997	121,822	154,728	69,626	89,526
Early retirement benefits .....	<u>64,313</u>	<u>89,617</u>	<u>23,458</u>	<u>11,729</u>	<u>7,462</u>
Total (Section 4(d)) .....	<u>143,310</u>	<u>211,439</u>	<u>178,186</u>	<u>81,355</u>	<u>96,988</u>

*(i) Tax*

The Group is subject to income tax on an entity basis on profits arising in or derived from the jurisdictions in which members of the Group are domiciled and operate. In accordance with an approval document issued by the relevant tax authorities, the filing of tax returns of the Relevant Businesses and all wholly-owned PRC-established subsidiaries of the Company prior to its incorporation on September 30, 2004 was handled by CNAHC on a consolidated group basis. The share of the income tax liability of the Relevant Businesses and all wholly-owned PRC-established subsidiaries of the Company was calculated at the applicable tax rate on their profits determined in accordance with PRC accounting principles and after the relevant adjustments made under the prevailing PRC Enterprise Income Tax Law as applicable to State-owned enterprises. Such tax was payable to CNAHC which in turn would settle the tax liability with the relevant tax bureau. Similarly, the net profit attributable to shareholders referred to in Section 4(j) for the period from January 1, 2004 to September 30, 2004 (the date of incorporation of the Company) will be calculated after deducting the amount of income tax payable to CNAHC, which in turn will settle any tax liability on profit arisen during that period with the relevant tax bureau. Following the incorporation of the Company, the Company is subject to enterprise income tax at the rate of 33% and the Company will settle its tax liability by itself with the respective tax bureaus.

The determination of current and deferred income tax was based on enacted tax rates. Major components of income tax charge/(credit) for each of the Relevant Periods are:

	Year ended December 31,			Six-month period ended June 30,	
	2001	2002	2003	2003	2004
	RMB'000	RMB'000	RMB'000	RMB'000	RMB'000
				(Unaudited)	
<i>Current income tax</i>					
Current income tax charge . . . . .	56,897	32,885	18,467	6,145	12,152
<i>Deferred income tax</i>					
Relating to origination and reversal of temporary differences (Section 5(c)) . . . . .	<u>430,000</u>	<u>244,000</u>	<u>33,847</u>	<u>(519,385)</u>	<u>346,650</u>
	486,897	276,885	52,314	(513,240)	358,802
<i>Share of tax attributable to associates . . . . .</i>	<u>65,763</u>	<u>92,188</u>	<u>37,467</u>	<u>(22,023)</u>	<u>32,636</u>
Income tax charge/(credit) reported in combined income statement . .	<u>552,660</u>	<u>369,073</u>	<u>89,781</u>	<u>(535,263)</u>	<u>391,438</u>

A reconciliation of income tax expense/(credit) applicable to profit/(loss) before income tax at the statutory income tax rate in the PRC to income tax expense at the Group's effective income tax rate for each of the Relevant Periods and for the six-month period ended June 30, 2003 was as follows:

	Year ended December 31,			Six-month period ended June 30,	
	2001	2002	2003	2003	2004
	RMB'000	RMB'000	RMB'000	RMB'000	RMB'000
Profit/(loss) before income tax	<u>1,609,722</u>	<u>1,039,826</u>	<u>178,279</u>	<u>(1,931,473)</u>	<u>1,260,846</u>
At statutory income tax rate of 33% . . . . .	531,208	343,143	58,832	(637,386)	416,079
Lower income tax rates of other territories . . . . .	(76,845)	(88,966)	2,610	54,273	(33,629)
Income not subject to tax . . . . .	(351)	(7,710)	(35,388)	(14,837)	(13,177)
Expenses not deductible for tax purposes . . . . .	95,860	120,837	70,164	69,124	25,907
Effect on opening deferred income tax of increase in other territories' income tax rate . . . . .	—	—	9,542	9,542	—
Share of adjustments in income tax of previous periods attributable to associates . . . . .	<u>2,788</u>	<u>1,769</u>	<u>(15,979)</u>	<u>(15,979)</u>	<u>(3,742)</u>
Tax charge/(credit) at Group's effective income tax rate . . . . .	<u>552,660</u>	<u>369,073</u>	<u>89,781</u>	<u>(535,263)</u>	<u>391,438</u>

**(j) Distributions**

The profit distributions disclosed during the Relevant Periods and for the six-month period ended June 30, 2003 represent the net assets which have been carved-out and treated as deemed distributions pursuant to the Restructuring set out in Section 2 of this report and dividends paid during the Relevant Periods and for the six-month period ended June 30, 2003.

Set out below are the details of distributions made:

	Year ended December 31,			Six-month period ended June 30,	
	2001	2002	2003	2003	2004
	RMB'000	RMB'000	RMB'000	RMB'000	RMB'000
Carved-out of net assets . . . . .	128,941	198,886	316,153	117,185	26,432
Dividends paid . . . . .	<u>29,052</u>	<u>28,722</u>	<u>26,690</u>	<u>19,421</u>	<u>14,537</u>
	<u>157,993</u>	<u>227,608</u>	<u>342,843</u>	<u>136,606</u>	<u>40,969</u>

The rates of dividend and the number of shares ranking for dividends are not presented for those profit distributions as such information is not considered meaningful.

As a result of the completion of BACL Agreement, SWACL Agreement and HKSACL Agreement (details of BACL Agreement, SWACL Agreement and HKSACL Agreement are set out in Section 11 of this report), the Group will make a payment of approximately RMB378 million to CNAHC, representing the total consideration payable by CNAC and HKSACL for the acquisitions of the entire shareholding interests held by the Group in BACL and SWACL pursuant to the Restructuring as set out in Section 1 above. This payment to be made to CNAHC will be accounted for as a special distribution to CNAHC by the Group.

In accordance with the (財政部關於印發《企業公司制改建有關國有資本管理與財務處理的暫行規定》的通知) “Provisional Regulation Relating to Corporate Reorganisation of Enterprises and Related Management of State-owned Capital and Financial Treatment” notice issued by the Ministry of Finance (English title is a direct translation of Chinese title of the notice), which became effective from August 27, 2002, and pursuant to the Restructuring, after the Company’s incorporation, the Group is required to make a distribution to CNAHC, which represents an amount equal to the net profit attributable to shareholders, as determined based on audited accounts prepared in accordance with the PRC GAAP, generated, during the period from January 1, 2004 to September 30, 2004 (the date of incorporation of the Company) by the businesses and operations (excluding those of CNAC) contributed to the Group by CNAHC (see also Section 6(c)). The net profit attributable to shareholders mentioned above for the said period is calculated after deducting the amount of income tax payable to CNAHC which in turn will settle any tax liability on profit arisen during that period with the relevant tax bureau as detailed in Section 4(i).

In addition, in accordance with the (財政部關於印發《企業公司制改建有關國有資本管理與財務處理的暫行規定》的通知) “Provisional Regulation Relating to Corporate Reorganisation of Enterprises and Related Management of State-owned Capital and Financial Treatment” notice issued by the Ministry of Finance and pursuant to the Restructuring, after the Company’s incorporation, the Group is required to make a distribution to CNACG, which represents an amount equal to the net profit attributable to shareholders, as determined based on audited accounts prepared in accordance with the PRC GAAP, generated, during the period from January 1, 2004 to September 30, 2004 (the date of incorporation of the Company) by the businesses and operations (excluding those directly contributed by CNAHC) contributed to the Group by the CNAC group, less the 2003 final dividend and 2004 interim dividend amounts already paid by CNAC to CNACG.

Following the Restructuring, the payment of future dividends will be determined by the Company’s board of directors. The payment of dividends will depend upon, inter alia, the future earnings, capital requirements and financial condition and general business conditions of the Company. As the controlling shareholder, CNAHC will be able to influence the Company’s dividend policy.

Cash dividends to shareholders in Hong Kong will be paid in Hong Kong dollars.

Following the incorporation of the Company, under the PRC Company Law and the Company’s articles of association, net profit after tax as reported in the PRC statutory financial statements can only be distributed as dividends after allowance has been made for the following:

- (i) Making up prior years’ cumulative losses, if any.
- (ii) Allocations to the statutory common reserve fund of at least 10% of after-tax profit, until the fund aggregates 50% of the Company’s registered capital. For the purpose of



calculating the transfer to reserves, the profit after tax shall be the amount determined under the PRC GAAP. The transfer to this reserve must be made before any distribution of dividends to shareholders.

The statutory common reserve fund can be used to offset previous years' losses, if any, and part of the statutory common reserve fund can be capitalised as the Company's share capital provided that the amount of such reserve remaining after the capitalisation shall not be less than 25% of the share capital of the Company.

- (iii) Allocations of 5% to 10% of after-tax profit, as determined under PRC GAAP, to the Company's statutory public welfare fund, which will be established for the purpose of providing for the Company's employees collective welfare benefits such as the construction of dormitories, canteens and other staff welfare facilities. The fund forms part of the shareholders' equity as only individual employees can use these facilities, while the title of such facilities is held by the Company. The transfer to this fund must be made before any distribution of dividends to shareholders.
- (iv) Allocations to the discretionary common reserve if approved by the shareholders.

The above reserves cannot be used for purposes other than those for which they are created and are not distributable as cash dividends.

In accordance with the articles of association of the Company, the net profit after tax of the Company for the purpose of profit distribution will be deemed to be the lesser of (i) the net profit determined in accordance with the PRC GAAP and (ii) the net profit determined in accordance with IFRS.

Prior to the incorporation of the Company on September 30, 2004, no profit appropriations to the aforesaid reserve funds were required.

***(k) Related party transactions***

The Group is part of a larger group of companies under CNAHC and has extensive transactions and relationships with members of CNAHC. As such, it is possible that the terms of these transactions are not the same as those that would result from transactions among wholly unrelated parties. Related parties refer to corporations in which CNAHC is a shareholder and is able to exercise control or significant influence. The transactions were made on terms agreed between the parties.

*Continuing transactions:*

The following is a summary of significant recurring transactions carried out in the ordinary course of business between the Group and (i) CNAHC, its subsidiaries (other than the Group), joint ventures and associates (collectively known as "CNAHC Group"), (ii) its joint ventures and (iii) its associates:

	Year ended December 31,			Six-month period ended June 30,	
	2001 RMB'000	2002 RMB'000	2003 RMB'000	2003 RMB'000 (Unaudited)	2004 RMB'000
A. Included in air traffic revenues					
Sale of air tickets					
a. CNAHC Group .....	584,407	83,320	23,477	9,270	9,050
b. Joint ventures .....	—	—	—	—	—
c. Associates .....	<u>1,184</u>	<u>1,285</u>	<u>1,363</u>	<u>1,135</u>	<u>2,233</u>
	<u>585,591</u>	<u>84,605</u>	<u>24,840</u>	<u>10,405</u>	<u>11,283</u>
Sale of cargo space					
a. CNAHC Group .....	321,530	254,803	282,895	136,814	180,186
b. Joint ventures .....	—	—	—	—	—
c. Associates .....	—	—	—	—	—
	<u>321,530</u>	<u>254,803</u>	<u>282,895</u>	<u>136,814</u>	<u>180,186</u>
B. Included in other operating revenues					
Aircraft and related equipment lease income					
a. CNAHC Group .....	7,535	24,581	9,983	4,055	450
b. Joint ventures .....	—	—	—	—	—
c. Associates .....	—	—	—	—	—
	<u>7,535</u>	<u>24,581</u>	<u>9,983</u>	<u>4,055</u>	<u>450</u>
Aircraft engineering income					
a. CNAHC Group .....	—	—	—	—	—
b. Joint ventures .....	—	—	—	—	—
c. Associates .....	<u>705</u>	<u>11,053</u>	<u>14,511</u>	<u>4,791</u>	<u>9,474</u>
	<u>705</u>	<u>11,053</u>	<u>14,511</u>	<u>4,791</u>	<u>9,474</u>
Ground service income					
a. CNAHC Group .....	—	—	—	—	—
b. Joint ventures .....	—	—	—	—	—
c. Associates .....	<u>13,854</u>	<u>21,914</u>	<u>15,281</u>	<u>6,373</u>	<u>9,547</u>
	<u>13,854</u>	<u>21,914</u>	<u>15,281</u>	<u>6,373</u>	<u>9,547</u>

	Year ended December 31,			Six-month period ended June 30,	
	2001 RMB'000	2002 RMB'000	2003 RMB'000	2003 RMB'000 (Unaudited)	2004 RMB'000
Others					
a. CNAHC Group .....	2,000	—	1,100	550	550
b. Joint ventures .....	100	100	100	50	50
c. Associates .....	578	759	622	243	266
	<u>2,678</u>	<u>859</u>	<u>1,822</u>	<u>843</u>	<u>866</u>
C. Included in finance costs					
Interest income					
a. CNAHC Group .....	—	—	—	—	—
b. Joint ventures .....	—	—	—	—	—
c. Associates .....	5,987	9,436	8,736	4,077	1,224
	<u>5,987</u>	<u>9,436</u>	<u>8,736</u>	<u>4,077</u>	<u>1,224</u>
Interest expense					
a. CNAHC Group .....	—	—	—	—	—
b. Joint ventures .....	—	—	—	—	—
c. Associates .....	3,011	4,441	21,268	2,816	9,947
	<u>3,011</u>	<u>4,441</u>	<u>21,268</u>	<u>2,816</u>	<u>9,947</u>
D. Included in operating expenses					
Airport ground services, take-off, landing and depot expenses					
a. CNAHC Group .....	93,144	95,444	76,802	37,368	50,450
b. Joint ventures .....	—	—	—	—	—
c. Associates .....	202,480	191,729	165,551	76,143	103,157
	<u>295,624</u>	<u>287,173</u>	<u>242,353</u>	<u>113,511</u>	<u>153,607</u>
Air catering charges					
a. CNAHC Group .....	33,371	29,715	42,401	13,514	18,607
b. Joint ventures .....	51,886	70,164	58,913	27,046	38,527
c. Associates .....	—	—	—	—	—
	<u>85,257</u>	<u>99,879</u>	<u>101,314</u>	<u>40,560</u>	<u>57,134</u>
Repair and maintenance costs					
a. CNAHC Group .....	—	—	—	—	—
b. Joint ventures .....	273,343	368,025	324,470	134,404	209,578
c. Associates .....	6,122	66,053	45,095	22,351	13,491
	<u>279,465</u>	<u>434,078</u>	<u>369,565</u>	<u>156,755</u>	<u>223,069</u>

	Year ended December 31,			Six-month period ended June 30,	
	2001	2002	2003	2003	2004
	RMB'000	RMB'000	RMB'000	RMB'000	RMB'000
				(Unaudited)	
Sales commission expenses					
a. CNAHC Group . . . . .	66,399	45,499	16,357	5,224	10,790
b. Joint ventures . . . . .	—	—	—	—	—
c. Associates . . . . .	—	—	—	—	—
	<u>66,399</u>	<u>45,499</u>	<u>16,357</u>	<u>5,224</u>	<u>10,790</u>
Management fees					
a. CNAHC Group . . . . .	6,424	9,294	10,176	5,088	5,088
b. Joint ventures . . . . .	—	—	—	—	—
c. Associates . . . . .	—	—	—	—	—
	<u>6,424</u>	<u>9,294</u>	<u>10,176</u>	<u>5,088</u>	<u>5,088</u>
Others					
a. CNAHC Group . . . . .	46,000	52,982	47,846	17,507	22,609
b. Joint ventures . . . . .	—	—	—	—	—
c. Associates . . . . .	—	—	—	—	—
	<u>46,000</u>	<u>52,982</u>	<u>47,846</u>	<u>17,507</u>	<u>22,609</u>

	As at December 31,			As at
	2001	2002	2003	June 30,
	RMB'000	RMB'000	RMB'000	2004
				RMB'000
E. Deposits, loans and bills payable				
Deposits placed with an associate . . . . .	380,756	513,551	1,457,103	495,601
Loans from an associate . . . . .	50,000	146,306	297,484	602,807
Bills payable to an associate . . . . .	—	—	692,372	186,198

In addition to the above, on October 18, 1997, CNAC entered into a licence agreement with China National Aviation Corporation (“CNAC (PRC)”) pursuant to which CNAC (PRC) has agreed to grant a licence to CNAC, free of royalty, for the right to use certain trademarks in Hong Kong, the Taiwan region and Macau so long as CNAC is a subsidiary of CNACG. No royalty charge was levied in respect of the use of these trademarks during each of the Relevant Periods.

On August 25, 2004, CNAC (PRC) entered into two assignment agreements with CNACG pursuant to which CNAC (PRC) has agreed to assign, free of royalty, the above-mentioned trademarks to CNACG for use in Hong Kong and Macau, respectively. On August 25, 2004, CNACG entered into two licence agreements with CNAC pursuant to which CNACG has agreed to grant licences to CNAC, free of royalty, for the rights to use those trademarks in Hong Kong and Macau, respectively, so long as CNAC is a direct or indirect subsidiary of CNAHC. These licence agreements supersede the licence agreement entered into between CNAC (PRC) and CNAC on October 18, 1997.

Pursuant to certain of the Company's aircraft finance lease arrangements and operating lease arrangements, the overseas lessors require guarantees to be given by some major PRC state-owned banks. In giving such guarantees, the PRC state-owned banks in turn would require CNAHC to provide counter-guarantees in favour of the banks. As at December 31, 2001, 2002 and 2003 and June 30, 2004, the amounts of such counter-guarantees provided by CNAHC were approximately nil, nil, RMB9,246 million and RMB8,886 million, respectively.

Certain of the Group's bank loans from PRC banks are guaranteed by Air China International Corporation and other related parties, further details of which are set out in Section 5(o).

In the opinion of the directors, the above transactions were conducted in the ordinary course of business and will continue after the listing of the H shares of the Company on the Hong Kong Stock Exchange and the Official List of the UK Listing Authority.

In connection with the Restructuring, the Company entered into several agreements with CNAHC which govern the use of trademarks granted by the Company to CNAHC, the provision for financial services by CNAF, the provision of construction project management services by China National Aviation Construction and Development Company, the subcontracting of charter-flight services to CNAHC, the leasing of properties from and to CNAHC, the provision of air ticketing and cargo services, media and advertising services arrangement to China National Aviation Media and Advertising Co., Ltd., the tourism services co-operation agreement with CNAHC, the comprehensive services agreement with CNAHC, and the provision of maintenance and other ground services by China Aircraft Services Limited. Further details of such agreements are set out in the section headed "Connected Transactions" in the Prospectus.

*Discontinued transaction:*

In 2003, CNAHC charged a non-recurring management fee to Air China International Corporation amounting to RMB26,317,000. The directors are of the opinion that such transaction will not continue after the listing of the H shares of the Company on the Hong Kong Stock Exchange and the Official List of the UK Listing Authority.

*(l) Earnings/(loss) per share*

The calculation of basic earnings per share for each of the Relevant Periods and loss per share for the six-month period ended June 30, 2003 is based on the net profit attributable to shareholders for each of the Relevant Periods and net loss attributable to shareholders (unaudited) for the six-month period ended June 30, 2003 and on the number of shares in issue during the Relevant Periods on the assumption that the 6,500,000,000 shares in issue as at the date of this report had been in issue throughout the Relevant Periods.

No diluted earnings/(loss) per share amounts have been presented as the Company did not have any dilutive potential ordinary shares during the Relevant Periods.

## 5. COMBINED BALANCE SHEETS

A summary of the combined balance sheets of the Group as at the end of each of the Relevant Periods prepared on the basis set out in Section 2 above is set out below:

	Notes	As at December 31,			As at
		2001	2002	2003	June 30, 2004
		RMB'000	RMB'000	RMB'000	RMB'000
<b>NON-CURRENT ASSETS</b>					
Property, plant and equipment . . . . .	(a)	44,056,144	42,876,169	42,423,920	42,382,962
Lease prepayments . . . . .		24,973	24,868	29,807	70,007
Interests in associates . . . . .	(b)				
— Share of net assets . . . . .		1,578,129	1,670,870	1,789,948	1,872,011
— Goodwill . . . . .		1,205,390	1,205,390	1,205,390	1,205,390
— Due from associates . . . . .		99,471	92,575	110,981	131,051
— Due to associates . . . . .		(15,784)	(65,995)	(38,473)	(38,031)
		<u>2,867,206</u>	<u>2,902,840</u>	<u>3,067,846</u>	<u>3,170,421</u>
Advance payments for aircraft and related equipment . . . . .		394,960	511,027	744,404	774,424
Government grant receivable		914,727	841,760	764,422	723,683
Deposits for aircraft under operating leases . . . . .		117,966	164,771	145,483	122,383
Other investments . . . . .		21,930	21,930	21,930	21,930
Deferred tax assets . . . . .	(c)	868,000	624,000	590,153	243,503
		<u>49,265,906</u>	<u>47,967,365</u>	<u>47,787,965</u>	<u>47,509,313</u>
<b>CURRENT ASSETS</b>					
Financial assets . . . . .	(v)(iv)	10,000	69,000	34,000	77,000
Trade receivables . . . . .	(d)	1,705,822	1,874,452	1,955,592	2,277,533
Inventories . . . . .	(e)	711,598	738,769	712,451	777,229
Prepayments, deposits and other receivables . . . . .	(f)	1,489,538	1,348,887	1,977,363	2,549,915
Pledged deposits . . . . .	(g)	131,154	391,584	1,245,542	138,617
Cash and cash equivalents . . . . .	(g)	3,994,800	3,699,520	2,620,221	3,758,507
Dividend receivable from an associate . . . . .		—	—	—	56,743
Due from CNAHC . . . . .	(h)	909,024	1,273,416	—	28,073
Due from other CNAHC group companies . . . . .	(i)	35,516	31,619	63,928	59,130
		<u>8,987,452</u>	<u>9,427,247</u>	<u>8,609,097</u>	<u>9,722,747</u>
<b>TOTAL ASSETS</b> . . . . .		<u>58,253,358</u>	<u>57,394,612</u>	<u>56,397,062</u>	<u>57,232,060</u>

## APPENDIX I

## ACCOUNTANTS' REPORT

	Notes	As at December 31,			As at
		2001	2002	2003	June 30,
		RMB'000	RMB'000	RMB'000	2004
				RMB'000	
<b>CURRENT LIABILITIES</b>					
Financial liabilities . . . . .	(v)(iv)	(98,000)	(110,000)	(6,000)	(1,000)
Trade payables . . . . .	(j)	(2,820,164)	(3,408,104)	(4,214,981)	(5,101,285)
Bills payable . . . . .	(k)	(210,075)	(416,400)	(1,317,220)	(727,118)
Other payables and accruals	(l)	(3,755,985)	(3,198,869)	(3,240,545)	(3,294,249)
Provision for major overhauls	(m)	(69,576)	(21,414)	(115,346)	(131,616)
Air traffic liabilities . . . . .		(975,948)	(888,233)	(1,165,116)	(1,171,542)
Tax payable . . . . .		(60,689)	(63,044)	(53,929)	(51,005)
Obligations under finance					
leases . . . . .	(n)	(3,804,335)	(1,961,181)	(1,607,056)	(1,644,035)
Bank and other loans . . . . .	(o)	(8,300,277)	(10,941,831)	(9,236,674)	(9,301,850)
Due to CNAHC . . . . .	(h)	—	—	(2,968)	(9,729)
Due to other CNAHC group companies . . . . .	(i)	(34,727)	(39,074)	(33,073)	(21,537)
		<u>(20,129,776)</u>	<u>(21,048,150)</u>	<u>(20,992,908)</u>	<u>(21,454,966)</u>
<b>NET CURRENT LIABILITIES . . . . .</b>		<u>(11,142,324)</u>	<u>(11,620,903)</u>	<u>(12,383,811)</u>	<u>(11,732,219)</u>
<b>TOTAL ASSETS LESS CURRENT LIABILITIES . . . . .</b>		<u>38,123,582</u>	<u>36,346,462</u>	<u>35,404,154</u>	<u>35,777,094</u>
<b>NON-CURRENT LIABILITIES</b>					
Obligations under finance					
leases . . . . .	(n)	(14,839,655)	(13,242,796)	(12,091,837)	(11,217,580)
Bank and other loans . . . . .	(o)	(15,374,885)	(14,280,454)	(12,819,821)	(11,910,523)
Long-term payables . . . . .	(p)	(1,116,490)	(933,858)	(801,349)	(721,090)
Deferred income . . . . .	(q)	(1,003,496)	(945,602)	(887,708)	(1,141,324)
Provision for major overhauls	(m)	(122,506)	(232,039)	(289,593)	(352,149)
Provision for early retirement benefits obligations . . . . .		(98,738)	(183,325)	(198,597)	(201,772)
		<u>(32,555,770)</u>	<u>(29,818,074)</u>	<u>(27,088,905)</u>	<u>(25,544,438)</u>
<b>NET ASSETS . . . . .</b>		<u>5,567,812</u>	<u>6,528,388</u>	<u>8,315,249</u>	<u>10,232,656</u>
<b>Represented by:</b>					
<b>OWNERS' EQUITY . . . . .</b>		4,250,523	5,020,263	6,892,869	7,657,336
<b>MINORITY INTERESTS . .</b>		1,317,289	1,508,125	1,422,380	2,575,320
<b>TOTAL EQUITY . . . . .</b>		<u>5,567,812</u>	<u>6,528,388</u>	<u>8,315,249</u>	<u>10,232,656</u>

## Notes:

## (a) Property, plant and equipment

	Aircraft and flight equipment	Buildings	Machinery	Transportation equipment	Office equipment	Construction in progress	Total
	RMB'000	RMB'000	RMB'000	RMB'000	RMB'000	RMB'000	RMB'000
At January 1, 2001, net of accumulated depreciation . . . . .	<b>41,110,530</b>	<b>2,053,390</b>	<b>1,031,610</b>	<b>267,219</b>	<b>25,855</b>	<b>537,433</b>	<b>45,026,037</b>
Additions . . . . .	2,785,343	171,857	128,531	49,205	13,729	252,504	3,401,169
Disposals . . . . .	(1,057,400)	(23,250)	(41,350)	(6,387)	(57)	—	(1,128,444)
Transfer from CIP . . . . .	—	340,916	4,530	206	25,702	(371,354)	—
Depreciation charge for the year . .	<u>(2,894,098)</u>	<u>(102,318)</u>	<u>(152,360)</u>	<u>(82,856)</u>	<u>(10,986)</u>	<u>—</u>	<u>(3,242,618)</u>
At December 31, 2001 and January 1, 2002, net of accumulated depreciation . . . . .	<b>39,944,375</b>	<b>2,440,595</b>	<b>970,961</b>	<b>227,387</b>	<b>54,243</b>	<b>418,583</b>	<b>44,056,144</b>
Additions . . . . .	1,722,003	33,289	53,037	99,244	40,646	252,705	2,200,924
Disposals . . . . .	(100,580)	(5,655)	(18,685)	(4,099)	(309)	—	(129,328)
Transfer from CIP . . . . .	—	83,753	56,363	9,156	2,122	(151,394)	—
Depreciation charge for the year . .	<u>(2,934,038)</u>	<u>(104,614)</u>	<u>(131,039)</u>	<u>(67,822)</u>	<u>(14,058)</u>	<u>—</u>	<u>(3,251,571)</u>
At December 31, 2002 and January 1, 2003, net of accumulated depreciation . . . . .	<b>38,631,760</b>	<b>2,447,368</b>	<b>930,637</b>	<b>263,866</b>	<b>82,644</b>	<b>519,894</b>	<b>42,876,169</b>
Additions . . . . .	2,226,754	23,773	102,500	111,797	27,458	580,766	3,073,048
Disposals . . . . .	(80,803)	(54,426)	(7,052)	(2,461)	(3,083)	—	(147,825)
Transfer from CIP . . . . .	—	421,311	195,250	—	610	(617,171)	—
Depreciation charge for the year . .	<u>(2,987,834)</u>	<u>(122,486)</u>	<u>(169,733)</u>	<u>(80,058)</u>	<u>(17,361)</u>	<u>—</u>	<u>(3,377,472)</u>
At December 31, 2003 and January 1, 2004, net of accumulated depreciation . . . . .	<b>37,789,877</b>	<b>2,715,540</b>	<b>1,051,602</b>	<b>293,144</b>	<b>90,268</b>	<b>483,489</b>	<b>42,423,920</b>
Additions . . . . .	1,435,515	8,454	46,034	36,898	25,916	155,746	1,708,563
Disposals . . . . .	(22,332)	(7,316)	(2,818)	(1,113)	(546)	—	(34,125)
Transfer from CIP . . . . .	156,395	92,866	7,538	—	496	(257,295)	—
Depreciation charge for the period	<u>(1,504,406)</u>	<u>(61,088)</u>	<u>(95,376)</u>	<u>(38,218)</u>	<u>(16,308)</u>	<u>—</u>	<u>(1,715,396)</u>
At June 30, 2004, net of accumulated depreciation . . . . .	<b><u>37,855,049</u></b>	<b><u>2,748,456</u></b>	<b><u>1,006,980</u></b>	<b><u>290,711</u></b>	<b><u>99,826</u></b>	<b><u>381,940</u></b>	<b><u>42,382,962</u></b>
At January 1, 2001							
Cost . . . . .	57,258,090	2,672,891	1,706,019	865,166	92,358	537,433	63,131,957
Accumulated depreciation . . . . .	<u>(16,147,560)</u>	<u>(619,501)</u>	<u>(674,409)</u>	<u>(597,947)</u>	<u>(66,503)</u>	<u>—</u>	<u>(18,105,920)</u>
Net carrying amount . . . . .	<b><u>41,110,530</u></b>	<b><u>2,053,390</u></b>	<b><u>1,031,610</u></b>	<b><u>267,219</u></b>	<b><u>25,855</u></b>	<b><u>537,433</u></b>	<b><u>45,026,037</u></b>
At December 31, 2001 and January 1, 2002							
Cost . . . . .	58,033,737	3,143,629	1,766,555	893,537	131,349	418,583	64,387,390
Accumulated depreciation . . . . .	<u>(18,089,362)</u>	<u>(703,034)</u>	<u>(795,594)</u>	<u>(666,150)</u>	<u>(77,106)</u>	<u>—</u>	<u>(20,331,246)</u>
Net carrying amount . . . . .	<b><u>39,944,375</u></b>	<b><u>2,440,595</u></b>	<b><u>970,961</u></b>	<b><u>227,387</u></b>	<b><u>54,243</u></b>	<b><u>418,583</u></b>	<b><u>44,056,144</u></b>
At December 31, 2002 and January 1, 2003							
Cost . . . . .	59,403,625	3,250,788	1,821,345	981,889	172,411	519,894	66,149,952
Accumulated depreciation . . . . .	<u>(20,771,865)</u>	<u>(803,420)</u>	<u>(890,708)</u>	<u>(718,023)</u>	<u>(89,767)</u>	<u>—</u>	<u>(23,273,783)</u>
Net carrying amount . . . . .	<b><u>38,631,760</u></b>	<b><u>2,447,368</u></b>	<b><u>930,637</u></b>	<b><u>263,866</u></b>	<b><u>82,644</u></b>	<b><u>519,894</u></b>	<b><u>42,876,169</u></b>
At December 31, 2003 and January 1, 2004							
Cost . . . . .	61,008,650	3,605,551	2,027,910	1,031,027	192,815	483,489	68,349,442
Accumulated depreciation . . . . .	<u>(23,218,773)</u>	<u>(890,011)</u>	<u>(976,308)</u>	<u>(737,883)</u>	<u>(102,547)</u>	<u>—</u>	<u>(25,925,522)</u>
Net carrying amount . . . . .	<b><u>37,789,877</u></b>	<b><u>2,715,540</u></b>	<b><u>1,051,602</u></b>	<b><u>293,144</u></b>	<b><u>90,268</u></b>	<b><u>483,489</u></b>	<b><u>42,423,920</u></b>



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	Aircraft and flight equipment	Buildings	Machinery	Transportation equipment	Office equipment	Construction in progress	Total
	RMB'000	RMB'000	RMB'000	RMB'000	RMB'000	RMB'000	RMB'000
At June 30, 2004							
Cost .....	62,562,792	3,698,033	2,072,076	1,064,039	214,228	381,940	69,993,108
Accumulated depreciation .....	<u>(24,707,743)</u>	<u>(949,577)</u>	<u>(1,065,096)</u>	<u>(773,328)</u>	<u>(114,402)</u>	<u>—</u>	<u>(27,610,146)</u>
Net carrying amount .....	<u><u>37,855,049</u></u>	<u><u>2,748,456</u></u>	<u><u>1,006,980</u></u>	<u><u>290,711</u></u>	<u><u>99,826</u></u>	<u><u>381,940</u></u>	<u><u>42,382,962</u></u>

Certain of the Group's bank loans are secured by certain of the Group's aircraft and flight equipment, which has an aggregate carrying value of approximately RMB16,982 million, RMB17,004 million, RMB16,422 million and RMB15,899 million, respectively, at the end of each of the Relevant Periods.

The carrying values of aircraft held under finance leases as at December 31, 2001, 2002, 2003 and June 30, 2004 are approximately RMB18,122 million, RMB15,276 million, RMB13,310 million and RMB12,693 million, respectively. Leased assets are pledged as security for the related finance lease liabilities.

As at June 30, 2004, the Group was in the process of applying to obtain the title certificates of certain of its buildings and land use rights with an aggregate carrying value of approximately RMB231 million. After consulting the legal counsel of the Company, the directors of the Company are of the view that the Group is entitled to lawfully and validly occupy and use the above-mentioned land and buildings. The directors of the Company are of the opinion that the aforesaid matter will not have any significant impact on the Group's financial position as at June 30, 2004.

**(b) Interests in associates**

	As at December 31,			As at June 30, 2004
	2001	2002	2003	RMB'000
	RMB'000	RMB'000	RMB'000	RMB'000
Share of net assets .....	1,578,129	1,670,870	1,789,948	1,872,011
Goodwill .....	1,205,390	1,205,390	1,205,390	1,205,390
Due from associates .....	99,471	92,575	110,981	131,051
Due to associates .....	<u>(15,784)</u>	<u>(65,995)</u>	<u>(38,473)</u>	<u>(38,031)</u>
	<u><u>2,867,206</u></u>	<u><u>2,902,840</u></u>	<u><u>3,067,846</u></u>	<u><u>3,170,421</u></u>

The amounts due from and amounts due to associates are unsecured, interest-free and have no fixed terms of repayment.

Movements of goodwill are as follows:

	As at December 31,			As at June 30, 2004
	2001	2002	2003	RMB'000
	RMB'000	RMB'000	RMB'000	RMB'000
Goodwill .....	1,205,390	1,205,390	1,205,390	1,205,390
Less: Accumulated impairment .....	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>
	<u><u>1,205,390</u></u>	<u><u>1,205,390</u></u>	<u><u>1,205,390</u></u>	<u><u>1,205,390</u></u>

The above goodwill related to the acquisition of shareholding interests of 35.86% and 7.43% in Dragonair by CNACG and its then wholly-owned subsidiary, CNAC, in June 1996 and October 1997, respectively. The aggregate goodwill arising from these two acquisitions was approximately RMB2,130 million and subsequently reduced to approximately RMB1,205 million through deemed disposal upon the initial public offering of CNAC and the accumulated amortisation on a straight-line basis over a period of 20 years until December 31, 2000 (the date of adoption of IFRS 3 by the Group). Since then, there were no changes in the amount of the unamortised goodwill.

*Impairment testing of goodwill*

Goodwill acquired through the business combinations detailed above has been allocated to the cash-generating unit, Dragonair, within the airline operations segment.

The recoverable amount of Dragonair has been determined based on a value in use calculation. To calculate this, cash flow projections are based on financial budgets approved by management covering a one-year period. The discount rate applied to the cash flow projections beyond the one-year period is 5.0%. No growth has been projected beyond the one-year period.

*Key assumptions used in the value in use calculation of Dragonair*

The following describes each key assumption on which management has based its cash flow projections when undertaking the impairment testing of goodwill:

Passenger revenues — the bases used to determine the value assigned to the budgeted passenger revenues are available seat kilometres, passenger traffic, passenger load factor and passenger yield. Values assigned to the key assumptions reflect past experience and are consistent with external information sources.

Operating expenses — the bases used to determine the values assigned are staff headcount, scheduled flight hours, passenger traffic and jet fuel consumption. Values assigned to the key assumptions reflect past experience and are consistent with external information sources.

Summarised financial information of the Group's associates is as follows:

	As at December 31,			As at
	2001	2002	2003	June 30, 2004
	RMB'000	RMB'000	RMB'000	RMB'000
Aggregate of associates' financial positions:				
Total assets . . . . .	<u>14,147,801</u>	<u>16,593,620</u>	<u>21,918,291</u>	<u>20,950,944</u>
Total liabilities . . . . .	<u>(10,099,931)</u>	<u>(12,303,762)</u>	<u>(17,215,202)</u>	<u>(16,112,422)</u>

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	Year ended December 31,			Six-month period ended June 30,	
	2001	2002	2003	2003	2004
	RMB'000	RMB'000	RMB'000	RMB'000	RMB'000
Aggregate of associates' results:				(Unaudited)	
Revenues . . . . .	7,681,726	9,363,010	9,639,481	3,916,726	6,203,402
Net profit/(loss) . . . . .	737,163	830,309	639,579	(196,186)	482,791
Share of profits less losses after tax from associates:					
Dragonair . . . . .	146,906	243,452	43,336	(123,788)	109,539
Shenzhen Airlines . . . . .	48,806	40,268	109,152	8,522	32,559
Others . . . . .	91,354	50,586	53,138	26,425	48,958
	287,066	334,306	205,626	(88,841)	191,056

Name	Business structure	Place of incorporation/ establishment	Percentage of equity interests attributable to the Group				Principal activities
			December 31,			June 30,	
			2001	2002	2003	2004	
Shenzhen Airlines (深圳航空有限責任公司) . . . . .	Corporate	PRC	25	25	25	25	Airline operator
Dragonair # (港龍航空有限公司) . . . . .	Corporate	Hong Kong	30.5	29.7	29.9	29.9	Airline operator
Sichuan SNECMA Aeroengine Maintenance Co., Ltd. (四川斯奈克瑪航空發動機維修有限公司) . . . . .	Corporate	PRC	40.3	40.3	40.3	40.3	Provision of maintenance and repair services for aircraft engines
Chengdu Falcon Aircraft Engineering Service Co., Ltd. (成都富凱飛機工程服務有限公司) . . . . .	Corporate	PRC	35.6	35.6	35.6	35.6	Provision of maintenance and repair services for aircraft engines
Yunan Airport Aircraft Maintenance Services Co., Ltd. (雲南空港飛機維修服務公司) . . . . .	Corporate	PRC	N/A	N/A	40	40	Provision of maintenance and repair services
Macau Aircraft Repair and Conversion Company Limited # (澳門飛機維修工程有限公司) . . . . .	Corporate	Macau	25	17.2	17.3	17.3	Provision of aircraft repair and conversion services
Jardine Airport Services Limited # (怡中航空服務有限公司) . . . . .	Corporate	Hong Kong	35.3	34.4	34.5	34.5	Provision of airport ground handling services
Menzies # (明捷澳門機場服務有限公司) . . . . .	Corporate	Macau	25.5	23.1	23.2	23.2	Provision of airport ground handling services

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**ACCOUNTANTS' REPORT**

Name	Business structure	Place of incorporation/ establishment	Percentage of equity interests attributable to the Group				Principal activities
			December 31,			June 30,	
			2001	2002	2003	2004	
CAAC Data Communications Co., Ltd. (民航數據通信有限責任公司) .....	Corporate	PRC	23.2	23.2	23.2	23.2	Provision of aviation data communication services
CAAC Cares Chongqing Co., Ltd. (重慶民航凱亞信息技術有限公司) .....	Corporate	PRC	24.5	24.5	24.5	24.5	Provision of airline-related information system services
成都民航西南凱亞有限責任公司..... (Chengdu CAAC Southwest Cares Co., Ltd.)**	Corporate	PRC	35	35	35	35	Provision of airline-related information system services
Tradeport Hong Kong Limited # (香港商貿港有限公司).....	Corporate	Hong Kong	17.6	17.2	17.3	17.3	Provision of services for developing and operating logistics centre
CNAF (中國航空集團財務有限責任公司)*.....	Corporate	PRC	42.5	42.5	42.5	42.5	Provision of financial services

\* 30% of the Group's equity interest in CNAF is held directly by the Company, while the remaining 12.5% is held indirectly through subsidiaries and a joint venture of the Company.

# Shareholding interests are held indirectly through subsidiaries of the Company.

\*\* The English name is a direct translation of the company's Chinese name.

**(c) Deferred tax assets**

	Year ended December 31,			Six-month period ended June 30,	
	2001	2002	2003	2003	2004
	RMB'000	RMB'000	RMB'000	RMB'000	RMB'000
Balance at beginning of year/period	1,298,000	868,000	624,000	624,000	590,153
Credit/(charge) for the year/period (Section 4(i)) .....	(430,000)	(244,000)	(33,847)	519,385	(346,650)
Balance at end of year/period .....	<u>868,000</u>	<u>624,000</u>	<u>590,153</u>	<u>1,143,385</u>	<u>243,503</u>

The principal components of the Group's provision for deferred tax are as follows:

	As at December 31,			As at
	2001	2002	2003	June 30,
	RMB'000	RMB'000	RMB'000	2004
Deferred income tax liabilities				RMB'000
Accelerated depreciation for tax purposes . . . .	(941,000)	(889,000)	(826,000)	(742,000)
Differences in air traffic revenues recognition	(115,000)	(187,000)	(27,000)	(37,000)
Other deferred income tax liabilities . . . . .	(43,000)	(110,000)	(52,000)	(49,000)
Gross deferred income tax liabilities . . . . .	<u>(1,099,000)</u>	<u>(1,186,000)</u>	<u>(905,000)</u>	<u>(828,000)</u>
Deferred income tax assets				
Provisions and accruals . . . . .	1,096,000	1,057,000	675,000	781,000
Losses available for offset against future taxable income . . . . .	816,000	710,000	685,153	216,503
Other deferred income tax assets . . . . .	55,000	43,000	135,000	74,000
Gross deferred income tax assets . . . . .	<u>1,967,000</u>	<u>1,810,000</u>	<u>1,495,153</u>	<u>1,071,503</u>
Net deferred income tax assets . . . . .	<u>868,000</u>	<u>624,000</u>	<u>590,153</u>	<u>243,503</u>

There was no material unprovided deferred income tax during the Relevant Periods.

*(d) Trade receivables*

The Group normally allows a credit period ranging from 30 days to 90 days to its sales agents and other customers. An aged analysis of the trade receivables, net of provision for doubtful debts, of the Group is analysed as follows:

	As at December 31,			As at
	2001	2002	2003	June 30,
	RMB'000	RMB'000	RMB'000	2004
Within 30 days . . . . .	1,063,720	1,097,354	1,257,040	1,726,862
31 to 60 days . . . . .	284,269	467,854	465,109	328,395
61 to 90 days . . . . .	50,933	43,369	106,603	64,451
Over 90 days . . . . .	306,900	265,875	126,840	157,825
At end of year/period . . . . .	<u>1,705,822</u>	<u>1,874,452</u>	<u>1,955,592</u>	<u>2,277,533</u>

*(e) Inventories*

Inventories consist of materials and supplies.

Set out below is the breakdown of materials and supplies:

	As at December 31,			As at
	2001	2002	2003	June 30,
	RMB'000	RMB'000	RMB'000	2004
Flight equipment spare parts . . . . .	573,894	629,340	577,478	677,349
Work in progress . . . . .	96,523	71,705	104,338	75,463
Catering supplies . . . . .	41,181	37,724	30,635	24,417
	<u>711,598</u>	<u>738,769</u>	<u>712,451</u>	<u>777,229</u>

*(f) Prepayments, deposits and other receivables*

Set out below is the breakdown of prepayments, deposits and other receivables:

	As at December 31,			As at
	2001	2002	2003	June 30,
	RMB'000	RMB'000	RMB'000	2004
Advance payments for aircraft and related equipment . . . . .	506,011	662,696	1,213,380	1,124,397
Advance and others . . . . .	245,314	153,662	191,448	706,457
Manufacturer credits on aircraft acquisition receivable . . . . .	112,236	56,723	84,935	82,237
Government grant receivable . . . . .	68,760	72,967	77,338	142,519
Prepaid aircraft operating lease rentals . . . .	40,020	41,269	65,790	84,150
Receivables from sale of staff quarters . . . .	253,265	103,918	57,962	72,729
Miscellaneous deposits . . . . .	263,932	257,652	286,510	337,426
	<u>1,489,538</u>	<u>1,348,887</u>	<u>1,977,363</u>	<u>2,549,915</u>

*(g) Cash and cash equivalents and pledged deposits*

	As at December 31,			As at
	2001	2002	2003	June 30,
	RMB'000	RMB'000	RMB'000	2004
Cash and bank balances . . . . .	3,248,129	3,658,538	3,604,537	2,176,816
Time deposits . . . . .	877,825	432,566	261,226	1,720,308
Less: Pledged bank and deposit balances against				
Bank loans . . . . .	81,327	336,141	1,177,064	59,262
Finance leases . . . . .	41,500	41,500	41,500	41,500
Aircraft operating leases . . . . .	3,310	8,761	21,917	32,536
Financial derivative facilities . . . . .	4,729	4,775	4,845	4,907
Others . . . . .	288	407	216	412
Total pledged bank and deposit balances . .	<u>131,154</u>	<u>391,584</u>	<u>1,245,542</u>	<u>138,617</u>
Cash and cash equivalents . . . . .	<u>3,994,800</u>	<u>3,699,520</u>	<u>2,620,221</u>	<u>3,758,507</u>

Cash at banks earns interest at floating rates based on daily bank deposit rates. Time deposits are made for terms of between three days and one year depending on the immediate cash requirements of the Group.

**(h) Balances with CNAHC**

The balances with CNAHC are unsecured, interest-free and have no fixed terms of repayment.

**(i) Balances with other CNAHC group companies**

The balances with other CNAHC group companies are unsecured, interest-free and have no fixed terms of repayment.

Set out below is the breakdown of the amounts due from other CNAHC group companies:

	As at December 31,			As at
	2001	2002	2003	June 30,
	RMB'000	RMB'000	RMB'000	2004
				RMB'000
浙江中宇航空發展股份有限公司 (Zhejiang Zhongyu Aviation Development Co., Ltd.)* . . .	19,048	19,122	18,998	—
西南航空旅遊公司 (Southwest Aviation Tourism Co., Ltd.)* . . . . .	9,914	—	—	—
中國航空集團建設開發有限公司 (China Aviation Group Construction Development Co., Ltd.)* . .	—	—	38,500	38,500
AMS Global Transportation Co., Ltd. . . . .	—	—	—	11,639
Other related companies . . . . .	6,554	12,497	6,430	8,991
	<u>35,516</u>	<u>31,619</u>	<u>63,928</u>	<u>59,130</u>

\* The English names are direct translations of the company's Chinese names.

**(j) Trade payables**

An aged analysis of trade payables is set out below:

	As at December 31,			As at
	2001	2002	2003	June 30,
	RMB'000	RMB'000	RMB'000	2004
				RMB'000
Within 30 days . . . . .	1,336,706	1,511,286	1,157,293	2,145,591
31 to 60 days . . . . .	581,785	638,966	669,970	716,431
61 to 90 days . . . . .	395,490	596,527	497,402	751,076
Over 90 days . . . . .	506,183	661,325	1,890,316	1,488,187
At end of year/period . . . . .	<u>2,820,164</u>	<u>3,408,104</u>	<u>4,214,981</u>	<u>5,101,285</u>

*(k) Bills payable*

An aged analysis of the bills payable of the Group is analysed as follows:

	As at December 31,			As at
	2001	2002	2003	June 30,
	RMB'000	RMB'000	RMB'000	2004
Within 30 days .....	55,075	106,400	256,220	103,056
31 to 60 days .....	60,000	70,000	189,931	—
61 to 90 days .....	—	55,000	248,687	189,415
Over 90 days .....	95,000	185,000	622,382	434,647
At end of year/period .....	<u>210,075</u>	<u>416,400</u>	<u>1,317,220</u>	<u>727,118</u>

Included in the Group's bills payable are the following amounts due to CNAF:

	As at December 31,			As at
	2001	2002	2003	June 30,
	RMB'000	RMB'000	RMB'000	2004
Due to CNAF .....	<u>—</u>	<u>—</u>	<u>692,372</u>	<u>186,198</u>

*(l) Other payables and accruals*

Set out below is a breakdown of other payables and accruals:

	As at December 31,			As at
	2001	2002	2003	June 30,
	RMB'000	RMB'000	RMB'000	2004
Provision for staff housing benefits .....	972,542	957,342	772,874	522,402
Accrued salaries, wages and benefits .....	386,948	400,684	647,561	633,504
Interest expense payable .....	426,350	358,294	315,617	289,136
Custom duties and levies payable .....	913,032	405,299	207,098	494,515
Current portion of long-term payables (Section 5(p)) .....	195,240	200,359	174,363	174,522
Current portion of deferred income (Section 5(q)) .....	57,894	57,894	57,894	80,118
Advances from customers .....	243,945	172,784	348,716	285,441
Accrued operating expenses .....	360,200	436,779	533,399	628,171
Others .....	199,834	209,434	183,023	186,440
	<u>3,755,985</u>	<u>3,198,869</u>	<u>3,240,545</u>	<u>3,294,249</u>



*(m) Provision for major overhauls*

	Year ended December 31,			Six-month period
	2001	2002	2003	ended June 30,
	RMB'000	RMB'000	RMB'000	2004
At beginning of year/period . . . . .	150,462	192,082	253,453	404,939
Provision for the year/period . . . . .	151,958	210,925	244,387	121,095
Utilised during the year/period . . . . .	<u>(110,338)</u>	<u>(149,554)</u>	<u>(92,901)</u>	<u>(42,269)</u>
At the end of year/period . . . . .	192,082	253,453	404,939	483,765
Less: Portion classified as current liabilities . . . . .	<u>(69,576)</u>	<u>(21,414)</u>	<u>(115,346)</u>	<u>(131,616)</u>
Long-term portion . . . . .	<u>122,506</u>	<u>232,039</u>	<u>289,593</u>	<u>352,149</u>

A provision is recognised for scheduled overhauls in respect of aircraft and engines under operating leases. The Group has the obligations to fulfil certain return conditions under relevant operating leases and, in order to fulfil these return conditions, major overhauls are required to be conducted on a regular basis. Estimated costs of major overhauls for aircraft and engines under operating leases are accrued over the estimated period between overhauls using the ratios of actual number of flying hours/cycles to the estimated number of flying hours/cycles between overhauls.

*(n) Obligations under finance leases*

The Group has obligations under finance lease agreements expiring during the years from 2004 to 2011 in respect of aircraft and related equipment. At the end of each of the Relevant Periods, future minimum lease payments under these finance leases, together with the present value of the net minimum lease payments, which are principally denominated in foreign currencies, are as follows:

	Minimum lease payments December 31, 2001	Present value of minimum lease payments December 31, 2001	Minimum lease payments December 31, 2002	Present value of minimum lease payments December 31, 2002	Minimum lease payments December 31, 2003	Present value of minimum lease payments December 31, 2003	Minimum lease payments June 30, 2004	Present value of minimum lease payments June 30, 2004
	RMB'000	RMB'000	RMB'000	RMB'000	RMB'000	RMB'000	RMB'000	RMB'000
Amounts repayable:								
Within one year . . . .	4,811,403	3,804,335	2,761,492	1,961,181	2,285,703	1,607,056	2,268,024	1,644,035
In the second year . . .	2,733,879	1,937,267	2,278,069	1,603,066	2,271,725	1,697,597	2,572,505	2,052,460
In the third to fifth years, inclusive . . . .	6,885,842	5,021,763	6,984,511	5,572,250	6,721,752	5,583,404	5,975,652	4,978,488
Over five years . . . . .	8,998,187	7,880,625	6,961,524	6,067,480	5,406,410	4,810,836	4,638,196	4,186,632
Total minimum finance lease payments . . . . .	23,429,311	<u>18,643,990</u>	18,985,596	<u>15,203,977</u>	16,685,590	<u>13,698,893</u>	15,454,377	<u>12,861,615</u>
Less: Amounts representing finance charges	<u>(4,785,321)</u>		<u>(3,781,619)</u>		<u>(2,986,697)</u>		<u>(2,592,762)</u>	
Present value of minimum lease payments . . . . .	18,643,990		15,203,977		13,698,893		12,861,615	
Less: Portion classified as current liabilities . . . . .	<u>(3,804,335)</u>		<u>(1,961,181)</u>		<u>(1,607,056)</u>		<u>(1,644,035)</u>	
Long-term portion . . . . .	<u>14,839,655</u>		<u>13,242,796</u>		<u>12,091,837</u>		<u>11,217,580</u>	

At June 30, 2004, there were 23 aircraft under finance lease agreements. Under the terms of the leases, the Group has the option to purchase, at the end of or during the lease terms, certain aircraft at fair market value and others at either fair market value or at the price as stipulated in the finance lease agreements. For each of the Relevant Periods, the effective borrowing rate ranged from 1.64% to 10.12%, 1.64% to 10.12%, 1.64% to 9.13% and 1.64% to 9.13%, respectively.

Finance leases of approximately RMB18,644 million, RMB15,204 million, RMB13,699 million and RMB12,862 million as at December 31, 2001, 2002, 2003 and June 30, 2004 are secured by:

- (i) mortgages over certain of the Group's aircraft and related equipment, which had an aggregate carrying value of approximately RMB18,122 million, RMB15,276 million, RMB13,310 million and RMB12,693 million, respectively; and
- (ii) the pledge of certain of the Group's bank deposits amounting to approximately RMB42 million at the end of each of the Relevant Periods.

At the end of each of the Relevant Periods, certain finance lease arrangements of the Group are guaranteed by the following parties:

	<u>As at December 31,</u>			<u>As at</u>
	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>June 30,</u>
	<u>RMB'000</u>	<u>RMB'000</u>	<u>RMB'000</u>	<u>2004</u>
	<u>RMB'000</u>	<u>RMB'000</u>	<u>RMB'000</u>	<u>RMB'000</u>
The Industrial and Commercial				
Bank of China . . . . .	12,916,071	12,094,642	11,855,625	11,353,347
Bank of China . . . . .	9,657,939	3,292,719	2,340,142	2,258,591
Export-Import Bank of Japan . . . . .	745,316	662,217	579,013	537,441
Export-Import Bank of the United States . . . . .	<u>4,690,454</u>	<u>4,594,012</u>	<u>4,173,879</u>	<u>3,930,686</u>
	<u>28,009,780</u>	<u>20,643,590</u>	<u>18,948,659</u>	<u>18,080,065</u>

In order for Export-Import Bank of Japan and Export-Import Bank of the United States to provide guarantees to certain of the finance lease arrangements of the Company, Export-Import Bank of Japan and Export-Import Bank of the United States require guarantees to be given by some major PRC state-owned banks. As at December 31, 2001, 2002 and 2003 and June 30, 2004, the amounts of these counter-guarantees provided by those major PRC state-owned banks to Export-Import Bank of Japan and Export-Import Bank of the United States were approximately RMB5,436 million, RMB5,256 million, RMB4,753 million and RMB4,468 million, respectively.

*(o) Bank and other loans*

	As at December 31,			As at
	2001	2002	2003	June 30,
	RMB'000	RMB'000	RMB'000	2004
				RMB'000
Bank loans:				
Secured . . . . .	14,121,716	14,260,048	14,519,345	13,237,111
Unsecured . . . . .	8,307,340	10,732,427	7,228,169	7,859,688
	<u>22,429,056</u>	<u>24,992,475</u>	<u>21,747,514</u>	<u>21,096,799</u>
Other loans:				
Secured . . . . .	1,178,612	162,315	81,487	74,080
Unsecured . . . . .	67,494	67,495	227,494	41,494
	<u>23,675,162</u>	<u>25,222,285</u>	<u>22,056,495</u>	<u>21,212,373</u>
Bank loans repayable:				
Within one year . . . . .	7,924,815	10,793,509	8,994,367	9,245,544
In the second year . . . . .	2,267,656	2,066,721	1,903,342	3,245,528
In the third to fifth years, inclusive . . . . .	6,006,864	6,001,543	6,227,447	5,014,452
Over five years . . . . .	6,229,721	6,130,702	4,622,358	3,591,275
Other loans repayable:				
Within one year . . . . .	375,462	148,322	242,307	56,306
In the second year . . . . .	88,008	14,813	14,813	14,813
In the third to fifth years, inclusive . . . . .	782,636	66,675	51,861	44,455
Total bank and other loans . . . . .	23,675,162	25,222,285	22,056,495	21,212,373
Less: Portion classified as current liabilities . . . . .	<u>(8,300,277)</u>	<u>(10,941,831)</u>	<u>(9,236,674)</u>	<u>(9,301,850)</u>
Long-term portion . . . . .	<u>15,374,885</u>	<u>14,280,454</u>	<u>12,819,821</u>	<u>11,910,523</u>

Further details of total bank and other loans at the end of each of the Relevant Periods are as follows:

Nature	Interest rate and final maturity	As at December 31,			As at
		2001	2002	2003	June 30,
		RMB'000	RMB'000	RMB'000	2004
					RMB'000
<b>RMB denominated loans:</b>					
Loans for construction projects	Floating interest rates ranging from 5.58% to 5.76%, 5.58% to 5.76% and 5.59% to 11.7% per annum at December 31, 2003, 2002 and 2001 with maturities through 2010 . . . . .	203,500	108,000	80,000	—
Loans for purchases of aircraft and related equipment	Floating interest rates ranging from 4.94% to 6.09%, 4.94% to 6.21%, 5.02% to 6.09% and 5.49% to 8.67% per annum at June 30, 2004, December 31, 2003, 2002 and 2001 with maturities through 2013 . . . . .	3,563,947	5,256,016	6,282,444	5,767,396
Loans for working capital	Floating interest rates ranging from 4.54% to 5.73%, 4.54% to 5.73%, 4.78% to 5.94% and 4.78% to 6.53% per annum at June 30, 2004, December 31, 2003, 2002 and 2001 with maturities through 2004, 2004, 2005 and 2004, respectively . . . . .	6,440,915	9,234,400	2,931,230	2,639,178
Loans for purchases of properties	Floating interest rates at 4.94%, 4.94%, and ranging from 4.94% to 5.02%, and 6.18% to 6.21% per annum at June 30, 2004, December 31, 2003, 2002 and 2001 with maturities through 2004, 2004, 2006 and 2006, respectively . . . . .	389,000	251,000	72,000	66,000
<b>United States dollars denominated loans:</b>					
Loans for purchases of aircraft and related equipment	Fixed interest rates ranging from 5.31% to 10.17%, 4.94% to 10.17%, 2.48% to 10.17% and 5.34% to 10.17% per annum at June 30, 2004, December 31, 2003, 2002 and 2001 with maturities through 2012 . . . . .	12,904,686	9,927,880	8,397,835	7,787,707
Loans for purchases of aircraft and related equipment	Floating interest rates at six-month LIBOR + 0.4% to 0.7% per annum at June 30, 2004, December 31, 2003 and 2002 with maturities through 2009 . . . . .	—	96,303	81,487	239,618
Loans for working capital	Floating interest rates at six-month LIBOR + 0.55% to 0.8%, three- to ten-month LIBOR + 0.3% to 0.9%, three-month LIBOR + 0.3% and 3% per annum at June 30, 2004, December 31, 2003, 2002 and 2001 with maturities through 2004, 2004, 2003 and 2002, respectively . . . . .	17,494	224,423	4,072,432	4,555,147
Loans for purchases of properties	Floating interest rates at six-month LIBOR + 0.5% per annum at December 31, 2001 with maturities through 2002 . . . . .	42,211	—	—	—

Nature	Interest rate and final maturity	As at December 31,			As at
		2001	2002	2003	June 30,
		RMB'000	RMB'000	RMB'000	2004
					RMB'000
<b>Japanese yen denominated loans:</b>					
Loans for purchases of aircraft and related equipment	Fixed interest rates ranging from 4.81% to 5.30%, 4.84% to 5.30%, 4.84% to 5.30% and 4.84% to 5.30% per annum at June 30, 2004, December 31, 2003, 2002 and 2001 with maturities through 2004 . . . . .	113,409	124,263	139,067	137,461
<b>Hong Kong dollars denominated loans:</b>					
Loans for working capital	Floating interest rates ranging from 1.61% to 1.70% per annum at June 30, 2004 with maturities through 2004 . . . . .	—	—	—	19,866
		23,675,162	25,222,285	22,056,495	21,212,373
Less: Loans due within one year classified as current liabilities . . . . .		(8,300,277)	(10,941,831)	(9,236,674)	(9,301,850)
Loans due after one year classified as long-term portion . . . . .		<u>15,374,885</u>	<u>14,280,454</u>	<u>12,819,821</u>	<u>11,910,523</u>

The interest rates of RMB denominated loans are set and subject to change by the People's Bank of China.

Bank loans of approximately RMB15,255 million, RMB14,539 million, RMB14,252 million and RMB13,311 million are secured by:

- (i) mortgages over certain of the Group's aircraft and flight equipment, which had an aggregate carrying value of approximately RMB16,982 million, RMB17,004 million, RMB16,422 million and RMB15,899 million as at December 31, 2001, 2002, 2003 and June 30, 2004, respectively; and
- (ii) the pledges of certain of the Group's bank deposits amounting to approximately RMB81 million, RMB336 million, RMB1,177 million and RMB59 million as at December 31, 2001, 2002, 2003 and June 30, 2004, respectively.

At the end of each of the Relevant Periods, certain bank loans of the Group were guaranteed by the following parties at the following amounts:

	As at December 31,			As at
	2001	2002	2003	June 30, 2004
	RMB'000	RMB'000	RMB'000	RMB'000
The Industrial and Commercial Bank of China . . . .	3,213,704	2,843,296	2,464,847	2,301,377
China Construction Bank . . . . .	560,988	515,513	472,349	448,204
Bank of China . . . . .	3,136,756	1,312,351	752,575	704,082
Export-Import Bank of the United States . . . . .	8,830,187	8,044,019	7,243,953	6,821,435
Air China International Corporation . . . . .	372,000	99,000	396,154	15,000
CNAHC . . . . .	—	—	3,198,407	2,922,492
CNACG . . . . .	269,714	—	—	—
CNAC (PRC) . . . . .	516,000	430,000	380,000	250,000
CNAF . . . . .	630,000	160,000	—	—
Chengdu Shuangliu International Airport . . . . .	480,000	379,100	—	—
Lufthansa Airlines . . . . .	42,211	—	—	—
CSWA . . . . .	92,000	82,000	—	—
Civil Aviation Oil Supply Company . . . . .	1,100,000	—	—	—
Civil Aviation Oil Supply Company Southwest Branch . . . . .	22,000	60,000	—	—
West China Securities Co., Ltd. . . . .	—	120,000	—	—
China Aviation Supplies Southwest Corp. . . . .	—	200,000	—	—
重慶西南航空勞動服務有限公司 (Chongqing Southwest Aviation Service Co., Ltd.)* . . . . .	—	20,000	—	—
	<u>19,265,560</u>	<u>14,265,279</u>	<u>14,908,285</u>	<u>13,462,590</u>

\* The English name is a direct translation of the company's Chinese name.

In order for Export-Import Bank of the United States to provide guarantees to certain of the bank loans of the Group, Export-Import Bank of the United States requires guarantees to be given by some major PRC state-owned banks. As at December 31, 2001, 2002 and 2003 and June 30, 2004, the amounts of these counter-guarantees provided by those major PRC state-owned banks to Export-Import Bank of the United States were approximately RMB8,830 million, RMB8,044 million, RMB7,244 million and RMB6,821 million, respectively.

Bank loans of the Group amounting to RMB130 million as at December 31, 2001 and 2002 were secured by the pledge of the investment in West China Securities Co., Ltd. held by the then CSWA with a carrying value of RMB130 million.

Subsequent to June 30, 2004, bank loans of RMB250 million and RMB15 million as at June 30, 2004 guaranteed by CNAC (PRC) and Air China International Corporation, respectively, have been fully repaid and the guarantees have been released accordingly.

**(p) Long-term payables**

Long-term payables mainly represent customs duties and value-added tax payable after one year to the PRC government in respect of the acquisition of aircraft and related equipment. The

customs duties and value-added tax are levied at rates applicable to state-owned enterprises and payable upon repayment of the corresponding finance lease instalments. Set out below are details of the customs duties and value-added tax payable further analysed into non-current and current portions at the end of each of the Relevant Periods:

	As at December 31,			As at
	2001	2002	2003	June 30,
	RMB'000	RMB'000	RMB'000	RMB'000
Customs duties and value-added tax payable	1,311,473	1,134,217	975,712	895,612
Others .....	257	—	—	—
	1,311,730	1,134,217	975,712	895,612
Less: Portion classified as current liabilities				
(Section 5(l)) .....	(195,240)	(200,359)	(174,363)	(174,522)
Long-term portion .....	<u>1,116,490</u>	<u>933,858</u>	<u>801,349</u>	<u>721,090</u>

*(q) Deferred income*

In 2000, the Company acquired an aircraft which was funded by the PRC government, and a further aircraft was injected into the Group by the PRC government during the six-month period ended June 30, 2004. In accordance with IAS 20 "Accounting for Government Grants and Disclosure of Government Assistance", the Company recorded these aircraft purchased in 2000 and received in the six-month period ended June 30, 2004 as property, plant and equipment with the corresponding amount of government grant recorded as deferred income at the date of the delivery of the aircraft. As such, the government subsidies in relation to the aforesaid aircraft purchased in 2000 and the aircraft received during the six-month period ended June 30, 2004 are recorded in deferred income of the Group in 2000 and during the six-month period ended June 30, 2004, respectively. The deferred income is recognised as income over the expected useful life of the relevant aircraft on the straight-line basis.



The movements of deferred income as stated under current and non-current liabilities in the combined balance sheets were as follows:

	As at December 31,			As at
	2001	2002	2003	June 30,
	RMB'000	RMB'000	RMB'000	2004
				RMB'000
Deferred income relating to the government grant:				
At beginning of year/period . . . . .	1,157,880	1,157,880	1,157,880	1,157,880
Addition during the year/period . . . . .	—	—	—	304,787
At end of year/period . . . . .	<u>1,157,880</u>	<u>1,157,880</u>	<u>1,157,880</u>	<u>1,462,667</u>
Accumulated income recognised as other operating revenues:				
At beginning of year/period . . . . .	38,596	96,490	154,384	212,278
Credit during the year/period				
(Section 4(b)) . . . . .	<u>57,894</u>	<u>57,894</u>	<u>57,894</u>	<u>28,947</u>
At end of year/period . . . . .	<u>96,490</u>	<u>154,384</u>	<u>212,278</u>	<u>241,225</u>
Net amount . . . . .	<u>1,061,390</u>	<u>1,003,496</u>	<u>945,602</u>	<u>1,221,442</u>
Less: Portion classified as current liabilities				
(Section 5(l)) . . . . .	<u>(57,894)</u>	<u>(57,894)</u>	<u>(57,894)</u>	<u>(80,118)</u>
Long-term portion . . . . .	<u>1,003,496</u>	<u>945,602</u>	<u>887,708</u>	<u>1,141,324</u>

**(r) Contingent liabilities**

- (i) Pursuant to the agreement for the Restructuring entered into by the Company with CNAHC and CNACG, except for liabilities constituting or arising out of or relating to business undertaken by the Company after the Restructuring, no other liabilities were assumed by the Company and the Company is not liable, whether severally, or jointly and severally, for debts and obligations incurred prior to the Restructuring by CNAHC and CNACG. CNAHC and CNACG have also undertaken to indemnify the Company in respect of any loss or damage incurred relating to the Relevant Businesses and the Relevant Companies prior to their transfer by CNAHC and CNACG to the Company in the Restructuring except for the litigation set out in item (iii) below, any loss or damage suffered or incurred by the Company in relation to the novation of relevant contracts from CNAHC to the Company and as a result of any breach by CNAHC Group and CNACG of any provision of the Restructuring Agreement. The Company has also undertaken to indemnify CNAHC and CNACG in respect of any damage suffered or incurred by CNAHC and CNACG as a result of any breach by the Company of any provision of the Restructuring Agreement.
- (ii) On April 15, 2002, Flight CA129 crashed on approach to Gimhae International Airport, South Korea. There were 129 fatalities among 166 passengers and crew members aboard the Boeing 767 aircraft. An investigation was conducted by the Chinese and the Korean civil aviation authorities, but the cause of the accident has yet to be released at the date of this report. Injured passengers and families of the deceased passengers have commenced proceedings in Korean courts seeking damages against

Air China International Corporation. As at June 30, 2004, the aggregate amount of the claims brought under these lawsuits totaled approximately KPW271,383 million, equivalent to approximately RMB1,945 million. The Group cannot predict the timing of the courts' judgements or the possible outcome of the lawsuits nor any possible appeal actions. Although the outcome of the outstanding and possible future litigation cannot be ascertained as at the date of this report, it is anticipated that the costs of settling the above-mentioned claims and other incidental costs incurred will be covered by the master policy underwritten by an insurance company maintained by the CAAC on behalf of Air China International Corporation. Up to June 30, 2004, approximately RMB31 million and approximately RMB59 million of the passenger liability claimed and the auxiliary costs incurred, respectively, have been prepaid by Air China International Corporation, of which approximately RMB74 million has been recovered from the Company's insurer as at the date of this report. As part of the Restructuring, CNAHC has agreed to indemnify the Group for any liabilities relating to the crash of Flight CA129, excluding the compensation already paid up to September 30, 2004 (being the date of incorporation of the Company). The directors of the Company believe that there will not be any material adverse impact to the Group's financial position.

- (iii) Air China International Corporation is one of the defendants in a civil litigation in the High Court of Hong Kong (Action No. 515 of 2001) ("Litigation"). United Aero-Supplies System of China Limited ("UASSC") had entered into an agreement with the defendants for the exclusive purchase of aviation equipment consigned to UASSC for sale and, that as the defendants failed to perform the agreement, UASSC has the right to compensation. Since UASSC is in the course of its winding up proceedings, all the rights and benefits of UASSC in connection with the claim have been transferred to New Link Consultants Limited ("NLC"). Air China International Corporation, as one of the defendants to the Litigation, has been claimed by NLC for compensation of HK\$60,000,000 (equivalent to approximately RMB63,600,000) for failing to perform the above agreement. Air China International Corporation has filed an objection in respect of the jurisdiction of the court, and has requested the court to transfer the case to Mainland China for trial. Air China International Corporation received an order in respect of this application on May 3, 2004. The judge granted the application and ordered that the action against Air China International Corporation be dismissed. Subsequent to this order, NLC has filed an appeal. The date for hearing of the appeal has been fixed on July 28, 2005. After considering the aforesaid order granted by the judge and consulting the legal counsel, the directors of the Company consider that Air China International Corporation has a reasonable chance of success in its defence to the claim. Accordingly, the directors of the Company consider that a provision for such claim and/or the associated legal costs is not required.

- (iv) The Group has issued guarantees to banks in respect of the bank loans granted to the following parties:

	As at December 31,			As at
	2001	2002	2003	June 30,
	RMB'000	RMB'000	RMB'000	2004
Joint ventures . . . . .	260,000	80,000	18,750	—
Associates . . . . .	—	89,500	380,521	316,921
Related party . . . . .	5,000	5,500	7,500	7,500
Third parties . . . . .	175,000	149,170	149,170	149,170
	<u>440,000</u>	<u>324,170</u>	<u>555,941</u>	<u>473,591</u>

- (v) The Group's associates have issued guarantees to banks in respect of the bank loans granted to the following parties:

	As at December 31,			As at
	2001	2002	2003	June 30,
	RMB'000	RMB'000	RMB'000	2004
Joint ventures . . . . .	8,502	—	—	—
Related parties . . . . .	50,774	145,176	40,537	107,620
Third parties . . . . .	15,541	18,921	20,722	74,634
	<u>74,817</u>	<u>164,097</u>	<u>61,259</u>	<u>182,254</u>

(s) *Commitments*

(i) *Capital commitments*

The Group had the following amounts of contractual commitments, for the acquisition and construction of property, plant and equipment:

	As at December 31,			As at
	2001	2002	2003	June 30,
	RMB'000	RMB'000	RMB'000	2004
Contractual commitments . . . . .	<u>7,526,971</u>	<u>5,873,691</u>	<u>8,704,390</u>	<u>9,095,314</u>

(ii) *Operating lease commitments*

The Group leases certain of its office premises, aircraft and related equipment under operating lease arrangements. Leases for these assets are negotiated for terms ranging from 1 to 20 years.

The Group had the following minimum lease payments under non-cancelable operating leases:

	As at December 31,			As at
	2001	2002	2003	June 30, 2004
	RMB'000	RMB'000	RMB'000	RMB'000
Within one year . . . . .	712,283	913,625	908,204	1,142,968
In the second to fifth years, inclusive . . . . .	2,430,006	2,754,362	2,626,283	2,945,628
Over five years . . . . .	<u>2,178,371</u>	<u>1,858,852</u>	<u>1,317,788</u>	<u>1,212,959</u>
	<u>5,320,660</u>	<u>5,526,839</u>	<u>4,852,275</u>	<u>5,301,555</u>

*(t) Distributable reserves*

The Company was incorporated on September 30, 2004. As at June 30, 2004, the Company had yet to be incorporated and as such, it did not have any retained profits available for distribution to its shareholders at that date.

*(u) Financial instruments*

Financial assets of the Group mainly include cash and cash equivalents, pledged assets, trade receivables, other investments, deposits and other receivables. Financial liabilities of the Group mainly include bank and other loans, obligations under finance leases, trade payables, other payables, bills payable and air traffic liabilities.

The carrying amounts of the Group's financial instruments approximated their fair value as at balance sheet date. Fair value estimates are made at a specific point in time and based on relevant market information about the financial instruments. These estimates are subjective in nature and involve uncertainties and matters of significant judgement and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

*(v) Concentration of risk*

*(i) Financial risk management objectives and policies*

The Group operates globally and generates revenues in various currencies. The Group's airline operations are exposed to business risk, liquidity risk, jet fuel price risk, foreign currency risk, interest rate risk and credit risk. The Group's overall risk management approach is to moderate the effects of such volatility on its financial performance.

Financial risk management policies are periodically reviewed and approved by the board of directors.

*(ii) Business risk*

The operations of the air transportation industry are substantially influenced by global political and economic development. Factors such as accidents and wars may have a material impact on the Group's operations or the industry as a whole. In addition, the Group primarily conducts its principal operations in the PRC and accordingly is subject to special consideration and significant risks not typically associated with companies in the United States of America and Western Europe. These include risks associated with, among other things, the political, economic

and legal environment, competition and influence of the CAAC in the Chinese civil aviation industry.

*(iii) Liquidity risk*

The Group's net current liabilities amounted to approximately RMB11,142 million, RMB11,621 million, RMB12,384 million and RMB11,732 million as at December 31, 2001, 2002 and 2003 and June 30, 2004, respectively. The Group recorded a net cash inflow from operating activities of approximately RMB5,538 million, RMB4,069 million, RMB5,511 million, RMB80 million (unaudited) and RMB2,032 million for the three years ended December 31, 2003 and for the six-month periods ended June 30, 2003 and 2004, respectively. For the same periods, the Group had a net cash outflow from investment activities of approximately RMB1,719 million, RMB2,076 million, RMB4,360 million, RMB1,884 million (unaudited) and RMB1,206 million, respectively. The Group also recorded a net cash outflow from financing activities of approximately RMB2,463 million, RMB2,316 million, RMB2,207 million, RMB409 million (unaudited) and RMB703 million for the three years ended December 31, 2003 and for the six-month periods ended June 30, 2003 and 2004, respectively. The Group had the increase in cash and cash equivalents of approximately RMB1,356 million in 2001 and RMB123 million for the six-month period ended June 30, 2004 but the decrease in cash and cash equivalents of approximately RMB323 million, RMB1,057 million and RMB2,214 million (unaudited) for the two years ended December 31, 2003 and for the six-month period ended June 30, 2003, respectively.

With regard to 2004 and thereafter, the liquidity of the Group is primarily dependent on its ability to maintain adequate cash inflow from operations to meet its debt obligations as they fall due, and on its ability to obtain external financing, to meet its committed future capital expenditures. With regard to its future capital commitments and other financing requirements, the Company has already obtained several banking facilities with several PRC banks of up to an amount of RMB71,700 million during 2004 and thereafter. As of October 31, 2004, the Company had a total amount of banking facilities of RMB71,700 million, of which an amount of approximately RMB44,427 million was utilised.

The directors of the Company have carried out a detailed review of the cash flow forecast of the Group for the period ending December 31, 2005. Based on such forecast, the directors have determined that adequate liquidity exists to finance the working capital and capital expenditure requirements of the Group during that period. In preparing the cash flow forecast, the directors have considered historical cash requirements of the Group as well as other key factors, including the availability of the above-mentioned loan finance which may impact the operations of the Group prior to the end of 2005. The directors are of the opinion that the assumptions and sensitivities which are included in the cash flow forecast are reasonable. However, as with all assumptions in regard to future events, these are subject to inherent limitations and uncertainties and some or all of these assumptions may not be realised.

*(iv) Jet fuel price risk*

The Group's strategy for managing the risk on jet fuel price aims to provide the Group with protection against sudden and significant increases in prices. In meeting these objectives, the Group allows for the judicious use of approved derivative instruments such as swaps and collars with approved counter-parties and within approved limits.

Moreover, counter-party credit risk is generally restricted to any gains on changes in fair value from time to time, and not the principal amount of the instrument. Therefore, the possibility of material loss arising in the event of non-performance by a counter-party is considered to be unlikely.

The fair values of derivative instruments at the end of each of the Relevant Periods are as follows:

	As at December 31,						As at June 30,	
	2001		2002		2003		2004	
	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
	RMB'000	RMB'000	RMB'000	RMB'000	RMB'000	RMB'000	RMB'000	RMB'000
Swaps and collars expiring:								
Within 6 months . . . . .	5,000	(55,000)	51,000	(28,000)	8,000	(2,400)	60,000	(200)
Over 6 months to								
21 months . . . . .	5,000	(43,000)	18,000	(82,000)	26,000	(3,600)	17,000	(800)
	<u>10,000</u>	<u>(98,000)</u>	<u>69,000</u>	<u>(110,000)</u>	<u>34,000</u>	<u>(6,000)</u>	<u>77,000</u>	<u>(1,000)</u>

Fair values of derivative instruments, denominated in United States dollars, are obtained from quoted market prices, dealer price quotations, discounted cash flow models and option pricing models, which consider current market and contractual prices for the underlying instruments, as well as time value of money, yield curve and volatility of the underlying instruments.

(v) *Foreign currency risk*

The Group's finance lease obligations as well as certain bank and other loans are denominated in United States dollars, Hong Kong dollars and Japanese yen, and certain expenses of the Group are denominated in currencies other than RMB. The Group generates foreign currency revenues from ticket sales made in overseas offices and would normally generate sufficient foreign currencies after payment of foreign currency expenses, to meet its foreign currency liabilities repayable within one year. RMB against United States dollars and Hong Kong dollars have been comparatively stable in the past. However, RMB against Japanese yen had experienced a significant level of fluctuation over the Relevant Periods which is the major reason for the significant exchange differences recognised by the Group for the Relevant Periods.

As at December 31, 2002, the Group had a contractual amount of US\$3 million (equivalent to approximately RMB25 million) in forward exchange contracts in Taiwanese currency to purchase foreign currencies.

(vi) *Interest rate risk*

The Group's earnings are also affected by changes in interest rates due to the impact of such changes on interest income and expense from short-term deposits and other interest-bearing financial assets and liabilities. A significant portion of the Group's interest-bearing financial liabilities with maturities above one year have predominately fixed rates of interest and are denominated in United States dollars and Japanese yen.

The Group's short-term deposits and other interest-bearing financial assets and liabilities are predominately denominated in RMB, United States dollars and Hong Kong dollars.

*(vii) Credit risk*

The Group's cash and cash equivalents are deposited with PRC banks, overseas banks and an associate. The Group has policies in place to limit the exposure to any one financial institution.

A significant portion of the Group's air tickets are sold by agents participating in the Billing and Settlements Plan ("BSP"), a clearing system between airlines and sales agents organised by the International Air Transportation Association. The balance due from BSP agents amounted to approximately RMB387 million, RMB321 million, RMB342 million and RMB749 million as at December 31, 2001, 2002, 2003 and June 30, 2004, respectively.

Except for the above, the Group has no significant concentration of credit risk, with exposure spread over a number of counterparties.

*(w) Interests in joint ventures*

As at the end of each of the Relevant Periods and for the years/period then ended, the Group's proportionate share of the assets, liabilities, revenues and expenses of the joint ventures are as follows:

	As at December 31,			As at June 30,	
	2001	2002	2003	2004	
	RMB'000	RMB'000	RMB'000	RMB'000	
Current assets . . . . .	505,745	601,098	610,502	643,270	
Non-current assets . . . . .	621,935	604,710	633,369	636,837	
	1,127,680	1,205,808	1,243,871	1,280,107	
Current liabilities . . . . .	(654,815)	(628,769)	(728,033)	(721,738)	
Non-current liabilities . . . . .	—	(72,000)	—	—	
<b>Net assets</b> . . . . .	<u>472,865</u>	<u>505,039</u>	<u>515,838</u>	<u>558,369</u>	
	Year ended December 31,			Six-month period ended June 30,	
	2001	2002	2003	2003	
	RMB'000	RMB'000	RMB'000	RMB'000	
				(Unaudited)	
Revenues . . . . .	814,882	930,942	959,938	394,752	561,506
Operating expenses . . . . .	(684,799)	(785,057)	(848,222)	(385,478)	(500,182)
Finance costs . . . . .	(26,841)	(25,588)	(21,919)	(9,736)	(9,238)
Share of profits less losses from associates . . . . .	5,126	(4,740)	1,111	(354)	928
<b>Profit/(loss) before tax</b> . . . . .	108,368	115,557	90,908	(816)	53,014
Tax . . . . .	(15,334)	(20,200)	(16,427)	(5,466)	(10,484)
<b>Net profit/(loss)</b> . . . . .	<u>93,034</u>	<u>95,357</u>	<u>74,481</u>	<u>(6,282)</u>	<u>42,530</u>

**APPENDIX I**
**ACCOUNTANTS' REPORT**

Set out below is the breakdown of the Group's share of net assets, revenues and net profit/(loss) from the joint ventures:

	As at December 31,			As at	
	2001	2002	2003	June 30,	
	RMB'000	RMB'000	RMB'000	2004	
Share of net assets:				RMB'000	
AMECO .....	361,504	367,601	382,089	410,577	
Other joint ventures .....	<u>111,361</u>	<u>137,438</u>	<u>133,749</u>	<u>147,792</u>	
	<u>472,865</u>	<u>505,039</u>	<u>515,838</u>	<u>558,369</u>	
	Year ended December 31,			Six-month period	
	2001	2002	2003	2003	2004
	RMB'000	RMB'000	RMB'000	RMB'000	RMB'000
					(Unaudited)
Share of revenues:					
AMECO .....	604,862	687,021	752,354	304,676	441,128
Other joint ventures .....	<u>210,020</u>	<u>243,921</u>	<u>207,584</u>	<u>90,076</u>	<u>120,378</u>
	<u>814,882</u>	<u>930,942</u>	<u>959,938</u>	<u>394,752</u>	<u>561,506</u>
Share of net profit/(loss):					
AMECO .....	58,682	56,469	56,192	(9,471)	28,488
Other joint ventures .....	<u>34,352</u>	<u>38,888</u>	<u>18,289</u>	<u>3,189</u>	<u>14,042</u>
	<u>93,034</u>	<u>95,357</u>	<u>74,481</u>	<u>(6,282)</u>	<u>42,530</u>



## 6. STATEMENT OF CHANGES IN EQUITY

The changes in the owners' equity of the Group for the Relevant Periods and for each of the two six-month periods ended June 30, 2003 and December 31, 2003, prepared on the basis set out in Section 2 above, are as follows:

	<u>Owners' equity</u>
	<u>RMB'000</u>
As at January 1, 2001 .....	3,411,653
Capital contributions .....	48,575
Distributions .....	(157,993)
Profit for the year .....	<u>948,288</u>
As at January 1, 2002 .....	4,250,523
Capital contributions .....	497,738
Distributions .....	(227,608)
Profit for the year .....	<u>499,610</u>
As at January 1, 2003 .....	5,020,263
Capital contributions (unaudited) .....	20,920
Distributions (unaudited) .....	(136,606)
Loss for the period (unaudited) .....	<u>(1,252,522)</u>
As at June 30, 2003 (unaudited) .....	3,652,055
Capital contributions (unaudited) .....	2,034,925
Distributions (unaudited) .....	(206,237)
Profit for the period (unaudited) .....	<u>1,412,126</u>
As at January 1, 2004 .....	6,892,869
Capital contributions .....	17,084
Distributions .....	(40,969)
Profit for the period .....	<u>788,352</u>
As at June 30, 2004 .....	<u><u>7,657,336</u></u>

## Notes:

- (a) As further described in Section 2, the combined results, combined balance sheets and combined cash flow statements of the Group have been prepared as if the Group had been in existence throughout the Relevant Periods. Upon the incorporation of the Company on September 30, 2004, the historical net value of the assets, liabilities and interests transferred to the Company were converted into the Company's share capital of RMB6,500 million of RMB1.00 each with all the then existing reserves eliminated and the resulting difference dealt with in the capital reserve. Accordingly, a capital reserve, being the difference between the amount of share capital issued and the historical net value of the assets, liabilities and interests transferred to the Company as at September 30, 2004, was presented in the reserves of both the Group and the Company. Separate classes of reserves, including retained profits of the Group prior to the incorporation of the Company (save for the amount as disclosed in note (c) below), were not separately disclosed as all of these reserves (save for the amounts as disclosed in notes (b) and (c) below) had been capitalised and incorporated in the capital reserve of the Group and the Company pursuant to the Restructuring.
- (b) As a result of the completion of BAACL Agreement, SWACL Agreement and HKSACL Agreement (see Section 11(j) for details), the Group will make a payment of approximately RMB378 million to CNAHC. Therefore, this amount was not capitalised by the Group and the Company upon incorporation of the Company.
- (c) In accordance with the (財政部關於印發《企業公司制改建有關國有資本管理與財務處理的暫行規定》)的通知 "Provisional Regulation Relating to Corporate Reorganisation of Enterprises and Related Management of State-

owned Capital and Financial Treatment” notice issued by the Ministry of Finance and pursuant to the Restructuring, after the Company’s incorporation, the Group is required to make a distribution to CNAHC, which represents an amount equal to the net profit attributable to shareholders, as determined based on audited accounts prepared in accordance with the PRC GAAP, generated, during the period from January 1, 2004 to September 30, 2004 (the date of incorporation of the Company) by the businesses and operations (excluding those of CNAC) contributed to the Group by CNAHC (see Section 4(j)). The net profit attributable to shareholders mentioned above for the said period is calculated after deducting the amount of income tax payable to CNAHC which in turn will settle any tax liability on profit arisen during that period with the relevant tax bureau as detailed in Section 4(i). Pursuant to the Restructuring, such undistributed profits of the Group for the above period are attributable to CNAHC and the Company agreed to pay such amount to CNAHC by way of a distribution (see Section 4(j)). Therefore, this amount was not capitalised by the Group and the Company upon incorporation of the Company.

In addition, in accordance with the (財政部關於印發《企業公司制改建有關國有資本管理與財務處理的暫行規定》的通知) “Provisional Regulation Relating to Corporate Reorganisation of Enterprises and Related Management of State-owned Capital and Financial Treatment” notice issued by the Ministry of Finance and pursuant to the Restructuring, after the Company’s incorporation, the Group is required to make a distribution to CNACG, which represents an amount equal to the net profit attributable to shareholders, as determined based on audited accounts prepared in accordance with the PRC GAAP, generated, during the period from January 1, 2004 to September 30, 2004 (the date of incorporation of the Company) by the businesses and operations (excluding those directly contributed by CNAHC) contributed to the Group by the CNAC group, less the 2003 final dividend and 2004 interim dividend amounts already paid by CNAC to CNACG. Pursuant to the Restructuring, such undistributed profits of the Group for the above period are attributable to CNACG and the Company agreed to pay such amount to CNACG by way of a distribution (see Section 4(j)). Therefore, this amount was not capitalised by the Group and the Company upon incorporation of the Company.

- (d) On September 9, 2004, CNAHC made a cash contribution of approximately RMB561 million to the Group.
- (e) Upon incorporation of the Company, CNAHC effected the transfer of certain land use rights in an aggregate amount of approximately RMB886 million to the Company which forms part of the Company’s paid-up capital of RMB6,500 million.
- (f) Subsequent to the public listing of the Company’s H Shares, in accordance with the relevant PRC regulations and articles of association of the Company, retained profits available for distribution by the Company will be deemed to be the lower of the amounts determined in accordance with the PRC GAAP and the amount determined in accordance with IFRS.

## 7. COMBINED CASH FLOW STATEMENTS

The combined cash flow statements of the Group for the Relevant Periods prepared on the basis set out in Section 2 above are as follows:

	Year ended December 31,			Six-month period ended June 30,	
	2001	2002	2003	2003	2004
	RMB'000	RMB'000	RMB'000	RMB'000	RMB'000
				(unaudited)	
CASH GENERATED FROM OPERATIONS (Note a)	8,454,654	6,659,247	7,787,224	1,252,391	2,964,270
Interest paid	(2,889,116)	(2,559,633)	(2,248,996)	(1,152,954)	(917,080)
Tax paid:					
Mainland China enterprise income tax paid	(25,785)	(23,220)	(17,032)	(18,244)	(14,419)
Overseas taxes paid	(1,496)	(7,310)	(10,550)	(1,384)	(657)
NET CASH INFLOW FROM OPERATING ACTIVITIES	<u>5,538,257</u>	<u>4,069,084</u>	<u>5,510,646</u>	<u>79,809</u>	<u>2,032,114</u>
CASH FLOWS FROM INVESTING ACTIVITIES					
Purchases of property, plant and equipment	(3,384,759)	(2,189,464)	(3,065,218)	(670,900)	(1,401,166)
Proceeds from disposals of property, plant and equipment	947,201	291,045	164,873	201,680	18,177
(Increase)/decrease in lease prepayments	(5,081)	105	(4,939)	52	(40,200)

**APPENDIX I**
**ACCOUNTANTS' REPORT**

	Year ended December 31,			Six-month period ended June 30,	
	2001	2002	2003	2003	2004
	RMB'000	RMB'000	RMB'000	RMB'000	RMB'000
				(unaudited)	
(Increase)/decrease in advance payments for aircraft and related equipment .....	671,815	(272,752)	(784,061)	(440,028)	58,963
Net cash settlements of derivatives .....	(16,826)	38,243	100,921	78,460	28,641
(Increase)/decrease in amounts due from associates .....	(99,025)	6,896	(18,406)	(92,661)	(20,070)
Increase/(decrease) in amounts due to associates ...	5,188	50,211	(27,522)	65,576	(442)
Increase in dividend receivable from an associate ..	—	—	—	—	(56,743)
(Increase)/decrease in time deposits with original maturity of more than three months .....	(25,784)	(27,629)	22,587	(1,090,130)	(1,015,001)
(Increase)/decrease in pledged deposits .....	(9,004)	(260,430)	(853,958)	10,216	1,106,925
Interest received .....	69,749	44,450	18,803	14,838	6,032
Capital contributions to associates .....	—	(7,014)	(4,000)	—	—
Dividends received on long-term investments .....	6,629	2,093	406	383	129
Dividends received from associates .....	120,783	248,579	90,551	38,055	108,993
Net cash outflow from investing activities .....	<u>(1,719,114)</u>	<u>(2,075,667)</u>	<u>(4,359,963)</u>	<u>(1,884,459)</u>	<u>(1,205,762)</u>
NET CASH INFLOW/(OUTFLOW) BEFORE FINANCING ACTIVITIES .....	3,819,143	1,993,417	1,150,683	(1,804,650)	826,352
CASH FLOWS FROM FINANCING ACTIVITIES					
New bank and other loans .....	5,672,347	8,566,170	10,205,236	6,846,170	6,937,744
Repayment of bank and other loans .....	(4,730,969)	(7,019,047)	(13,371,026)	(5,872,840)	(7,781,866)
Repayment of principal under finance lease obligations .....	(3,156,555)	(3,804,335)	(1,961,181)	(1,224,344)	(846,112)
Settlement of long-term payables .....	(197,783)	(182,632)	(132,509)	(87,098)	(80,259)
(Increase)/decrease in net balance due from CNAHC .....	1,739	(364,392)	1,276,384	15,434	(21,312)
Contributions by CNAHC .....	48,575	497,738	2,055,845	20,920	17,084
Distributions to CNAHC .....	(157,993)	(227,608)	(342,843)	(136,606)	(40,969)
Capital contributions received from minority shareholders .....	1,470	178,139	—	—	1,078,009
Dividends paid to minority shareholders .....	(12,140)	(33,326)	(14,639)	(8,934)	(6,125)
Receipt of government grants .....	68,596	72,967	77,338	38,225	40,739
Net cash outflow from financing activities .....	<u>(2,462,713)</u>	<u>(2,316,326)</u>	<u>(2,207,395)</u>	<u>(409,073)</u>	<u>(703,067)</u>
NET INCREASE/(DECREASE) IN CASH AND CASH EQUIVALENTS .....	1,356,430	(322,909)	(1,056,712)	(2,213,723)	123,285
Cash and cash equivalents at beginning of year/period	2,612,586	3,969,016	3,646,107	3,646,107	2,589,395
CASH AND CASH EQUIVALENTS AT END OF YEAR/PERIOD .....	<u>3,969,016</u>	<u>3,646,107</u>	<u>2,589,395</u>	<u>1,432,384</u>	<u>2,712,680</u>

*(a) Cash flows from operating activities:*

	Year ended December 31,			Six-month period ended June 30,	
	2001	2002	2003	2003	2004
	RMB'000	RMB'000	RMB'000	RMB'000 (unaudited)	RMB'000
Profit/(loss) before tax and minority interests . . . . .	1,609,722	1,039,826	178,279	(1,931,473)	1,260,846
Adjustments for:					
Exchange (gains)/losses, net . . . . .	(769,099)	345,242	456,094	40,022	8,834
(Gains)/losses on disposal of property, plant and equipment, net . . . . .	181,243	(161,717)	(17,048)	(33,928)	15,948
(Gains)/losses on fuel derivatives, net . . . . .	104,826	(85,243)	(169,921)	(112,117)	(76,641)
Dilution gain on investment in a subsidiary . . . . .	—	(106,040)	—	—	—
Depreciation . . . . .	3,242,618	3,251,571	3,377,472	1,667,350	1,715,396
Share of profits less losses from associates . . . . .	(352,829)	(426,494)	(243,093)	110,864	(223,692)
Dividend income on long-term investments . . . . .	(6,629)	(2,093)	(406)	(383)	(129)
Interest income . . . . .	(69,749)	(44,450)	(18,803)	(14,838)	(6,032)
Interest expense . . . . .	2,872,706	2,548,173	2,241,166	1,149,039	914,470
Provision for doubtful debts . . . . .	5,122	2,427	12,144	9,055	1,447
Provision against inventories, net . . . . .	56,722	14,742	24,090	23,910	11,277
Operating profit before working capital changes . . . . .	6,874,653	6,375,944	5,839,974	907,501	3,621,724
(Increase)/decrease in inventories . . . . .	(61,516)	(41,913)	2,228	33,789	(76,055)
(Increase)/decrease in trade receivables . . . . .	82,931	(171,057)	(93,284)	132,865	(323,388)
(Increase)/decrease in amounts due from other CNAHC group companies . . . . .	(26,790)	3,897	(32,309)	16,329	4,798
(Increase)/decrease in prepayments, deposits and other receivables . . . . .	194,938	297,336	(77,792)	(111,791)	(661,535)
(Increase)/decrease in deposits for aircraft under operating leases . . . . .	(40,818)	(46,805)	19,288	7,114	23,100
Increase/(decrease) in amounts due to other CNAHC group companies . . . . .	7,890	4,347	(6,001)	(25,938)	(11,536)
Increase in trade payables . . . . .	372,284	587,940	806,877	580,314	886,304
Increase/(decrease) in bills payable . . . . .	162,442	206,325	900,820	(171,400)	(590,102)
Increase/(decrease) in other payables and accruals . . . . .	666,881	(557,116)	41,676	115,792	31,480
Increase in provision for major overhauls . . . . .	41,620	61,371	151,486	59,914	78,826
Increase/(decrease) in air traffic liabilities . . . . .	174,942	(87,715)	276,883	(270,787)	6,426
Provision for early retirement benefit obligations . . . . .	63,091	84,587	15,272	7,636	3,175
Recognition of deferred income . . . . .	(57,894)	(57,894)	(57,894)	(28,947)	(28,947)
Cash generated from operations . . . . .	<u>8,454,654</u>	<u>6,659,247</u>	<u>7,787,224</u>	<u>1,252,391</u>	<u>2,964,270</u>

*(b) Analysis of balances of cash and cash equivalents:*

	Year ended December 31,			Six-month period ended June 30,	
	2001	2002	2003	2003	2004
	RMB'000	RMB'000	RMB'000	RMB'000 (unaudited)	RMB'000
Cash and bank balances . . . . .	3,248,129	3,658,538	3,604,537	1,571,455	2,176,816
Less: Pledged bank balances . . . . .	(22,115)	(256,930)	(1,117,852)	(261,726)	—
Non-pledged cash and bank balances . . . . .	3,226,014	3,401,608	2,486,685	1,309,729	2,176,816
Non-pledged time deposits with original maturity of not longer than three months when acquired . . . . .	<u>743,002</u>	<u>244,499</u>	<u>102,710</u>	<u>122,655</u>	<u>535,864</u>
	<u>3,969,016</u>	<u>3,646,107</u>	<u>2,589,395</u>	<u>1,432,384</u>	<u>2,712,680</u>

*(c) Notes to cash flow statements:*

- (i) In 2002, CNACG transferred its entire 51% shareholding interest in Air Macau (the shareholding interest of Air Macau is considered as if it had been directly held by the Company as of January 1, 2001 in accordance with the basis set out in Section 2 of this report) to CNAC, which was then a 70% owned subsidiary of CNACG, for an aggregate consideration of HK\$665,000,000 (equivalent to approximately RMB704,900,000). Subsequent to the Disposal, the Group's effective shareholding interest in Air Macau was reduced from 51% to approximately 35% and, accordingly, a gain on deemed disposal of approximately RMB106,040,000 arose.
- (ii) Certain share options previously granted by CNAC were exercised on April 4, 2002 for a gross proceed of HK\$87,491,000 (equivalent to approximately RMB92,740,000). A gain arising from the deemed disposal of shareholding interests in CNAC of approximately RMB19,080,000 was resulted and recorded in other operating revenues.

## 8. SEGMENT INFORMATION

Segment information is presented by way of two segment formats: (i) on a primary segment reporting basis, by business segment; and (ii) on a secondary segment reporting basis, by geographical segment.

The Group's operating businesses are structured and managed separately, according to the nature of their operations and the services they provide. Each of the Group's business segments represents a strategic business unit that offers services which are subject to risks and returns that are different from those of the other business segments.

Currently the Group's business segment information is divided into four business segments — airline operations, engineering services, airport terminal services and other businesses ("others"). Segment net profit represents revenues less expenses directly attributable to a segment and the relevant portion of enterprise revenues less expenses that can be allocated on a reasonable basis to a segment, whether from external transactions or from transactions with other segments of the Group.

Segment assets and liabilities mainly comprise those operating assets and liabilities that are directly attributable to the segment or can be allocated to the segment on a reasonable basis.

In determining the Group's geographical segments, revenues are attributed to the segments based on origin and destination of each flight segment. Assets, which consist principally of flight and ground equipment, support the entire worldwide transportation system, are mainly located in the PRC. An analysis of assets and capital expenditure of the Group by geographical distribution has therefore not been included.

Intersegment sales and transfers are transacted with reference to the selling prices used for sales made to third parties at the then prevailing market prices.

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<u>Six-month period ended June 30, 2004</u>	<u>Airline operations</u>	<u>Engineering services</u>	<u>Airport terminal services</u>	<u>Others</u>	<u>Eliminations</u>	<u>Total</u>
	<u>RMB'000</u>	<u>RMB'000</u>	<u>RMB'000</u>	<u>RMB'000</u>	<u>RMB'000</u>	<u>RMB'000</u>
<b>REVENUES</b>						
Sales to external customers . . . . .	14,948,542	128,798	129,527	104,153	—	15,311,020
Intersegment sales . . . . .	—	314,367	—	70,319	(384,686)	—
Total revenues . . . . .	<u>14,948,542</u>	<u>443,165</u>	<u>129,527</u>	<u>174,472</u>	<u>(384,686)</u>	<u>15,311,020</u>
<b>PROFIT FROM OPERATIONS</b>						
Segment results . . . . .	1,664,760	41,585	94,553	25,627	—	1,826,525
Finance costs . . . . .	(779,791)	(7,390)	(860)	(1,330)	—	(789,371)
Share of profits less losses from associates . . . . .	<u>162,804</u>	<u>(7,182)</u>	<u>72,470</u>	<u>(4,400)</u>	—	<u>223,692</u>
Profit before tax . . . . .	1,047,773	27,013	166,163	19,897	—	1,260,846
Tax . . . . .						(391,438)
Minority interests . . . . .						<u>(81,056)</u>
Net profit from operating activities attributable to shareholders . . . . .						<u>788,352</u>
<b>ASSETS</b>						
Segment assets . . . . .	52,743,456	1,001,076	261,016	869,494	(1,056,906)	53,818,136
Interests in associates . . . . .	2,824,064	6,805	141,083	198,469	—	3,170,421
Unallocated assets . . . . .						<u>243,503</u>
Total assets . . . . .						<u>57,232,060</u>
<b>LIABILITIES</b>						
Segment liabilities . . . . .	(46,544,277)	(582,186)	(232,170)	(646,672)	1,056,906	(46,948,399)
Unallocated liabilities . . . . .						<u>(51,005)</u>
Total liabilities . . . . .						<u>(46,999,404)</u>
<b>OTHER INFORMATION</b>						
Capital expenditures — property, plant and equipment	1,293,322	16,180	9,309	23,392	—	1,342,203
Depreciation of property, plant and equipment . . . . .	1,679,158	19,566	9,470	7,202	—	1,715,396
Provision for doubtful debts . . . . .						1,447
Provision against inventories, net . . . . .						11,277
<b>Six-month period ended June 30, 2003 (unaudited)</b>						
	<u>Airline operations</u>	<u>Engineering services</u>	<u>Airport terminal services</u>	<u>Others</u>	<u>Eliminations</u>	<u>Total</u>
	<u>RMB'000</u>	<u>RMB'000</u>	<u>RMB'000</u>	<u>RMB'000</u>	<u>RMB'000</u>	<u>RMB'000</u>
<b>REVENUES</b>						
Sales to external customers . . . . .	8,961,954	82,836	117,254	63,866	—	9,225,910
Intersegment sales . . . . .	—	221,607	—	49,620	(271,227)	—
Total revenues . . . . .	<u>8,961,954</u>	<u>304,443</u>	<u>117,254</u>	<u>113,486</u>	<u>(271,227)</u>	<u>9,225,910</u>
<b>PROFIT/(LOSS) FROM OPERATIONS</b>						
Segment results . . . . .	(939,088)	2,051	89,782	11,599	—	(835,656)
Finance costs . . . . .	(975,222)	(8,921)	(398)	(412)	—	(984,953)
Share of profits less losses from associates . . . . .	<u>(144,496)</u>	<u>(3,610)</u>	<u>36,506</u>	<u>736</u>	—	<u>(110,864)</u>
Profit/(loss) before tax . . . . .	(2,058,806)	(10,480)	125,890	11,923	—	(1,931,473)

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<u>Six-month period ended June 30, 2003 (unaudited)</u>	<u>Airline operations</u> RMB'000	<u>Engineering services</u> RMB'000	<u>Airport terminal services</u> RMB'000	<u>Others</u> RMB'000	<u>Eliminations</u> RMB'000	<u>Total</u> RMB'000
Tax .....						535,263
Minority interests .....						<u>143,688</u>
Net loss from operating activities attributable to shareholders .....						<u>(1,252,522)</u>
<b>OTHER INFORMATION</b>						
Capital expenditures .....						
— property, plant and equipment ....	1,074,499	10,221	9,992	16,216	—	1,110,928
Depreciation of property, plant and equipment .....	1,632,352	19,606	8,158	7,234	—	1,667,350
Provision for doubtful debts .....						9,055
Provision against inventories, net .....						23,910
<u>Year ended December 31, 2003</u>	<u>Airline operations</u> RMB'000	<u>Engineering services</u> RMB'000	<u>Airport terminal services</u> RMB'000	<u>Others</u> RMB'000	<u>Eliminations</u> RMB'000	<u>Total</u> RMB'000
<b>REVENUES</b>						
Sales to external customers .....	23,910,300	285,493	251,266	194,346	—	24,641,405
Intersegment sales .....	—	486,705	—	126,485	(613,190)	—
Total revenues .....	<u>23,910,300</u>	<u>772,198</u>	<u>251,266</u>	<u>320,831</u>	<u>(613,190)</u>	<u>24,641,405</u>
<b>PROFIT FROM OPERATIONS</b>						
Segment results .....	1,995,224	84,743	173,290	31,007	—	2,284,264
Finance costs .....	(2,326,582)	(17,631)	(1,160)	(3,705)	—	(2,349,078)
Share of profits less losses from associates .....	<u>172,016</u>	<u>(18,660)</u>	<u>104,043</u>	<u>(14,306)</u>	—	<u>243,093</u>
Profit/(loss) before tax .....	(159,342)	48,452	276,173	12,996	—	178,279
Tax .....						(89,781)
Minority interests .....						<u>71,106</u>
Net profit from operating activities attributable to shareholders .....						<u>159,604</u>
<b>ASSETS</b>						
Segment assets .....	51,284,337	1,076,308	250,923	746,182	(618,687)	52,739,063
Interests in associates .....	2,747,942	6,984	124,398	188,522	—	3,067,846
Unallocated assets .....						<u>590,153</u>
Total assets .....						<u>56,397,062</u>
<b>LIABILITIES</b>						
Segment liabilities .....	(47,237,228)	(683,204)	(174,326)	(551,813)	618,687	(48,027,884)
Unallocated liabilities .....						<u>(53,929)</u>
Total liabilities .....						<u>(48,081,813)</u>
<b>OTHER INFORMATION</b>						
Capital expenditures						
— property, plant and equipment	3,703,236	20,332	38,986	86,725	—	3,849,279
Depreciation of property, plant and equipment .....	3,309,582	37,119	13,661	17,110	—	3,377,472
Provision for doubtful debts .....						12,144
Provision against inventories, net ...						24,090

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**ACCOUNTANTS' REPORT**

<u>Year ended December 31, 2002</u>	<u>Airline operations</u> RMB'000	<u>Engineering services</u> RMB'000	<u>Airport terminal services</u> RMB'000	<u>Others</u> RMB'000	<u>Eliminations</u> RMB'000	<u>Total</u> RMB'000
<b>REVENUES</b>						
Sales to external customers . . . . .	24,435,795	152,868	180,464	214,550	—	24,983,677
Intersegment sales . . . . .	—	552,037	—	137,436	(689,473)	—
Total revenues . . . . .	<u>24,435,795</u>	<u>704,905</u>	<u>180,464</u>	<u>351,986</u>	<u>(689,473)</u>	<u>24,983,677</u>
<b>PROFIT FROM OPERATIONS</b>						
Segment results . . . . .	3,069,934	87,255	56,312	70,878	—	3,284,379
Finance costs . . . . .	(2,749,010)	(23,410)	(1,235)	(3,432)	—	(2,777,087)
Dilution gain on investment in a subsidiary . . . . .	106,040	—	—	—	—	106,040
Share of profits less losses from associates . . . . .	350,661	(10,865)	129,357	(42,659)	—	426,494
Profit before tax . . . . .	777,625	52,980	184,434	24,787	—	1,039,826
Tax . . . . .						(369,073)
Minority interests . . . . .						(171,143)
Net profit from operating activities attributable to shareholders . . . . .						<u>499,610</u>
<b>ASSETS</b>						
Segment assets . . . . .	52,697,589	1,046,009	144,344	553,001	(573,171)	53,867,772
Interests in associates . . . . .	2,596,644	(981)	108,319	198,858	—	2,902,840
Unallocated assets . . . . .						624,000
Total assets . . . . .						<u>57,394,612</u>
<b>LIABILITIES</b>						
Segment liabilities . . . . .	(50,087,236)	(672,211)	(273,301)	(343,603)	573,171	(50,803,180)
Unallocated liabilities . . . . .						(63,044)
Total liabilities . . . . .						<u>(50,866,224)</u>
<b>OTHER INFORMATION</b>						
Capital expenditures						
— property, plant and equipment	2,387,864	16,119	31,186	27,047	—	2,462,216
Depreciation of property, plant and equipment . . . . .	3,179,195	36,895	20,120	15,361	—	3,251,571
Provision for doubtful debts . . . . .						2,427
Provision against inventories, net . . .						14,742



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<u>Year ended December 31, 2001</u>	<u>Airline operations</u>	<u>Engineering services</u>	<u>Airport terminal services</u>	<u>Others</u>	<u>Eliminations</u>	<u>Total</u>
	<u>RMB'000</u>	<u>RMB'000</u>	<u>RMB'000</u>	<u>RMB'000</u>	<u>RMB'000</u>	<u>RMB'000</u>
<b>REVENUES</b>						
Sales to external customers . . . . .	22,216,516	195,314	162,253	162,369	—	22,736,452
Intersegment sales . . . . .	—	410,014	—	122,298	(532,312)	—
Total revenues . . . . .	<u>22,216,516</u>	<u>605,328</u>	<u>162,253</u>	<u>284,667</u>	<u>(532,312)</u>	<u>22,736,452</u>
<b>PROFIT FROM OPERATIONS</b>						
Segment results . . . . .	3,101,049	93,683	52,470	38,903	—	3,286,105
Finance costs . . . . .	(2,006,954)	(26,378)	(1,260)	5,380	—	(2,029,212)
Share of profits less losses from associates . . . . .	235,507	(10,034)	132,785	(5,429)	—	352,829
Profit before tax . . . . .	1,329,602	57,271	183,995	38,854	—	1,609,722
Tax . . . . .						(552,660)
Minority interests . . . . .						(108,774)
Net profit from operating activities attributable to shareholders . . . . .						<u>948,288</u>
<b>ASSETS</b>						
Segment assets . . . . .	53,130,054	1,050,762	140,621	437,802	(241,087)	54,518,152
Interests in associates . . . . .	2,461,896	60,507	117,451	227,352	—	2,867,206
Unallocated assets . . . . .						868,000
Total assets . . . . .						<u>58,253,358</u>
<b>LIABILITIES</b>						
Segment liabilities . . . . .	(51,741,789)	(686,994)	(165,348)	(271,813)	241,087	(52,624,857)
Unallocated liabilities . . . . .						(60,689)
Total liabilities . . . . .						<u>(52,685,546)</u>
<b>OTHER INFORMATION</b>						
Capital expenditures						
— property, plant and equipment	2,680,199	8,752	16,388	7,605	—	2,712,944
Depreciation of property, plant and equipment . . . . .	3,165,849	43,064	18,055	15,650	—	3,242,618
Provision for doubtful debts . . . . .						5,122
Provision against inventories, net . . . . .						56,722

The following tables set forth additional information relating to the Group's airline operations for the years ended December 31, 2001, 2002, 2003 and for the six-month periods ended June 30, 2003 and June 30, 2004:

<u>Six-month period ended June 30, 2004</u>	<u>Airline operations</u>		<u>Total</u>
	<u>Air China</u>	<u>Air Macau</u>	
	<u>RMB'000</u>	<u>RMB'000</u>	<u>RMB'000</u>
<b>REVENUES</b>			
Sales to external customers . . . . .	14,077,071	871,471	14,948,542
Intersegment sales . . . . .	—	—	—
Total revenues . . . . .	<u>14,077,071</u>	<u>871,471</u>	<u>14,948,542</u>
<b>PROFIT FROM OPERATIONS</b>			
Segment results . . . . .	<u>1,662,158</u>	<u>2,602</u>	<u>1,664,760</u>

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<u>Six-month period ended June 30, 2003 (unaudited)</u>	<u>Airline operations</u>		<u>Total</u> RMB'000
	<u>Air China</u>	<u>Air Macau</u>	
	<u>RMB'000</u>	<u>RMB'000</u>	
<b>REVENUES</b>			
Sales to external customers .....	8,384,815	577,139	8,961,954
Intersegment sales .....	—	—	—
Total revenues .....	<u>8,384,815</u>	<u>577,139</u>	<u>8,961,954</u>
<b>LOSS FROM OPERATIONS</b>			
Segment results .....	<u>(750,913)</u>	<u>(188,175)</u>	<u>(939,088)</u>
<u>Year ended December 31, 2003</u>	<u>Airline operations</u>		<u>Total</u> RMB'000
	<u>Air China</u>	<u>Air Macau</u>	
	<u>RMB'000</u>	<u>RMB'000</u>	
<b>REVENUES</b>			
Sales to external customers .....	22,478,217	1,432,083	23,910,300
Intersegment sales .....	—	—	—
Total revenues .....	<u>22,478,217</u>	<u>1,432,083</u>	<u>23,910,300</u>
<b>PROFIT/(LOSS) FROM OPERATIONS</b>			
Segment results .....	<u>2,207,119</u>	<u>(211,895)</u>	<u>1,995,224</u>
<u>Year ended December 31, 2002</u>	<u>Airline operations</u>		<u>Total</u> RMB'000
	<u>Air China</u>	<u>Air Macau</u>	
	<u>RMB'000</u>	<u>RMB'000</u>	
<b>REVENUES</b>			
Sales to external customers .....	22,563,784	1,872,011	24,435,795
Intersegment sales .....	—	—	—
Total revenues .....	<u>22,563,784</u>	<u>1,872,011</u>	<u>24,435,795</u>
<b>PROFIT FROM OPERATIONS</b>			
Segment results .....	<u>3,003,491</u>	<u>66,443</u>	<u>3,069,934</u>
<u>Year ended December 31, 2001</u>	<u>Airline operations</u>		<u>Total</u> RMB'000
	<u>Air China</u>	<u>Air Macau</u>	
	<u>RMB'000</u>	<u>RMB'000</u>	
<b>REVENUES</b>			
Sales to external customers .....	20,448,936	1,767,580	22,216,516
Intersegment sales .....	—	—	—
Total revenues .....	<u>20,448,936</u>	<u>1,767,580</u>	<u>22,216,516</u>
<b>PROFIT FROM OPERATIONS</b>			
Segment results .....	<u>3,025,585</u>	<u>75,464</u>	<u>3,101,049</u>

**Geographical segments**

The following tables present revenues information by geographical segments for the years ended December 31, 2001, 2002 and 2003 and for the six-month periods ended June 30, 2003 and June 30, 2004:

<u>Six-month period ended June 30, 2004</u>	<u>Domestic</u>	<u>HK/ Macau</u>	<u>Europe</u>	<u>North America</u>	<u>Japan/ Korea</u>	<u>Asia Pacific, others</u>	<u>Total</u>
	<u>RMB'000</u>	<u>RMB'000</u>	<u>RMB'000</u>	<u>RMB'000</u>	<u>RMB'000</u>	<u>RMB'000</u>	<u>RMB'000</u>
<b>REVENUES</b>							
Sales to external customers . .	7,864,516	893,250	2,032,439	1,504,764	1,566,052	1,449,999	15,311,020
Intersegment sales . . . . .	—	—	—	—	—	—	—
Total revenues . . . . .	<u>7,864,516</u>	<u>893,250</u>	<u>2,032,439</u>	<u>1,504,764</u>	<u>1,566,052</u>	<u>1,449,999</u>	<u>15,311,020</u>
<b>Six-month period ended June 30, 2003 (Unaudited)</b>							
	<u>Domestic</u>	<u>HK/ Macau</u>	<u>Europe</u>	<u>North America</u>	<u>Japan/ Korea</u>	<u>Asia Pacific, others</u>	<u>Total</u>
	<u>RMB'000</u>	<u>RMB'000</u>	<u>RMB'000</u>	<u>RMB'000</u>	<u>RMB'000</u>	<u>RMB'000</u>	<u>RMB'000</u>
<b>REVENUES</b>							
Sales to external customers . .	4,813,583	614,898	1,249,463	882,831	908,421	756,714	9,225,910
Intersegment sales . . . . .	—	—	—	—	—	—	—
Total revenues . . . . .	<u>4,813,583</u>	<u>614,898</u>	<u>1,249,463</u>	<u>882,831</u>	<u>908,421</u>	<u>756,714</u>	<u>9,225,910</u>
<b>Year ended December 31, 2003</b>							
	<u>Domestic</u>	<u>HK/ Macau</u>	<u>Europe</u>	<u>North America</u>	<u>Japan/ Korea</u>	<u>Asia Pacific, others</u>	<u>Total</u>
	<u>RMB'000</u>	<u>RMB'000</u>	<u>RMB'000</u>	<u>RMB'000</u>	<u>RMB'000</u>	<u>RMB'000</u>	<u>RMB'000</u>
<b>REVENUES</b>							
Sales to external customers . .	12,926,434	1,572,902	3,547,743	2,336,207	2,287,004	1,971,115	24,641,405
Intersegment sales . . . . .	—	—	—	—	—	—	—
Total revenues . . . . .	<u>12,926,434</u>	<u>1,572,902</u>	<u>3,547,743</u>	<u>2,336,207</u>	<u>2,287,004</u>	<u>1,971,115</u>	<u>24,641,405</u>
<b>Year ended December 31, 2002</b>							
	<u>Domestic</u>	<u>HK/ Macau</u>	<u>Europe</u>	<u>North America</u>	<u>Japan/ Korea</u>	<u>Asia Pacific, others</u>	<u>Total</u>
	<u>RMB'000</u>	<u>RMB'000</u>	<u>RMB'000</u>	<u>RMB'000</u>	<u>RMB'000</u>	<u>RMB'000</u>	<u>RMB'000</u>
<b>REVENUES</b>							
Sales to external customers . .	11,867,153	2,017,989	3,486,348	2,254,448	3,081,052	2,276,687	24,983,677
Intersegment sales . . . . .	—	—	—	—	—	—	—
Total revenues . . . . .	<u>11,867,153</u>	<u>2,017,989</u>	<u>3,486,348</u>	<u>2,254,448</u>	<u>3,081,052</u>	<u>2,276,687</u>	<u>24,983,677</u>
<b>Year ended December 31, 2001</b>							
	<u>Domestic</u>	<u>HK/ Macau</u>	<u>Europe</u>	<u>North America</u>	<u>Japan/ Korea</u>	<u>Asia Pacific, others</u>	<u>Total</u>
	<u>RMB'000</u>	<u>RMB'000</u>	<u>RMB'000</u>	<u>RMB'000</u>	<u>RMB'000</u>	<u>RMB'000</u>	<u>RMB'000</u>
<b>REVENUES</b>							
Sales to external customers . .	11,609,440	1,991,941	2,511,333	1,491,146	3,020,252	2,112,340	22,736,452
Intersegment sales . . . . .	—	—	—	—	—	—	—
Total revenues . . . . .	<u>11,609,440</u>	<u>1,991,941</u>	<u>2,511,333</u>	<u>1,491,146</u>	<u>3,020,252</u>	<u>2,112,340</u>	<u>22,736,452</u>

**9. DIRECTORS' AND SUPERVISORS' REMUNERATION**

Save as disclosed in Section 4(g), no remuneration has been paid or is payable in respect of any of the Relevant Periods referred to in this report by the Company or any of the companies now comprising the Group, to the directors and supervisors of the Company. Under the arrangements

currently in force, the estimated amount of directors' and supervisors' fees and other emoluments payable to the directors and supervisors of the Company for the year ending December 31, 2004 will be approximately RMB4.7 million, excluding discretionary bonuses payable under directors' and supervisors' service contracts.

#### **10. ULTIMATE HOLDING COMPANY**

The directors consider CNAHC, a company established in the PRC, as the ultimate holding company of the Company.

#### **11. SUBSEQUENT EVENTS**

- (a) The companies now comprising the Group underwent a Restructuring in preparation for the listing of the Company's H Shares on the Hong Kong Stock Exchange and the Official List of the UK Listing Authority. Further details of which are set out in Section 1 of this report.
- (b) On September 9, 2004, CNAHC made a cash contribution of approximately RMB561 million to the Group which forms part of the Company's paid-up capital as disclosed in (d) below.
- (c) Upon incorporation of the Company, CNAHC effected the transfer of certain land use rights in an aggregate amount of approximately RMB886 million to the Company which forms part of the Company's paid-up capital as disclosed in (d) below.
- (d) As described in Section 1 above, the Company was established in the PRC on September 30, 2004 with a paid-up capital of RMB6,500 million.
- (e) In connection with the Restructuring, the Company and CNAHC entered into a number of agreements regarding related party transactions subsequent to June 30, 2004, further details of which are set out in the section headed "Connected Transactions" in the Prospectus.
- (f) On September 30, 2004, the Company entered into an agreement with CNAHC whereby CNAHC agreed to assume the obligation to settle an aggregate amount of approximately RMB757 million of which was recorded by the Group as government grant receivable as at the end of each of the Relevant Periods (June 30, 2004: RMB866 million). This amount is unsecured, interest-free and repayable over eight years commencing from December 31, 2004 by 16 semi-annual instalments to be made by June 30 and December 31 each year. Pursuant to the relevant agreement, the first instalment amount of RMB25 million will be settled by December 31, 2004 and the final instalment amount of approximately RMB32 million will be settled by June 30, 2012, with the remaining 14 semi-annual instalment amounts of RMB50 million each to be settled by June 30 and December 31 each year between 2005 and December 31, 2011.
- (g) On February 28, 2004, CNAHC entered into a stock purchase agreement with Shandong Economic Development Investment Company (the "Shandong Aviation Agreement") to acquire a 42% equity interest in Shandong Aviation Group Corporation ("Shandong Aviation") for a consideration of approximately RMB290 million. Pursuant to the Shandong Aviation Agreement, CNAHC is required to make a further capital injection of approximately RMB105 million into Shandong Aviation, such that, upon completion

of the aforesaid acquisition, CNAHC would hold a 48% equity interest in Shandong Aviation.

In addition to the above, on February 28, 2004, CNAHC entered into a stock purchase agreement with Shandong Aviation (the "Shandong Airlines Agreement") to acquire 22.8% equity interest in Shandong Airlines Co., Ltd. ("Shandong Airlines") from Shandong Aviation for a consideration of approximately RMB166 million.

Pursuant to the Restructuring Agreement entered into with CNAHC, CNACG and the Company, CNAHC would transfer to the Company all of its rights and liabilities under Shandong Aviation Agreement and Shandong Airlines Agreement and the Company would assume all of CNAHC's equity interest in Shandong Aviation and Shandong Airlines. On October 8, 2004, CNAHC transferred all of its rights and liabilities under the aforesaid acquisition agreements. As at the date of this report, all the pre-completion undertakings of Shandong Aviation Agreement and Shandong Airlines Agreement have not been fully fulfilled and, therefore, these acquisition agreements have not been completed as at the date of this report. Upon completion of the aforesaid acquisition agreements, Shandong Aviation and Shandong Airlines will be accounted for as associates of the Company and their financial statements will be equity accounted for in the Group's combined financial statements. Estimated goodwill arising on the above acquisitions is approximately RMB183 million (unaudited).

- (h) On April 21, 2004, Fly Top Limited, a wholly-owned subsidiary of CNAC, entered into the following acquisition agreements which were supplemented on April 26, 2004:
- (i) a share purchase agreement with Air China International Corporation in relation to the acquisition of 60% of the equity interest in BACL ("BACL Agreement") for a consideration of RMB294 million; and
  - (ii) a share purchase agreement with Air China International Corporation in relation to the acquisition of 60% of the equity interest in SWACL ("SWACL Agreement") for a consideration of RMB67 million.

On November 12, 2004, all the pre-completion undertakings of BACL Agreement and SWACL Agreement were completed and these two acquisition agreements were effective on that date accordingly.

On April 20, 2004, Air China International Corporation entered into a stock transfer agreement with Hongkong Southwest Air Catering Limited ("HKSACL Agreement"), the minority shareholder of SWACL, pursuant to which, Air China International Corporation disposed of 15% of the equity interest in SWACL to Hongkong Southwest Air Catering Limited for a consideration of approximately RMB17 million. On November 12, 2004, all the pre-completion undertakings of HKSACL Agreement were completed and this agreement was effective on that date accordingly.

Immediately after the completion of BACL Agreement, SWACL Agreement and HKSACL Agreement, the Group's effective shareholding interests in BACL and SWACL reduced from 60% and 75% to approximately 41% and 41%, respectively.

- (i) On August 19, 2004, Fly Top Limited entered into the following acquisition agreements:
- (i) a sale and purchase agreement with CNACG in relation to the acquisition of approximately 16% of the issued share capital of LSG Lufthansa Service Hong Kong Limited (“LLSHK”), a company incorporated in Hong Kong with limited liability (“CNACG Agreement”) for a consideration of HK\$89 million (equivalent to approximately RMB94.3 million); and
  - (ii) a sale and purchase agreement with Hong Kong International Air Catering Limited (“HKIAC”), a company incorporated in Hong Kong with limited liability and in which Air China International Corporation has a 25% equity interest, in relation to the acquisition of approximately 4.2% of the issued share capital of LLSHK (“HKIAC Agreement”) for a consideration of HK\$24.5 million (equivalent to approximately RMB26 million).

As at the date of this report, all the pre-completion undertakings of CNACG Agreement and HKIAC Agreement have not been fully fulfilled and, therefore, these two acquisition agreements have not been completed as at the date of this report.

Immediately after the completion of the CNACG Agreement and HKIAC Agreement, the Group's effective shareholding interests in LLSHK is approximately 14%.

- (j) As a result of the completion of BAACL Agreement, SWACL Agreement and HKSACL Agreement, the Group will make a payment of approximately RMB378 million to CNAHC, details of which are set out in Section 4(j).
- (k) In accordance with the (財政部關於印發《企業公司制改建有關國有資本管理與財務處理的暫行規定》的通知) “Provisional Regulation Relating to Corporate Reorganisation of Enterprises and Related Management of State-owned Capital and Financial Treatment” notice issued by the Ministry of Finance and pursuant to the Restructuring, after the Company's incorporation, the Group is required to make a distribution to CNAHC and CNACG, details of which are set out in Section 4(j).
- (l) Subsequent to June 30, 2004 and up to the date of this report, distribution totalling approximately RMB15 million was declared by a subsidiary of the Company.
- (m) On July 25, 2004, the PRC government narrowed the shortfall guarantee for third-party war liability, from the range of US\$50 million to US\$1.25 billion, to the range of US\$150 million to US\$1.25 billion. The additional cost incurred as a result of such change in government policy will be approximately US\$783,000 (equivalent to approximately RMB6.5 million) for the remaining year 2004.
- (n) Certain counter-guarantees provided by CNAHC against certain of the Group's finance lease obligations, bank loans and operating lease arrangements in an aggregate amount of RMB7,609 million as at June 30, 2004 were released subsequently.
- (o) Save as aforesaid, no other significant events took place subsequent to June 30, 2004.

**12. SUBSEQUENT FINANCIAL STATEMENTS**

No audited accounts have been prepared for the Company or any of the companies comprising the Group in respect of any period subsequent to June 30, 2004 and save as disclosed in this report, no dividend or other distribution has been declared, made or paid in respect of any period subsequent to June 30, 2004.

Yours faithfully,

**Ernst & Young**  
*Certified Public Accountants*  
Hong Kong