

Notes to the Financial Statements

For the year ended 31 December 2004

1. GROUP RESTRUCTURING AND BASIS OF PRESENTATION OF FINANCIAL STATEMENTS

The Company was incorporated and registered as an exempted company with limited liability in the Cayman Islands under the Companies Law (2001 Second Revision) Chapter 22 of the Cayman Islands on 14 August 2002 and its shares have been listed on the Mainboard of the Stock Exchange of Hong Kong Limited (the “Stock Exchange”) with effect from 2 December 2004.

Under a group reorganisation scheme to rationalise the structure of the Group in preparation for the listing of the Company’s shares on the Stock Exchange, the Company became the holding company of the Group on 10 November 2004. Details of the group reorganisation were set out in the prospectus issued by the Company, dated 23 November 2004.

The principal steps of the group reorganisation were as follows:

- (1) Shineway Pharmaceutical Co., Ltd. (“Shineway Pharmaceutical”) was established for the purpose of taking over the business of manufacture and trading of Chinese pharmaceutical products and the relevant assets and liabilities from 神威醫藥科技股份有限公司 Shineway Medical Science & Technology Co., Ltd. (“Shineway Medical”) (formerly known as 石家莊神威藥業股份有限公司 Shijiazhuang Shineway Pharmaceutical Co., Ltd.) (“Shineway Pharmaceutical Business”) and Hebei Shineway Pharmaceutical Co., Ltd. (“Hebei Shineway”) was established for the purpose of taking over the business of manufacture and trading of Chinese pharmaceutical products and the relevant assets and liabilities from 神威醫藥科技（廊坊）有限公司 Shineway Medical Science & Technology (Lang Fang) Co., Ltd. (“Shineway Lang Fang”) (formerly known as 神威藥業（燕郊）有限公司 Shineway Pharmaceutical (Yanjiao) Co., Ltd.) (“Yanjiao Pharmaceutical Business”) (hereinafter collectively referred to as the “Relevant Pharmaceutical Business”). Pursuant to the approval from Hebei Municipal Government, Shineway Pharmaceutical and Hebei Shineway took over the Shineway Pharmaceutical Business and Yanjiao Pharmaceutical Business at the consideration of RMB44,540,200 and RMB27,931,200 respectively with effect from 31 March 2004 (“Transfer of Relevant Pharmaceutical Business”).
- (2) On 31 March 2004, the bank balances and cash of RMB195,596,000 and RMB33,501,000 of Shineway Pharmaceutical Business and Yanjiao Pharmaceutical Business were retained by Shineway Medical and Shineway Lang Fang respectively, together with the settlements of current accounts with Shineway Medical and Shineway Lang Fang of RMB119,168,000 (including tax liabilities of RMB29,255,000) and RMB5,207,000 (including tax liabilities of RMB15,219,000) and net assets of RMB24,698,000 and RMB20,157,000 acquired from Shineway Medical and Shineway Lang Fang respectively, by way of a deemed distribution.
- (3) Share transactions taken place between the Company, Yuan Da International Limited, (“Yuan Da”), the immediate holding company of Shineway Pharmaceutical, Hong Zhan International Limited (“Hong Zhan”), the immediate holding company of Hebei Shineway and Sinovest International Investment Limited (“Sinovest”).

Notes to the Financial Statements

For the year ended 31 December 2004

1. GROUP RESTRUCTURING AND BASIS OF PRESENTATION OF FINANCIAL STATEMENTS *(Continued)*

The Group resulting from the above mentioned group reorganisation is regarded as a continuing entity. Accordingly, the financial statements of the Group have been prepared using the principles of merger accounting.

The Group's books and records are maintained in Renminbi the currency in which the majority of the Group's transactions are denominated.

2. SIGNIFICANT ACCOUNTING POLICIES

The financial statements have been prepared under the historical cost convention and have been prepared in accordance with the International Financial Reporting Standards ("IFRS"). The principal accounting policies adopted are as follows:

Basis of consolidation

The consolidated financial statements incorporate the financial statements of the Company and its subsidiaries made up to 31 December each year.

The results of subsidiaries acquired or disposed of during the year are included in the consolidated income statement from the effective date of acquisition or up to the effective date of disposal, as appropriate.

Revenue recognition

Sales of goods are recognised when goods are delivered and title has been passed.

Rental income, including rental invoiced in advance from properties under operating leases, is recognised on a straight line basis over the lease terms.

Interest income is accrued on a time basis by reference to the principal outstanding and at the interest rate applicable.

Notes to the Financial Statements

For the year ended 31 December 2004

2. SIGNIFICANT ACCOUNTING POLICIES (Continued)

Property, plant and equipment

Property, plant and equipment, other than construction in progress, are stated at cost less depreciation and amortisation and any accumulated impairment losses.

Construction in progress is stated at cost less any accumulated impairment losses. Cost includes all construction costs and other direct costs attributable to such projects. It is not depreciated until completion of construction. Costs of completed construction works are transferred to the appropriate category of property, plant and equipment.

Depreciation and amortisation is provided to write off the cost of other property, plant and equipment over their estimated useful lives after taking into account their estimated residual value, if any, using the straight line method, at the following rates per annum:

| | |
|---------------------|--------------------------------|
| Leasehold land | Over the unexpired lease terms |
| Buildings | 5% |
| Plant and machinery | 10% - 33% |
| Office equipment | 20% |
| Motor vehicles | 33% |

The gain or loss arising on the disposal or retirement of an asset is determined as the difference between the sale proceeds and the carrying amount of the asset and is recognised in the income statement.

Research and development expenditure

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

An internally-generated intangible asset is recognised only if all of the following conditions are met:

- an asset is created that can be identified;
- it is probable that the asset created will generate future economic benefits; and
- the development cost of the asset can be measured reliably.

When no internally-generated intangible asset can be recognised, development expenditure is recognised as an expense in the period in which it is incurred.

Notes to the Financial Statements

For the year ended 31 December 2004

2. SIGNIFICANT ACCOUNTING POLICIES *(Continued)*

Impairment

At each balance sheet date, the Group reviews the carrying amounts of its tangible and intangible assets to determine whether there is any indication that those assets have suffered an impairment loss. If any such indication exists, the recoverable amount of the asset is estimated in order to determine the extent of the impairment loss (if any). Where it is not possible to estimate the recoverable amount of an individual asset, the Group estimates the recoverable amount of the cash-generating unit to which the asset belongs.

Recoverable amount 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.

If the recoverable amount of an asset (or cash-generating unit) is estimated to be less than its carrying amount, the carrying amount of the asset (cash-generating unit) is reduced to its recoverable amount. An impairment loss is recognised as an expense immediately, unless the relevant asset is carried at a revalued amount, in which case the impairment loss is treated as a revaluation decrease.

Where an impairment loss subsequently reverses, the carrying amount of the asset (cash-generating unit) is increased to the revised estimate of its recoverable amount, but so that the increased carrying amount does not exceed the carrying amount that would have been determined had no impairment loss been recognised for the asset (cash-generating unit) in prior years. A reversal of an impairment loss is recognised as income immediately, unless the relevant asset is carried at a revalued amount, in which case the reversal of the impairment loss is treated as a revaluation increase.

Inventories

Inventories are stated at the lower of cost and net realisable value. Cost is calculated using the weighted average method.

Financial instruments

Financial assets and financial liabilities are recognised on the balance sheet when the Group becomes a party to the contractual provision of the instrument.

Trade and other receivables and amounts due from related companies

Receivables are stated at their nominal value as reduced by appropriate allowances for estimated irrecoverable amounts.

Trade and other payables and amounts due to related companies

Payables are stated at their nominal value.

Notes to the Financial Statements

For the year ended 31 December 2004

2. SIGNIFICANT ACCOUNTING POLICIES *(Continued)*

Equity instruments

Equity instruments issued by the Company are recorded at the proceeds received, net of direct issue cost.

Taxation

Income tax expense represents the sum of the tax currently payable and deferred tax.

The tax currently payable is based on taxable profit for the year. Taxable profit differs from net profit as reported in the income statement because it excludes items of income and expense that are taxable or deductible in other years, and it further excludes income statement items that are never taxable and deductible. The Group's liability for current tax is calculated using tax rates that have been enacted or substantively enacted by the balance sheet date.

Deferred tax is the tax expected to be payable or recoverable on differences between the carrying amounts of assets and liabilities in the financial statements and the corresponding tax bases used in the computation of taxable profit, and is accounted for using the balance sheet liability method. Deferred tax liabilities are generally recognised for all taxable temporary differences, and deferred tax assets are recognised to the extent that it is probable that taxable profits will be available against which deductible temporary differences can be utilised. Such assets and liabilities are not recognised if the temporary difference arises from the initial recognition (other than in a business combination) of other assets and liabilities in a transaction that affects neither the tax profit nor the accounting profit.

Deferred tax liabilities are recognised for taxable temporary differences arising on investments in subsidiaries, except where the Group is able to control the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future.

The carrying amount of deferred tax assets is reviewed at each balance sheet date and reduced to the extent that it is no longer probable that sufficient taxable profits will be available to allow all or part of the asset to be recovered.

Deferred tax is calculated at the tax rates that are expected to apply in the period when the liability is settled or the asset is realised. Deferred tax is charged or credited to the income statement, except when it relates to items charged or credited directly to equity, in which case the deferred tax is also dealt with in equity.

Deferred tax assets and liabilities are offset when they related to income taxes levied by the same taxation authority and the Group intends to settle its current tax assets and liabilities on a net basis.

Notes to the Financial Statements

For the year ended 31 December 2004

2. SIGNIFICANT ACCOUNTING POLICIES *(Continued)*

Foreign currencies

Transactions in foreign currencies other than Renminbi are translated at the rates ruling on the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies other than Renminbi are re-translated at the rates ruling on the balance sheet date. Gains and losses arising on exchange are dealt with in the income statement.

On consolidation, the assets and liabilities of the Group's overseas operation which are denominated in currencies other than Renminbi are translated at the rates ruling on the balance sheet date. Income and expense items are translated at the average exchange rates for the year. Exchange differences arising, if any, are classified as reserve. Such translation differences are recognised as income or as expenses in the period in which the subsidiary is disposed of.

Operating leases

Rentals payable under operating leases are charged to the income statement on a straight line basis over the period of the leases.

Pension cost

The pension cost, which represents the amount payable in accordance with the regulations promulgated by the local Municipal Government, is charged to the income statement as incurred.

Retirement plan

The employees of the Group participate in retirement and medicare insurances in accordance with the People's Republic of China (the "PRC") laws and related regulations. When an employee joins the Group, he is enrolled with the local retirement plan. Contributions to the retirement insurance, borne by the Group and the employee jointly at the proportions stipulated by the local Municipal Government, are paid to the social insurance institutions monthly. The cost of the plan is borne by the Group and the employee jointly with the benefits vested in the employee. When the employee retires, he receives his retirement funds from the insurance company directly and is also entitled to enjoy medical benefits after retirement provided by the insurance company. Other than this, the Group has no obligation for any related retirement benefits.

3. TURNOVER AND SEGMENT INFORMATION

Turnover represents the net amount received and receivable for Chinese pharmaceutical products sold to customers.

The Group's operation is regarded as a single segment, being an enterprise engaged in research and development, manufacture and trading of Chinese pharmaceutical products. Over 90% of the Group's sales are made in the PRC and over 90% of the Group's assets are situated in the PRC during the year. Accordingly, no segmental analysis of business and geographical segments is presented for the year.

Notes to the Financial Statements

For the year ended 31 December 2004

4. PROFIT BEFORE TAXATION

| | 2004 | 2003 |
|--|-------------------|-------------------|
| | RMB'000 | RMB'000 |
| Profit before taxation has been arrived at after charging: | | |
| Auditors' remuneration | 1,272 | 306 |
| Allowance for bad and doubtful debts | 27 | 59 |
| Depreciation and amortisation of property, plant and equipment | 22,284 | 21,956 |
| Staff costs (including directors' remuneration (see note 5)) | 37,541 | 23,496 |
| Pension costs | 2,465 | 471 |
| | <u>40,006</u> | <u>23,967</u> |
| Loss on disposal of property, plant and equipment | 494 | 400 |
| Minimum lease payments under operating lease in respect of land and buildings | 282 | 3,028 |
| Research and development costs | 8,367 | 3,407 |
| and after crediting: | | |
| Interest income | 790 | 177 |
| Rental income | — | 178 |
| | <u> </u> | <u> </u> |

Notes to the Financial Statements

For the year ended 31 December 2004

5. DIRECTORS', SUPERVISORS' AND EMPLOYEES' REMUNERATION

Directors' remuneration:

Year ended 31 December 2004

| | Fees | Salaries, allowance and other benefits | Pension costs | Performance related incentive payments | Total emoluments |
|--|------------|---|------------------|---|---------------------|
| | RMB'000 | RMB'000 | RMB'000 | RMB'000 | RMB'000 |
| Name of directors | | | | | |
| Li Zhengjiang | 12 | 478 | 56 | 146 | 692 |
| Wang Zhihua | 12 | 180 | 25 | 73 | 290 |
| Xin Yunxia | 12 | 205 | 26 | 80 | 323 |
| Hou Jiangtao | 12 | 100 | 17 | 47 | 176 |
| Li Huimin | 12 | 145 | 22 | 65 | 244 |
| Name of independent non-executive directors | | | | | |
| Li Kung Man | 30 | — | — | — | 30 |
| Wang Jianping | 20 | — | — | — | 20 |
| Zhou Chaofan | 30 | — | — | — | 30 |
| | <u>140</u> | <u>1,108</u> | <u>146</u> | <u>411</u> | <u>1,805</u> |

Year ended 31 December 2003

| | Fees | Salaries, allowance and other benefits | Pension costs | Performance related incentive payments | Total emoluments |
|--|----------|---|------------------|---|---------------------|
| | RMB'000 | RMB'000 | RMB'000 | RMB'000 | RMB'000 |
| Name of directors | | | | | |
| Li Zhengjiang | — | 257 | 21 | 46 | 324 |
| Wang Zhihua | — | 105 | 10 | 32 | 147 |
| Xin Yunxia | — | 105 | 10 | 32 | 147 |
| Hou Jiangtao | — | — | — | — | — |
| Li Huimin | — | 59 | 5 | 25 | 89 |
| Name of independent non-executive directors | | | | | |
| Li Kung Man | — | — | — | — | — |
| Wang Jianping | — | — | — | — | — |
| Zhou Chaofan | — | — | — | — | — |
| | <u>—</u> | <u>526</u> | <u>46</u> | <u>135</u> | <u>707</u> |

During the year, the emoluments of each of the directors were less than HK\$1,000,000 (equivalent to RMB1,060,000).

Notes to the Financial Statements

For the year ended 31 December 2004

5. DIRECTORS', SUPERVISORS' AND EMPLOYEES' REMUNERATION (Continued)

Employees' remuneration:

The five highest paid individuals of the Company included 4 directors for the year (2003: 4), details of whose remuneration are set out above. The remuneration of the remaining 1 employee for the year (2003: 1) is as follows:

| | 2004 | 2003 |
|---|------------|------------|
| | RMB'000 | RMB'000 |
| Salaries, allowances and other benefits | 398 | 104 |
| Pension costs | — | 10 |
| Performance related incentive payments | — | 32 |
| | <u>398</u> | <u>146</u> |

During the year, no remuneration was paid by the Group to the directors, supervisors or the five highest paid individuals as an inducement to join or upon joining the Group or as compensation for loss of office. None of the directors and supervisors has waived any remuneration during the year.

6. INCOME TAX

| | 2004 | 2003 |
|---------------------------|-----------------|--------------|
| | RMB'000 | RMB'000 |
| Current tax: | | |
| PRC Enterprise Income Tax | (13,225) | 11,265 |
| Deferred tax (note 13) | 2,566 | (3,957) |
| | <u>(10,659)</u> | <u>7,308</u> |

The provision for PRC Enterprise Income Tax is based on the estimated taxable income for PRC taxation purposes at the rate of taxation applicable for the year.

Notes to the Financial Statements

For the year ended 31 December 2004

6. INCOME TAX (Continued)

The reconciliation of the effective tax rate for the year is as follows:

| | 2004 | | 2003 | |
|--|-----------------|--------------|----------------|------------|
| | RMB'000 | % | RMB'000 | % |
| Profit before taxation | <u>280,809</u> | | <u>185,082</u> | |
| Tax at the applicable tax rate of 33% | (92,667) | (33.0) | (61,077) | (33.0) |
| Tax effect of expenses that are not deductible in determining taxable profit | (11,975) | (4.3) | (3,085) | (1.7) |
| Tax effect of income that are not taxable in determining taxable profit | 422 | 0.2 | — | — |
| Tax loss not recognised | (2,992) | (1.1) | (6,123) | (3.3) |
| Tax effect on tax holiday | 85,469 | 30.5 | 62,086 | 33.5 |
| Tax effect of utilisation of tax losses not previously recognised | 6,123 | 2.2 | — | — |
| Effect of different tax rate of a subsidiary | 6,225 | 2.2 | — | — |
| Reduction of income tax in respect of Tax Benefit | — | 0.0 | 17,374 | 9.4 |
| Others | (1,264) | (0.5) | (1,867) | (1.0) |
| Taxation and effective tax rate for the year | <u>(10,659)</u> | <u>(3.8)</u> | <u>7,308</u> | <u>3.9</u> |

Prior to the transfer of the Relevant Pharmaceutical Business to Shineway Pharmaceutical and Hebei Shineway, it was part of Shineway Medical and Shineway Lang Fang whose tax returns to the tax authority included the results of the Relevant Pharmaceutical Business. The PRC Enterprise Income Tax rate applicable to Shineway Medical and Shineway Lang Fang is 33% on their assessable profits.

Pursuant to the relevant law and regulations in the PRC, Shineway Pharmaceutical and Hebei Shineway are entitled to exemption from PRC Enterprise Income Tax for two years commencing from their first profit-making year of operation and thereafter, they are entitled to a 50% relief from PRC Enterprise Income Tax for the following three years. The first profit-making period of Shineway Pharmaceutical and Hebei Shineway commenced on 1 January 2004.

Notes to the Financial Statements

For the year ended 31 December 2004

6. INCOME TAX (Continued)

In addition, pursuant to 琼海國稅發2004 151號, Shineway Pharmaceutical Sales Co., Ltd. (“Shineway Sales”) was exempted from the PRC Enterprise Income Tax for the year ended 31 December 2003. Pursuant to 國發1988 26號, the PRC Enterprise Income Tax rate applicable to Shineway Sales is 15% on its assessable profit.

Pursuant to Cai Shui Zi (1999) No. 290 issued by the Ministry of Finance and the State Tax Bureau, the Group was entitled to a tax benefit (“Tax Benefit”), which was calculated as 40% of the current year’s additions of PRC manufactured plant and equipment for technological improvements. The Tax Benefit was, however, limited to the amount of increase in enterprise income tax for the year in which the plant and equipment were acquired as compared with the tax amount of the preceding year. The portion of the Tax Benefit that was not utilised can be carried forward for future application for a period of not more than five years from the year in which the plant and machinery are acquired.

7. DIVIDEND

The directors do not recommend the payment of any dividend for the year ended 31 December 2004.

During the year ended 31 December 2003, Shineway Sales had paid the following amount of dividend to the then shareholders prior to the group reorganisation:

| | 2004 | 2003 |
|---|---------|-----------|
| | RMB'000 | RMB'000 |
| Final dividends declared by Shineway Sales | — | (160,220) |
| Less: Elimination of intra-group dividends | — | 128,176 |
| Dividends received by minority shareholders | — | 32,044 |
| | — | — |
| | — | — |

The rate of dividends and the number of shares ranking for dividends are not presented as such information is not meaningful in the context of the financial statements.

Notes to the Financial Statements

For the year ended 31 December 2004

8. DISTRIBUTION

Pursuant to part of the group reorganisation which took effect from 31 March 2004, Shineway Pharmaceutical and Hebei Shineway took over the Shineway Pharmaceutical Business and Yanjiao Pharmaceutical Business from Shineway Medical and Shineway Lang Fang at the consideration of RMB44,540,200 and RMB27,931,000 respectively. The consideration paid represented the net amounts of assets and liabilities of the Shineway Pharmaceutical Business and Yanjiao Pharmaceutical Business transferred to Shineway Pharmaceutical and Hebei Shineway respectively. Accordingly, the reserves and accumulated profits of Shineway Pharmaceutical Business and Yanjiao Pharmaceutical Business were distributed to the shareholders of Shineway Medical and Shineway Lang Fang respectively by way of a deemed distribution which represented the net assets values of Shineway Pharmaceutical Business and Yanjiao Pharmaceutical Business of RMB339,462,000 and RMB58,865,000 respectively.

The deemed distribution was settled by bank balances and cash of RMB195,596,000 and RMB33,501,000 of Shineway Pharmaceutical Business and Yanjiao Pharmaceutical Business, current accounts with Shineway Medical and Shineway Lang Fang of RMB119,168,000 (including tax liabilities of RMB29,255,000) and RMB5,207,000 (including tax liabilities of RMB15,219,000) and net assets of RMB24,698,000 and RMB20,157,000 acquired from Shineway Medical and Shineway Lang Fang respectively.

9. EARNINGS PER SHARE

The calculations of basic earnings per share is based on the following data:

| | 2004 | 2003 |
|---|----------------------------------|--------------------|
| | RMB'000 | RMB'000 |
| Net profit for the year and earnings for the purposes of basic earnings per share | <u>260,793</u> | <u>151,370</u> |
| | Number of ordinary shares | |
| | 2004 | 2003 |
| Weighted average number of ordinary shares for the purposes of basic earnings per share | <u>617,232,877</u> | <u>600,000,000</u> |

For the purpose of basis calculation of basic earnings per share, the weighted average number of 600,000,000 shares in issue was assumed that the group reorganisation was taken place on 1 January 2003.

No diluted earnings per share has been presented for both 2004 and 2003 as there were no dilutive potential ordinary shares in both years.

Notes to the Financial Statements

For the year ended 31 December 2004

10. PROPERTY, PLANT AND EQUIPMENT

| | Land and buildings | Plant and machinery | Office equipment | Motor vehicles | Construction in progress | Total |
|---|-----------------------|------------------------|---------------------|-------------------|-----------------------------|----------|
| | RMB'000 | RMB'000 | RMB'000 | RMB'000 | RMB'000 | RMB'000 |
| THE GROUP | | | | | | |
| COST | | | | | | |
| At 1 January 2004 | 122,424 | 127,430 | 1,461 | — | 4,563 | 255,878 |
| Additions | 6,184 | 5,847 | 1,869 | 247 | 8,217 | 22,364 |
| Reclassifications | 1,153 | 294 | — | — | (1,447) | — |
| Reclassification to deposit for purchase of building | — | — | — | — | (11,022) | (11,022) |
| Disposals | (368) | (180) | (187) | — | — | (735) |
| At 31 December 2004 | 129,393 | 133,391 | 3,143 | 247 | 311 | 266,485 |
| DEPRECIATION AND AMORTISATION | | | | | | |
| At 1 January 2004 | 18,872 | 44,905 | 1,047 | — | — | 64,824 |
| Provided for the year | 5,422 | 16,506 | 300 | 56 | — | 22,284 |
| Eliminated on disposals | (192) | (27) | (22) | — | — | (241) |
| At 31 December 2004 | 24,102 | 61,384 | 1,325 | 56 | — | 86,867 |
| NET BOOK VALUES | | | | | | |
| At 31 December 2004 | 105,291 | 72,007 | 1,818 | 191 | 311 | 179,618 |
| At 31 December 2003 | 103,552 | 82,525 | 414 | — | 4,563 | 191,054 |

The Group's leasehold properties situated in the PRC are held under medium-term leases.

Notes to the Financial Statements

For the year ended 31 December 2004

11. SUBSIDIARIES

Details of the subsidiaries at 31 December 2004 are as follows:

| Name of company | Place and date of incorporation/ establishment | Issued and fully paid/ registered capital | Percentage of equity interest held | | Principal activities |
|---|--|---|------------------------------------|----------|---|
| | | | Direct | Indirect | |
| Yuan Da 遠大國際有限公司 | British Virgin Islands ("BVI") 20 November 2002 | Share US\$1 | 100% | — | Investment holding |
| Hong Zhan 宏展國際有限公司 | BVI 20 November 2002 | Share US\$1 | 100% | — | Investment holding |
| 神威藥業營銷有限公司 Shineway Sales (Note 1) | PRC 3 March 2003 for a term of 30 years | Registered capital RMB50,000,000 | — | 80% | Trading of Chinese pharmaceutical products |
| 神威藥業有限公司 Shineway Pharmaceutical (Note 2) | PRC 30 December 2003 for a term of 30 years | Registered capital US\$6,100,000 | — | 100% | Research and development, manufacture and trading of Chinese pharmaceutical products |
| 河北神威藥業有限公司 Hebei Shineway (Note 2) | PRC 30 December 2003 for a term of 30 years | Registered capital US\$3,700,000 | — | 100% | Manufacture and trading of Chinese pharmaceutical products |

Notes to the Financial Statements

For the year ended 31 December 2004

11. SUBSIDIARIES (Continued)

| Name of company | Place and date of incorporation/ establishment | Issued and fully paid/ registered capital | Attributable equity interest of the Group | | Principal activities |
|---|--|---|---|----------|--|
| | | | Direct | Indirect | |
| China Shineway Pharmaceutical (Hong Kong) Limited 中國神威藥業（香港）有限公司 ("Shineway Hong Kong") | Hong Kong 21 April 2004 | HK\$2 | — | 100% | Trading of Chinese pharmaceutical products |

Notes:

1. Shineway Sales is a limited liability company. Pursuant to an approval by Hainan Municipal Government dated 16 March 2004, the form of Shineway Sales has changed from a limited liability company to a Sino-foreign equity joint venture.
2. Shineway Pharmaceutical and Hebei Shineway are foreign wholly-owned enterprises.

12. DEPOSIT FOR PURCHASE OF BUILDING

The Chinese Medicine Extraction Workshop ("Extraction Workshop") under construction was transferred to the Group pursuant to the transfer of Shineway Pharmaceutical Business. Subsequent to the transfer of Shineway Pharmaceutical Business to the Group, Shineway Pharmaceutical has entered into an purchase agreement with Shineway Medical in respect of the purchase of the Extraction Workshop from Shineway Medical ("Purchase Agreement"). Pursuant to the Purchase Agreement, Shineway Pharmaceutical will purchase the Extraction Workshop from Shineway Medical at a consideration of RMB51,105,000. Shineway Pharmaceutical has paid a deposit of RMB11,022,000, which form part of the consideration for the transfer of Shineway Pharmaceutical Business, for the purchase of Extraction Workshop. The amount is reclassified to deposit for the purchase of building from construction in progress.

Notes to the Financial Statements

For the year ended 31 December 2004

13. DEFERRED TAXATION

The followings are the major deferred tax liabilities and assets recognised and movement thereon during the year.

| | Accelerated tax depreciation | Others | Total |
|---|------------------------------------|---------|---------|
| | RMB'000 | RMB'000 | RMB'000 |
| THE GROUP | | | |
| At 1 January 2003 | (2,847) | 1,619 | (1,228) |
| Charge to income for the year | (2,637) | (1,320) | (3,957) |
| At 31 December 2003 and 1 January 2004 | (5,484) | 299 | (5,185) |
| Release upon corporate restructuring | 4,187 | (299) | 3,888 |
| Reversal of revaluation surplus of property, plant and equipment in relation to transfer of business (note) | — | 7,713 | 7,713 |
| Release of deferred tax asset arising from reversal of revaluation surplus of property, plant and equipment in relation to transfer of business | — | (193) | (193) |
| Credit to income for the year | 1,297 | 1,462 | 2,759 |
| At 31 December 2004 | — | 8,982 | 8,982 |

Note: The property, plant and equipment was purchased from Shineway Medical and Shineway Lang Fang at revalued amounts. The revalued amounts were the cost, representing the tax bases, to Shineway Pharmaceutical and Hebei Shineway. Such revalued surplus was reversed on consolidation and therefore, deferred tax assets arisen.

Notes to the Financial Statements

For the year ended 31 December 2004

13. DEFERRED TAXATION *(Continued)*

The following is the analysis of the deferred tax balances for financial reporting purposes:

| | 2004 | 2003 |
|--------------------------|--------------|----------------|
| | RMB'000 | RMB'000 |
| Deferred tax liabilities | — | (5,484) |
| Deferred tax assets | 8,982 | 299 |
| | <u>8,982</u> | <u>(5,185)</u> |

14. INVENTORIES

| | THE GROUP | |
|------------------|---------------|---------------|
| | 2004 | 2003 |
| | RMB'000 | RMB'000 |
| Raw materials | 8,869 | 9,988 |
| Work in progress | 2,341 | 2,164 |
| Finished goods | 6,955 | 34,161 |
| | <u>18,165</u> | <u>46,313</u> |

All inventories were carried at cost at the respective balance sheet date.

Notes to the Financial Statements

For the year ended 31 December 2004

15. OTHER FINANCIAL ASSETS

| | THE GROUP | |
|---|----------------|---------------|
| | 2004 | 2003 |
| | RMB'000 | RMB'000 |
| Trade receivables | 7,140 | 528 |
| Bills receivable | 187,004 | 57,357 |
| Other receivables, deposits and prepayments | 11,532 | 4,975 |
| | <u>205,676</u> | <u>62,860</u> |

The Group allows a credit period normally ranging from six months to one year to its trade customers. The bill receivables are of the age within six months at the balance sheet date. An aged analysis of the Group's trade receivables at the balance sheet date is as follows:

| | THE GROUP | |
|------------------------------------|--------------|------------|
| | 2004 | 2003 |
| | RMB'000 | RMB'000 |
| Within 6 months | 7,140 | 523 |
| Over 6 months but less than 1 year | — | 5 |
| | <u>7,140</u> | <u>528</u> |

Notes to the Financial Statements

For the year ended 31 December 2004

15. OTHER FINANCIAL ASSETS (Continued)

The directors consider that the carrying amounts of trade receivables, bills receivables, other receivables, deposits and prepayment approximate their fair values.

Bank balances and cash comprises cash held by the Group and short-term bank deposits with an original maturity of three months or less. The carrying amounts of these assets approximate their fair values.

Credit risk

The Group's credit risk is primarily attributable to its trade receivables. The amounts presented in the consolidated balance sheet are net of allowances for doubtful receivables, estimated by the Group's management based on prior experience and their assessment of the current economic environment.

The credit risk on liquid funds is limited because the counterparties are banks with high credit-ratings assigned by international credit-rating agencies.

The Group has no significant concentration of credit risk, with exposure spread over a large number of counterparties and customers.

16. AMOUNTS DUE FROM (TO) SHINEWAY MEDICAL AND SHINEWAY LANG FANG

The amounts represent the balances with Shineway Medical and Shineway Lang Fang at balance sheet date in respect of the assets and liabilities excluded from the Relevant Pharmaceutical Business. The aggregate amount of RMB124,375,000 is unsecured, interest-free and settled by the deemed distribution of the reserves and accumulated profits of Shineway Medical and Shineway Lang Fang as at 31 March 2004.

The balances with Shineway Medical and Shineway Lang Fang as at 31 December 2004 are arised from the provision of general services by Shineway Medical and Shineway Lang Fang.

Notes to the Financial Statements

For the year ended 31 December 2004

17. AMOUNT DUE FROM A RELATED COMPANY

| | THE GROUP | |
|---|------------|------------|
| | 2004 | 2003 |
| | RMB'000 | RMB'000 |
| Hebei Shineway Chain Drugstores Co., Ltd. ("Shineway Drugstores") | <u>358</u> | <u>243</u> |

The amount due from Shineway Drugstores, in which certain directors of the Company have beneficial interests, are trade nature and with the age of six months from the balance sheet dates. In the opinion of the directors, the carrying amounts approximate their fair values.

18. SHARE CAPITAL

| | Number of shares | Amount |
|---|---------------------|----------------|
| | '000 | RMB'000 |
| Ordinary shares of HK\$0.10 each | | |
| Authorised: | | |
| On the date of incorporation (note a) | 50 | 414 |
| Redenomination and subdivision of shares (note b) | 3,850 | — |
| Increase during the year (note d) | <u>4,996,100</u> | <u>529,586</u> |
| Balance at 31 December | <u>5,000,000</u> | <u>530,000</u> |
| Issued and fully paid: | | |
| Allotted and issued on the date of incorporation (note a) | — | — |
| Redenomination and subdivision of shares (note b) | 8 | — |
| Issue of shares on Group Reorganisation (note d) | 599,992 | 63,600 |
| Issue of shares by placing, public offering and exercise of over-allotment option (note e) | <u>230,000</u> | <u>24,380</u> |
| | <u>830,000</u> | <u>87,980</u> |

Notes to the Financial Statements

For the year ended 31 December 2004

18. SHARE CAPITAL (Continued)

Notes:

- (a) The Company was incorporated on 14 August 2004 with an authorised share capital of US\$50,000 (equivalent to RMB413,400) divided into 50,000 shares of US\$1 each. 1 share of US\$1 in the Company was allotted and issued to the initial subscriber for cash at par and was then transferred to Li Zhenjiang for cash at par. On the same date, 99 shares of US\$1 each in the Company were allotted and issued to Li Zhenjiang for cash at par.
- (b) Pursuant to the written resolutions of the sole shareholder of the Company passed on 17 June 2004:
 - (1) the authorised share capital of the Company of US\$50,000 divided into 50,000 shares of US\$1 each was redenominated and subdivided as HK\$390,000 divided into 3,900,000 shares of HK\$0.10 each; and
 - (2) the issued share capital of the Company of US\$100 comprising 100 shares of US\$1.00 each was also redenominated and subdivided as HK\$780, divided into 7,800 shares of HK\$0.10 each.
- (c) On 9 July 2004, Li Zhenjiang transferred 7,800 shares of HK\$0.10 each in the share capital of the Company, representing the entire issued share capital of the Company, to Sinovest for cash at par.
- (d) Pursuant to the written resolutions of the sole shareholder of the Company passed on 10 November 2004:
 - (1) the authorised share capital of the Company was increased from HK\$390,000 to HK\$500,000,000 (divided into 5,000,000,000 shares) by the creation of an additional 4,996,100,000 shares.
 - (2) as consideration for the acquisition by the Company of the entire issued share capital of Yuan Da and Hong Zhan from Sinovest on 10 November 2004, the Company issued an aggregate of 599,992,200 shares of Sinovest, credited as fully paid.
- (e) On 2 December 2004 and 29 December 2004, the Company allotted and issued 200,000,000 shares of HK\$0.10 each upon listing of the shares on the Mainboard of the Stock Exchange and 30,000,000 shares of HK\$0.10 each upon the exercise of the over-allotment options, both at a price of HK\$4.36 per share, respectively. These shares rank pari passu with the then existing shares.

The share capital shown on the consolidated balance sheet as at 31 December 2003 represented the aggregate amount of the nominal value of the share capital/registered capital of the Company, Yuan Da and Hong Zhan.

19. SHARE OPTIONS

The Company's share option scheme (the "Scheme"), was adopted pursuant to a resolution passed on 10 November 2004 for the primary purpose of providing incentives to:

- (1) director of employee of any member of the Group; and
- (2) any discretionary object of a discretionary trust established by any substantial shareholder of the Company or any employee of any member of the Group.

The Scheme will expire on 9 November 2014. Under the Scheme, the Board of Directors of the Company may grant options to eligible person to subscribe for shares in the Company.

Notes to the Financial Statements

For the year ended 31 December 2004

19. SHARE OPTIONS *(Continued)*

The total number of shares in respect of which options may be granted under the Scheme is not permitted to exceed 10% of the shares of the Company in issue at any point of time, without prior approval from the Company's shareholders. The number of shares issued and to be issued in respect of which options granted and may be granted to any individual in any one year is not permitted to exceed 1% of the shares of the Company in issue at any point in time, without prior approval from the Company's shareholders. Options granted to substantial shareholders, independent non-executive directors, or any of their respective associates (including a discretionary trust whose discretionary objects include a substantial shareholder or an independent non-executive director or a company beneficially owned by any substantial shareholder or independent non-executive director of the Company) in excess of 0.1% of the Company's share capital or with a value in excess of HK\$5,000,000 must be approved in advance by the Company's shareholders.

Option granted must be taken up within 14 days from the date of offer, upon payment of HK\$1 per option. Options may be exercised at any time from the date of grant of the share option to the 10 anniversary of the date of grant. The exercise price is determined by the directors of the Company, and will not be less than the higher of (i) the closing price of the Company's shares on the date of grant, (ii) the average closing price of the shares for the five business days immediately preceding the date of grant; and (iii) the nominal value of the Company's share.

No option was granted since adoption.

20. RESERVES

The Group

Statutory surplus reserve fund, statutory public welfare fund, discretionary surplus reserve fund and accumulated profits ("Reserves") represented the Reserves of the Relevant Pharmaceutical Business and the Group companies arising during the year.

Notes:

- (a) Basis of appropriations to reserves

The transfers to statutory surplus reserve fund, statutory public welfare fund and discretionary surplus reserve fund are based on the net profit in the financial statements prepared under PRC Accounting Standards.

Notes to the Financial Statements

For the year ended 31 December 2004

20. RESERVES (Continued)

(b) Statutory surplus reserve fund

Shineway Medical's, Shineway Lang Fang's and Shineway Sales's Articles of Association ("Articles") require the appropriation of 10% of its profit after taxation each year to the statutory surplus reserve fund until the balance reaches 50% of the registered share capital. According to the provision of the Articles, in normal circumstances, the statutory surplus reserve fund shall only be used for making up losses, capitalisation into share capital and expansion of Shineway Medical's, Shineway Lang Fang's and Shineway Sales's production and operation. For the capitalisation of statutory surplus reserve fund into share capital, the remaining amount of such reserve fund shall not be less than 25% of the registered share capital.

(c) Statutory public welfare fund

Pursuant to the PRC Company Law, Shineway Medical, Shineway Lang Fang and Shineway Sales's shall make allocation from its profit after taxation at the rate of 5% to 10% to the statutory public welfare fund. The statutory public welfare fund can only be utilised on capital items for employees collective welfare. Individual employees only have the right to use these facilities, the titles to which will remain with Shineway Medical, Shineway Lang Fang and Shineway Sales's. The statutory public welfare fund forms part of the shareholders' equity but is not distributable other than in liquidation.

(d) Discretionary surplus reserve fund

Pursuant to the Articles, Shineway Medical, Shineway Lang Fang and Shineway Sales's shall make allocation from its profit after taxation and appropriations to statutory surplus reserve fund and statutory public welfare fund to the discretionary surplus reserve fund at the rate decided by the shareholders annually. In normal circumstances, the discretionary surplus reserve fund shall only be used for making up losses, capitalisation into share capital and expansion of Shineway Medical's, Shineway Lang Fang's and Shineway Sales's production and operation.

(e) Special reserve

Special reserve represents the reserves and accumulated profits of the Relevant Pharmaceutical Business prior to the group reorganisation, which was distributed to Shineway Medical and Shineway Lang Fang pursuant to the group restructuring.

(f) Merger reserve

Merger reserve of the Group represents the difference between the net asset value of Yuan Da and Hong Zhan and the nominal amount of the Company's shares which were issued as consideration for the acquisition of Yuan Da and Hong Zhan at the time of the group reorganization during the year.

Notes to the Financial Statements

For the year ended 31 December 2004

20. RESERVES (Continued)

The Company

| | Share premium | Accumulated loss | Total |
|---|------------------|---------------------|----------------|
| | RMB'000 | RMB'000 | RMB'000 |
| Premium arising on issue of shares | 1,038,588 | — | 1,038,588 |
| Expenses incurred in connection with the issue of shares | (56,180) | — | (56,180) |
| Net loss for the year | — | (1,150) | (1,150) |
| | <u>982,408</u> | <u>(1,150)</u> | <u>981,258</u> |

Under the Companies Law of the Cayman Islands, share premium is distributable to shareholders, subject to the condition that the Company cannot declare or pay a dividend, or make a distribution out of share premium, capital redemption reserve, unless immediately following the date on which distributions or dividend is proposed to be paid, the Company shall be able to pay its debts as they fall due in the ordinary course of business.

At the balance sheet date, the Company's reserves available for distribution to shareholders amounted to RMB981,258.

Notes to the Financial Statements

For the year ended 31 December 2004

21. OTHER FINANCIAL LIABILITIES

| | THE GROUP | |
|--|----------------|---------------|
| | 2004 | 2003 |
| | RMB'000 | RMB'000 |
| Trade payables | 33,129 | 39,794 |
| Receipt in advance | 2,255 | 20,481 |
| Other payables, deposits and accrued charges | 95,906 | 13,646 |
| | <u>131,290</u> | <u>73,921</u> |

An aged analysis of the Group's trade payables at the balance sheet date is as follows:

| | THE GROUP | |
|------------------------------------|---------------|---------------|
| | 2004 | 2003 |
| | RMB'000 | RMB'000 |
| Within 6 months | 31,407 | 37,930 |
| Over 6 months but less than 1 year | 1,060 | 938 |
| Over 1 year but less than 2 years | 346 | 754 |
| Over 2 years | 316 | 172 |
| | <u>33,129</u> | <u>39,794</u> |

Trade and other payables principally comprise amounts outstanding for trade purchases and ongoing costs. The average credit period taken for trade purchase ranges from two months to four months.

The directors consider that the carrying amounts of trade payables approximate their fair values.

Notes to the Financial Statements

For the year ended 31 December 2004

22. AMOUNT DUE TO A RELATED COMPANY

| | THE GROUP | |
|---|-----------|---------|
| | 2004 | 2003 |
| | RMB'000 | RMB'000 |
| Shijiazhuang Shineway Packaging Company Limited ("Shineway Packaging") | — | 908 |

The amount due to Shineway Packaging, in which a director of the Company has beneficial interests, is unsecured, interest-free and settled during the year.

23. NON-CASH TRANSACTION

Pursuant to the group reorganisation on 31 March 2004, the balances with Shineway Medical and Shineway Lang Fang were settled by deemed distribution of reserves and accumulated profits of the Relevant Pharmaceutical Business as at 31 March 2004.

24. OPERATING LEASE

At the balance sheet date, the Group had commitments for future minimum lease payments under non-cancellable operating lease in respect of land and buildings which fall due as follows:

| | THE GROUP | |
|---------------------------------------|--------------|---------------|
| | 2004 | 2003 |
| | RMB'000 | RMB'000 |
| Within one year | 1,203 | 2,428 |
| In the second to fifth year inclusive | 1,560 | 9,440 |
| Over five years | — | 3,737 |
| | <u>2,763</u> | <u>15,605</u> |

Operating lease payments represent rentals payable by the Group for certain of its office premises, staff quarters and warehouse. Leases are negotiated for a term of ten years and rentals are fixed.

The Company did not have any operating lease commitments as at 31 December 2003 and 2004.

Notes to the Financial Statements

For the year ended 31 December 2004

25. CAPITAL COMMITMENTS

| | THE GROUP | |
|--|---------------|---------------|
| | 2004 | 2003 |
| | RMB'000 | RMB'000 |
| Capital expenditure in respect of acquisition of property, plant and equipment contracted for but not provided | <u>41,196</u> | <u>24,697</u> |

The Company did not have any capital commitments as at 31 December 2003 and 2004.

26. RELATED PARTY TRANSACTIONS

During the year, the Group had the following significant transactions with related parties:

| | 2004 | 2003 |
|--|------------|----------|
| | RMB'000 | RMB'000 |
| Sales of goods to Hebei Shineway Traditional Chinese Medicine Preparation Co., Ltd. ("Shineway TCMP") (note a) | — | 9 |
| Sale of goods to Shineway Drugstores (note a) | 1,673 | 5,182 |
| Sale of goods to Hebei Shineway Medical Co., Ltd. (note a) | 95 | 2,464 |
| Sales of goods to Shineway Packaging (note b) | 22 | 748 |
| Rental income received from Shineway TCMP (note a) | — | 62 |
| Rental income from Shineway Packaging (note b) | — | 116 |
| Purchase of goods from Shineway Packaging (note b) | 4,790 | 12,598 |
| Sales of property, plant and equipment to Shineway Packaging (note b) | — | 2,518 |
| Service fee to Shineway Medical (note c) | 4,705 | — |
| Service fee to Shineway Lang Fang (note c) | <u>788</u> | <u>—</u> |

Notes:

- (a) Shineway Medical, which is owned by the beneficial shareholder of the Company, holds 80% equity interest in the related companies. The directors are of the opinion that the above transactions were carried out with reference to the cost incurred.
- (b) Shineway Medical, which is owned by the beneficial shareholder of the Company, holds 25% equity interest in Shineway Packaging. During the year, Shineway Medical disposed of its entire interest in Shineway Packaging. The directors are of the opinion that the above transactions were carried out with reference to the cost incurred.
- (c) The transactions were carried out at cost.

Notes to the Financial Statements

For the year ended 31 December 2004

27. Balance Sheet of the Company

| | 2004 | 2003 |
|-------------------------------|-------------------------|-----------------|
| | RMB'000 | RMB'000 |
| ASSETS | | |
| Non-current asset | | |
| Investments in subsidiaries | 63,600 | — |
| Current assets | | |
| Other receivables | 544 | — |
| Amount due from a subsidiary | 4,506 | — |
| Bank balances and cash | 1,023,100 | — |
| | <u>1,028,150</u> | <u>—</u> |
| Total assets | <u><u>1,091,750</u></u> | <u><u>—</u></u> |
| EQUITY AND LIABILITIES | | |
| Capital and reserves | | |
| Share capital | 87,980 | — |
| Reserves | 981,258 | — |
| | <u>1,069,238</u> | <u>—</u> |
| Current liabilities | | |
| Other payables | 20,570 | — |
| Amount due to a subsidiary | 1,942 | — |
| | <u>22,512</u> | <u>—</u> |
| Total equity and liabilities | <u><u>1,091,750</u></u> | <u><u>—</u></u> |