NOTES TO FINANCIAL STATEMENTS

31 December 2004

1. GROUP REORGANISATION, PRINCIPAL ACTIVITIES AND BASIS OF PRESENTATION OF FINANCIAL STATEMENTS

Air China Limited (the "Company") was incorporated on 30 September 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 CNAHC, a PRC state-owned enterprise under the supervision of the State Council, in preparation for the listing of the Company's H shares on The Stock Exchange of Hong Kong Limited (the "Hong Kong Stock Exchange") and the London Stock Exchange as described below.

Pursuant to the Restructuring, CNAHC and through its wholly-owned subsidiaries, effected the transfer of the following to the Company upon its incorporation:

(a) the assets, liabilities and undertakings which principally relate to the business of the provision of airline operations (the "Relevant Businesses"); and

(b) 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").

Pursuant to the Restructuring, the Company entered into a restructuring agreement with CNAHC and CNACG on 20 November 2004 (the "Restructuring Agreement"). In accordance with the Restructuring Agreement, CNAHC transferred to the Company, among other things, the following:

(a) all of the airline and airline-related businesses operated by Air China International Corporation (中國國際航空公司), the Company's immediate predecessor;

(b) all related assets, including aircraft and other property, plant and equipment of Air China International Corporation;

(c) all related liabilities, including Air China International Corporation's bank loans; and

(d) the equity interests in various investees in airline and airline-related businesses owned by Air China International Corporation, including equity interests in Air China Cargo Co., Ltd. ("Air China Cargo"), Aircraft Maintenance and Engineering Corporation, Beijing ("AMECO") and Shenzhen Airlines Co., Ltd. ("Shenzhen Airlines").

In accordance with the Restructuring Agreement, CNACG transferred its approximately 69% equity interests in China National Aviation Company Limited ("CNAC") to the Company by way of a capital contribution.

The effective date of the Restructuring was 30 September 2004, after which date the Company assumed the rights and obligations of the businesses, assets and liabilities transferred to the Company by CNAHC and CNACG.

1. GROUP REORGANISATION, PRINCIPAL ACTIVITIES AND BASIS OF PRESENTATION OF FINANCIAL STATEMENTS (continued)

As at the date of approval of these financial statements, the Group is in the process of applying to the relevant government authorities to obtain the title certificates of certain of the above-mentioned assets, primarily buildings and land use rights, with an aggregate carrying value of approximately RMB3,098 million, and to register the already transferred equity interests in certain investees, including equity interests in Air China Cargo, AMECO and Shenzhen Airlines, from Air China International Corporation into the Company's name. The Directors of the Company are of the view that the Group is entitled to lawfully and validly occupy and use the above-mentioned assets and own the aforesaid equity interests. 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 31 December 2004.

In consideration for CNAHC and CNACG transferring the Relevant Businesses and the Relevant Companies to the Company, the Company issued 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 RMB1.00 each to CNAHC and CNACG, respectively (note 37 (a)). The shares issued to CNAHC and CNACG represented the then entire registered and issued share capital of the Company upon its incorporation.

Prior to the incorporation of the Company, the Relevant Businesses and the Relevant Companies were held by two subsidiaries of CNAHC, namely, Air China International Corporation and CNAC, a Hong Kong incorporated company with its shares publicly traded on the Hong Kong Stock Exchange. Air China International Corporation is a state-owned enterprise established in the PRC on 1 July 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 14 July 2002 and 9 August 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 China National Aviation Corporation ("CNAC (PRC)"), which owned 100% interest in 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.

The Group's principal activities are airline and airline-related services, including aircraft engineering services, air catering services and airport ground handling services conducted mainly in the PRC, Hong Kong and Macau.

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, the PRC.

In the opinion of the Directors, the Company's ultimate holding company is CNAHC.

Further details of the Restructuring are set out in the Company's prospectus dated 3 December 2004 issued in respect of the listing of the Company's H shares on the Hong Kong Stock Exchange and the London Stock Exchange.

NOTES TO FINANCIAL STATEMENTS

31 December 2004

1. GROUP REORGANISATION, PRINCIPAL ACTIVITIES AND BASIS OF PRESENTATION OF FINANCIAL STATEMENTS (continued)

On 15 December 2004, 2,805,680,000 new H shares in the Company, details of which are set out in note 37 (b) to these financial statements, were listed on the Hong Kong Stock Exchange and the London Stock Exchange. On 11 January 2005, an additional 420,852,000 new H shares in the Company, details of which are set out in note 47 (a) to these financial statements, were issued and listed on the Hong Kong Stock Exchange and the London Stock Exchange upon the exercise of the over-allotment option.

As CNAHC controlled the Relevant Businesses and Relevant Companies before the Restructuring and continues to control the Company after the Restructuring, the consolidated financial statements of the Group for the years ended 31 December 2003 and 2004 have been prepared as a reorganisation of companies under common control in a manner similar to a pooling-of-interests. Accordingly, the assets and liabilities of the Company are stated at historical amounts, except for the measurement at fair value of financial instruments in accordance with IAS 39 (amended 2004).

The consolidated balance sheets as at 31 December 2003 and 2004 present the Group's assets and liabilities as if the Restructuring had been completed at 1 January 2003. The consolidated results and consolidated 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 1 January 2003. The Company's Directors are of the opinion that the consolidated financial statements prepared on this basis present fairly the consolidated financial position, consolidated results and consolidated cash flows of the Group as a whole. Therefore, the net profit for the year ended 31 December 2004 includes the consolidated results before the Restructuring.

As the Company was only incorporated on 30 September 2004, there are no comparative figures as at 31 December 2003 in the Company's balance sheet.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of preparation

The consolidated financial statements of the Group have been prepared in accordance with International Financial Reporting Standards ("IFRS") which comprise standards and interpretations approved by the International Accounting Standards Board, and International Accounting Standards ("IAS") 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 1 January 2001, which is the earliest date for the preparation of the financial information in relation to the listing of the Company's H shares:

- 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;*

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Basis of preparation (continued)

- 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.*

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Basis of preparation (continued)

The consolidated 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).

Basis of consolidation

The consolidated financial statements comprise the financial statements of the Company and all its subsidiaries. The financial statements of the subsidiaries are prepared for the same reporting period as the parent company using consistent accounting policies. Adjustments are made to bring into line any dissimilar accounting policies that may exist.

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. All significant inter-company transactions and balances within the Group are eliminated on consolidation.

Minority interests represent the interests of outside shareholders in the results and net assets of the Company's subsidiaries, not held by the Group and are presented in the consolidated balance sheet within equity, separately from the shareholders' equity.

Foreign currencies

The Group's functional and presentation 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 into RMB 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 these 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 consolidated cash flow statement, the cash flows of the overseas subsidiaries 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.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Subsidiaries

A subsidiary is a company whose financial and operating policies the Company controls, directly or indirectly, so as to obtain benefits from its activities. A subsidiary is consolidated from the date the Company obtains control until such time as control ceases.

The results of subsidiaries are included in the Company's income statement to the extent of dividends received and receivable. In the Company's balance sheet, the Company's interests in subsidiaries are stated at cost less any impairment losses.

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 consolidated financial statements on a line-by-line basis.

Interests 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. When the Group's share of losses in an associate equals or exceeds its interest in the associate, the Group does not recognise further losses, unless the Group has incurred obligations or made payments on behalf of the associates.

In the Company's balance sheet, the investments in associates are stated at cost less any impairment losses. The results of associates are accounted for by the Company on the basis of dividends received and receivable.

Property, plant and equipment

Property, plant and equipment, other than construction in progress ("CIP"), are stated at cost less accumulated depreciation and 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 the 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.

NOTES TO FINANCIAL STATEMENTS

31 December 2004

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Property, plant and equipment (continued)

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:

	Depreciation life	Residual value
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%

The gain or loss on disposal or retirement of a property, plant and equipment recognised in the income statement is the difference between the net sales proceeds and the carrying amount of the relevant asset at the time of disposal.

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 losses, 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 fair value less costs to sell 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.

Lease prepayments

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

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Goodwill

Goodwill represents the excess of cost over the fair value of the identifiable assets, liabilities and contingent liabilities 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 1 January 2001. In accordance with IFRS 3, the Group ceased amortising goodwill as of 1 January 2001.

On disposal of subsidiaries, associates or joint ventures, the gain or loss on disposal is calculated by reference to the net assets at the date of disposal, including the attributable amount of goodwill which remains unamortised and any relevant reserves, as appropriate.

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.

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.

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 available-for-sale and measured at fair value through profit or loss. Gains or losses on available-for-sale investments 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.

NOTES TO FINANCIAL STATEMENTS

31 December 2004

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

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. Where the Group is the lessor, assets leased by the Group under operating leases are included in non-current assets and rentals receivables under the operating leases are credited to the income statement on the straight-line basis over the lease terms. Where the Group is the lessee, rentals payable under the operating leases are charged to the income statement on the straight-line basis over the lease terms.

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 costs to be incurred to completion and disposal.

Cash and cash equivalents

For the purpose of the consolidated cash flow statement, cash and cash equivalents comprise cash on hand and demand deposits, and short term highly liquid investments which are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value, and have a short maturity of generally within three months when acquired, less bank overdrafts which are repayable on demand and form an integral part of the Group's cash management.

For the purpose of the balance sheet, cash and cash equivalents comprise cash on hand and at banks and other financial institutions, including term deposits, which are not restricted as to use.

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.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Employee benefits

(a) *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.

(b) *Termination and early retirement benefits*

Termination benefits are payable whenever an employee's employment is voluntarily 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.

(c) *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 before the incorporation of the Company 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 quarters 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, position 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.

NOTES TO FINANCIAL STATEMENTS

31 December 2004

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Employee benefits (continued)

(c) *Housing benefits (continued)*

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.

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.

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 leases, 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.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

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:

(a) *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 1 January 2004. From 2004, contributions to the CAAC Infrastructure Development Fund are 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.

(b) *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.

(c) *Trading of investments*

Revenue is recognised on a trade date basis.

(d) *Interest income*

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

(e) *Dividends*

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

NOTES TO FINANCIAL STATEMENTS

31 December 2004

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Revenue recognition (continued)

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

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

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 in the balance sheet as a current liability.

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.

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 5.76% 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.

Income tax

Income tax comprises current and deferred income tax. Income tax is recognised in the income statement, or in equity if it relates to items that are recognised in the same or a different period directly in equity.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Income tax (continued)

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 goodwill amortisation or 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 differences can be controlled and it is probable that the temporary differences will not reverse in the foreseeable future.

Deferred income tax assets are recognised for all deductible temporary differences, carry-forward 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, and the carry-forward 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 differences 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.

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.

NOTES TO FINANCIAL STATEMENTS

31 December 2004

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Derivative financial instruments (continued)

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 hedged 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 income statement 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 the income statement.

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 year in which the hedged firm commitment affects the income statement, 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 year. 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 year.

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.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

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.

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.

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.

Other receivables are recognised and carried at cost less allowances for any uncollectible amounts.

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 borrowings.

After initial recognition, interest-bearing loans and borrowings are subsequently measured at amortised cost using the effective interest rate method. Amortised cost is calculated by taking into account any issue costs, and any discount or premium on settlement.

Gains and losses are recognised in the income statement when the liabilities are derecognised or impaired, as well as through the amortisation process.

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.

NOTES TO FINANCIAL STATEMENTS

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2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Impact of recently issued accounting standards

IFRS 2, *Share-based Payment*, is applicable for accounting periods beginning on or after 1 January 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 re-measure the fair value of the liability at each reporting date and at the date of settlement, with any changes in value recognised in the income statement 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 7 November 2002 and had not yet vested at the beginning on or after 1 January 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 1 January 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.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Impact of recently issued accounting standards (continued)

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 1 January 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.

3. 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, supporting 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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3. SEGMENT INFORMATION (continued)

Business segments

The following table presents revenue, profit and certain asset, liability and expenditure information for the Group's business segments for the year ended 31 December 2004:

	Airline operations RMB'000	Engineering services RMB'000	Airport terminal services RMB'000	Others RMB'000	Eliminations RMB'000	Total RMB'000
REVENUES						
Sales to external customers	32,766,164	296,775	287,905	169,913	—	33,520,757
Intersegment sales	—	731,589	—	131,299	(862,888)	—
Total revenues	32,766,164	1,028,364	287,905	301,212	(862,888)	33,520,757
PROFIT FROM OPERATIONS						
Segment results	4,146,402	824,858	203,133	173,746	(862,888)	4,485,251
Finance costs	(1,785,196)	(14,541)	(1,978)	1,842	—	(1,799,873)
Dilution gains on investments	330,222	—	—	79,915	—	410,137
Share of profits less losses from associates	416,813	(4,649)	191,323	(42,469)	—	561,018
Profit before tax	3,108,241	805,668	392,478	213,034	(862,888)	3,656,533
Tax						(1,107,838)
Minority interests						(162,731)
Net profit attributable to equity holders of the parent						2,385,964
ASSETS						
Segment assets	62,308,593	1,077,748	160,087	379,390	(2,014,154)	61,911,664
Interests in associates	3,589,574	25,539	186,056	200,352	—	4,001,521
Unallocated assets						776,084
Total assets						66,689,269
LIABILITIES						
Segment liabilities	(48,845,870)	(652,749)	(312,765)	(677,442)	2,014,154	(48,474,672)
Unallocated liabilities						(186,055)
Total liabilities						(48,660,727)
OTHER INFORMATION						
Capital expenditures — property, plant and equipment	6,046,355	32,697	25,912	33,641	—	6,138,605
Depreciation of property, plant and equipment	3,395,049	35,797	19,247	13,159	—	3,463,252
Provision for/(write-back of) doubtful debts, net	(4,483)	2,642	—	853	—	(988)
Provision for/(write-back of) inventories, net	12,492	(24,000)	—	—	—	(11,508)

3. SEGMENT INFORMATION (continued)

Business segments (continued)

The following table presents revenue, profit/(loss) and certain asset, liability and expenditure information for the Group's business segments for the year ended 31 December 2003:

	Airline operations RMB'000	Engineering services RMB'000	Airport terminal services RMB'000	Others RMB'000	Eliminations RMB'000	Total RMB'000
REVENUES						
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	23,910,300	772,198	251,266	320,831	(613,190)	24,641,405
PROFIT FROM OPERATIONS						
Segment results	1,995,224	571,448	173,290	157,492	(613,190)	2,284,264
Finance costs	(2,326,582)	(17,631)	(1,160)	(3,705)	—	(2,349,078)
Share of profits less losses from associates	172,016	(18,660)	104,043	(14,306)	—	243,093
Profit/(loss) before tax	(159,342)	535,157	276,173	139,481	(613,190)	178,279
Tax						(89,781)
Minority interests						71,106
Net profit attributable to equity holders of the parent						159,604
ASSETS						
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						590,153
Total assets						56,397,062
LIABILITIES						
Segment liabilities	(47,237,228)	(683,204)	(174,326)	(551,813)	618,687	(48,027,884)
Unallocated liabilities						(53,929)
Total liabilities						(48,081,813)
OTHER INFORMATION						
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/(write-back of) doubtful debts, net	13,824	(1,562)	—	(118)	—	12,144
Provision for inventories, net	90	24,000	—	—	—	24,090

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31 December 2004

3. SEGMENT INFORMATION (continued)

Geographical segments

The following tables present consolidated revenue information by geographical segments for each of the two years ended 31 December 2004:

For the year ended 31 December 2004	Domestic RMB'000	HK/Macau RMB'000	Europe RMB'000	North America RMB'000	Japan/ Korea RMB'000	Asia Pacific, others RMB'000	Total RMB'000
REVENUES							
Sales to external customers and total revenues	**18,482,949**	**1,744,590**	**4,232,489**	**2,477,214**	**3,846,973**	**2,736,542**	**33,520,757**

For the year ended 31 December 2003	Domestic RMB'000	HK/Macau RMB'000	Europe RMB'000	North America RMB'000	Japan/ Korea RMB'000	Asia Pacific, others RMB'000	Total RMB'000
REVENUES							
Sales to external customers and total revenues	12,926,434	1,572,902	3,547,743	2,336,207	2,287,004	1,971,115	24,641,405

4. 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. The CAAC Infrastructure Development Fund, which was netted against gross air traffic revenues for the year ended 31 December 2003, was included in other flight operation expenses for the year ended 31 December 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:

	Group	
	2004 RMB'000	2003 RMB'000
Passenger	**27,665,018**	19,030,187
Cargo and mail	**3,169,804**	4,392,473
	30,834,822	23,422,660

4. AIR TRAFFIC REVENUES (continued)

(a) 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:

Type of revenue	Applicable business tax rate
Air traffic revenues	3% of air traffic revenues. All inbound international and Hong Kong and Macau regional flights are exempted 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 the two years ended 31 December 2003 and 2004, netted against air traffic revenues, amounted to approximately RMB240 million and RMB711 million, respectively.

For the period from 1 May 2003 to 31 December 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.

(b) 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 the year ended 31 December 2003.

For the period from 1 May 2003 to 31 December 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 1 January 2004 to 31 March 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 31 March 2004. Effective from 1 April 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 the two years ended 31 December 2003 and 2004 amounted to approximately RMB247 million and RMB353 million, respectively.

NOTES TO FINANCIAL STATEMENTS

31 December 2004

5. OTHER OPERATING REVENUES

	Group	
	2004	2003
	RMB'000	RMB'000
Bellyhold income	**1,384,457**	—
Aircraft engineering income	**296,775**	285,493
Ground services income	**287,905**	251,266
General aviation income	**159,990**	152,574
Air catering income	**118,140**	102,133
Government grants:		
(i) Recognition of deferred income *(note 36)*	**70,593**	57,894
(ii) Fixed cash subsidy	**37,500**	50,000
(iii) Others	**44,853**	1,525
Service charges on return of unused flight tickets	**63,821**	51,678
Cargo handling service income	**49,850**	90,021
Sale of materials	**33,008**	20,699
Import and export service income	**29,767**	23,589
Training service income	**23,761**	17,915
Aircraft and related equipment lease income	**11,516**	33,519
Gain on disposal of property, plant and equipment, net	**—**	17,048
Others	**73,999**	63,391
	2,685,935	1,218,745

6. PROFIT FROM OPERATIONS

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

	Group	
	2004	2003
	RMB'000	RMB'000
Repair and maintenance costs	**3,608,348**	2,804,507
Depreciation *(note 16)*	**3,463,252**	3,377,472
Employee compensation costs *(note 7)*	**2,921,322**	2,379,102
Minimum lease payments under operating leases:		
Aircraft and jet engines	**1,071,256**	910,134
Land and buildings	**187,471**	181,984
(Gain)/loss on disposal of property, plant and equipment, net	**33,872**	(17,048)
Auditors' remuneration	**7,206**	1,614
Provision for/(write-back of) doubtful debts, net	**(988)**	12,144
Provision for/(write-back of) inventories, net	**(11,508)**	24,090

7. EMPLOYEE COMPENSATION COSTS

	Group	
	2004	2003
	RMB'000	RMB'000
Employee compensation costs (including Directors', supervisors' and management's emoluments):		
Wages, salaries and social security costs	**2,732,927**	2,200,916
Retirement benefit costs *(note 11)*	**188,395**	178,186
	2,921,322	2,379,102

The Group had 26,881 and 25,236 employees as at 31 December 2003 and 31 December 2004, respectively.

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8. FINANCE COSTS

	Group	
	2004	2003
	RMB'000	RMB'000
Interest expense	**1,827,002**	2,248,996
Less: Interest capitalised	**(2,610)**	(7,830)
	1,824,392	2,241,166
Less: Interest income	**(33,703)**	(18,803)
Exchange losses, net	**54,842**	297,042
Gains on fuel derivatives, net	**(41,036)**	(169,921)
Dividend income on long-term investments	**(4,622)**	(406)
	1,799,873	2,349,078

The interest capitalisation rate represented the cost of capital from raising the related borrowings and it ranged from 5.58% to 5.76% per annum.

9. DILUTION GAINS ON INVESTMENTS

	Group	
	2004	2003
	RMB'000	RMB'000
Dilution gain on investment in Air Cargo Business *(note 9 (a))*	**330,222**	—
Dilution gains on investments in BACL and SWACL *(note 9 (b))*	**79,915**	—
	410,137	—

Notes:

(a) Pursuant to the Restructuring, the air cargo business and relevant air cargo assets and liabilities (the "Air Cargo Business") were operated and owned solely by the Group as if it had been directly held by the Group as of 1 January 2003 in accordance with the basis of presentation as set out in note 1 to these financial statements. In 2004, the entire Air Cargo Business was transferred to Air China Cargo, a 51% owned joint venture of the Company, in the form of the Company's capital contribution and advance to Air China Cargo. Subsequent to the transfer of Air Cargo Business to Air China Cargo, the Group's effective interest in the Air Cargo Business was diluted from 100% to 51% and, accordingly, a gain on dilution of investment in Air Cargo Business of approximately RMB330 million arose.

9. DILUTION GAINS ON INVESTMENTS (continued)

(b) In accordance with the basis of presentation as set out in note 1 to these financial statements, 60% shareholding interest in Beijing Air Catering Co., Ltd. ("BACL") and 75% shareholding interest in Southwest Air Catering Company Limited ("SWACL") were deemed to be held by the Group as of 1 January 2003.

During 2004, the Group transferred its entire 60% shareholding interest in BACL and 60% shareholding interest in SWACL to Fly Top Limited, a wholly-owned subsidiary of CNAC, for a consideration of RMB294 million and RMB67 million, respectively.

In addition to the above, the Group also transferred its remaining 15% shareholding interest in SWACL to Hongkong Southwest Air Catering Limited ("HKSACL"), the minority shareholder of SWACL, for a consideration of approximately RMB17 million.

Subsequent to the completion of the above transactions, the Group's effective shareholding interests in BACL and SWACL were diluted from 60% and 75% to approximately 41% and 41%, respectively and, accordingly, gains on dilution of investments in BACL and SWACL aggregating approximately RMB80 million arose.

10. DIRECTORS', SUPERVISORS' AND SENIOR MANAGEMENT'S EMOLUMENTS

Directors' and supervisors' remuneration for the year disclosed pursuant to the Rules Governing the Listing of Securities on the Hong Kong Stock Exchange and Section 161 of the Hong Kong Companies Ordinance, is as follows:

	Group	
	2004	2003
	RMB'000	RMB'000
Fees	**29**	—
Basic salaries, housing benefits, other allowances and benefits in kind	**4,279**	4,390
Discretionary bonuses	**636**	508
Pension scheme contributions	**43**	45
	4,987	4,943

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

	Group	
	2004 Number of Directors and supervisors	2003 Number of Directors and supervisors
Nil to HK$1,000,000 (RMB1,060,000 equivalent)	**13**	13
HK$1,500,001 to HK$2,000,000 (RMB2,120,000 equivalent)	**1**	1
HK$2,000,001 to HK$2,500,000 (RMB2,650,000 equivalent)	**1**	1
	15	15

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10. DIRECTORS', SUPERVISORS' AND SENIOR MANAGEMENT'S EMOLUMENTS (continued)

Fees of approximately RMB29,000 (2003: Nil) are wholly payable to the independent non-executive Directors. There were no other emoluments payable to the independent non-executive Directors during the year (2003: Nil).

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

	Group	
	2004 Number of individuals	2003 Number of individuals
Director	**1**	1
Supervisor	**1**	1
Employees	**3**	3

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

	Group	
	2004 RMB'000	2003 RMB'000
Basic salaries, housing benefits, other allowances and benefits in kind	**5,360**	4,240
Discretionary bonuses	**—**	30
Pension scheme contributions	**164**	180
	5,524	4,450

The remuneration of the three highest paid individuals for the year fell within the following bands:

	Group	
	2004 Number of individuals	2003 Number of individuals
HK$1,000,001 to HK$1,500,000 (RMB1,590,000 equivalent)	**1**	3
HK$1,500,001 to HK$2,000,000 (RMB2,120,000 equivalent)	**2**	—
	3	3

10. DIRECTORS', SUPERVISORS' AND SENIOR MANAGEMENT'S EMOLUMENTS (continued)

There was no arrangement under which a Director or a supervisor or any of the five highest paid individuals waived or agreed to waive any remuneration during the year (2003: Nil).

There was no emolument paid by the Group to any of 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 during the year (2003: Nil).

11. 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 year 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 pension payments relating to the Supplementary Pension Benefits borne by CNAHC was approximately RMB39 million for the year ended 31 December 2004 (2003: RMB54 million) (note 46). 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.

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 costs in the income statement.

11. RETIREMENT BENEFITS (continued)

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

	Group	
	2004	2003
	RMB'000	RMB'000
Contributions to PRC government-regulated defined contribution retirement scheme	**179,740**	154,728
Early retirement benefits	**8,655**	23,458
Total *(note 7)*	**188,395**	178,186

Forfeited contribution totaling RMB1,579,000 (2003: RMB983,000) was utilised during the year. At 31 December 2004, the Group had no forfeited contributions available to reduce its contributions to the pension scheme in future years (2003: RMB54,000).

12. TAX

According to the PRC Enterprise Income Tax Law, the Company, its subsidiaries, joint ventures and associates established in the PRC are subject to the enterprise income tax at a rate of 33% (2003: 33%) on their taxable income.

Hong Kong profits tax has been provided at the rate of 17.5% (2003: 17.5%) on the estimated assessable profits arising in Hong Kong during the year.

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 30 September 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 prior to its incorporation 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 domestic 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 CNAHC for the period from 1 January 2004 to 30 September 2004 (the date of incorporation of the Company) referred to in note 14 (b) to these financial statements 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 will settle its tax liability by itself with the respective tax bureaus.

12. TAX (continued)

The determination of current and deferred income tax was based on enacted tax rates. Major components of income tax charge are as follows:

	Group	
	2004	2003
	RMB'000	RMB'000
Current income tax		
Current income tax charge		
— Mainland China	**398,944**	18,313
— Hong Kong	**4,096**	154
Deferred income tax		
Relating to origination and reversal of temporary differences *(note 22)*	**607,824**	33,847
	1,010,864	52,314
Share of tax attributable to associates	**96,974**	37,467
Income tax charge for the year	**1,107,838**	89,781

A reconciliation of income tax expense applicable to profit before income tax at the statutory income tax rate in the PRC to income tax expense at the Group's effective income tax rate, and a reconciliation of the applicable rates (i.e., the statutory tax rates) to the effective tax rates, are as follows:

	Group			
	2004		2003	
	RMB'000	**%**	RMB'000	%
Profit before income tax	**3,656,533**		178,279	
At statutory income tax rate of 33%	**1,206,656**	**33.0**	58,832	33.0
Lower income tax rates of other territories	**(109,440)**	**(3.0)**	2,610	1.5
Income not subject to tax	**(145,333)**	**(4.0)**	(35,388)	(19.8)
Expenses not deductible for tax purposes	**155,955**	**4.3**	70,164	39.4
Effect on opening deferred income tax of increase in other territories' income tax rates	**—**	**—**	9,542	5.4
Share of adjustments in income tax of previous periods attributable to associates	**—**	**—**	(15,979)	(9.0)
Tax charge at Group's effective income tax rate	**1,107,838**	**30.3**	89,781	50.5

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31 December 2004

12. TAX (continued)

At 31 December 2004, there was no significant unrecognised deferred tax liability (2003: Nil) for taxes that would be payable on the un-remitted earnings of certain of the Group's subsidiaries and joint ventures, as the Directors of the Company do not have intention to remit any significant amount of earnings to the Company in the foreseeable future.

There are no income tax consequences attaching to the payment of dividends by the Company to its shareholders.

13. NET PROFIT ATTRIBUTABLE TO EQUITY HOLDERS OF THE PARENT

The net profit attributable to equity holders of the parent for the period from 1 October 2004 to 31 December 2004 dealt with in the financial statements of the Company was approximately RMB1,230 million (note 38).

14. APPROPRIATIONS

Set out below are the details of distributions made by the Company for the two years ended 31 December 2004:

	Group	
	2004	2003
	RMB'000	RMB'000
Carved-out of net assets *(note 14 (c))*	**39,136**	316,153
Dividends paid *(note 14 (c))*	**29,074**	26,690
Distribution to CNAHC *(note 14 (a))*	**377,550**	—
Distribution to CNAHC *(note 14 (b))*	**2,025,105**	—
Distribution to CNACG *(note 14 (b))*	**118,680**	—
Total	**2,589,545**	342,843

(a) On 21 April 2004, Fly Top Limited, a wholly-owned subsidiary of CNAC, entered into the following acquisition agreements which were supplemented on 26 April 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 12 November 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.

14. APPROPRIATIONS (continued)

On 20 April 2004, Air China International Corporation entered into a stock transfer agreement with HKSACL ("HKSACL Agreement"), the minority shareholder of SWACL, pursuant to which, Air China International Corporation disposed of 15% of the equity interest in SWACL to HKSACL for a consideration of approximately RMB17 million. On 12 November 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 were diluted from 60% and 75% to approximately 41% and 41%, respectively.

As a result of the completion of BACL Agreement, SWACL Agreement and HKSACL Agreement, the Group made 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 note 1 to these financial statements. This payment has been made to CNAHC and accounted for as a special distribution to CNAHC by the Company.

(b) 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 Regulations Relating to Corporate Reorganisation of Enterprises and Related Management of State-owned Capital and Financial Treatment" notice issued by the Ministry of Finance (the English title is a direct translation of the Chinese title of the notice), which became effective from 27 August 2002, and pursuant to the Restructuring, after the Company's incorporation, the Company is required to make a distribution to CNAHC, which represents an amount equal to the net profit attributable to shareholders, as determined based on the audited accounts prepared in accordance with the accounting principles and the financial regulations applicable in the PRC (the "PRC GAAP"), generated during the period from 1 January 2004 to 30 September 2004 (the date of incorporation of the Company) by the businesses and operations (excluding those of CNAC) contributed to the Group by CNAHC after giving effect to relevant necessary adjustments. The net profit attributable to shareholders mentioned above for the said period is calculated after deducting the amount of income tax payable to CNAHC of approximately RMB191,721,000 which in turn will settle the tax liability on profit arisen during that period with the relevant tax bureau as detailed in note 12 to these financial statements.

In addition, in accordance with (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 Regulations 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 Company 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 1 January 2004 to 30 September 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.

NOTES TO FINANCIAL STATEMENTS

31 December 2004

14. APPROPRIATIONS (continued)

(c) The profit distributions made prior to the incorporation of the Company represent the net assets which have been carved-out and treated as deemed distributions pursuant to the Restructuring set out in note 1 to these financial statements and dividends paid during that period.

The rates of dividend and the number of shares ranking for dividends are not presented in this footnote for those profit distributions made prior to the incorporation of the Company as such information is not considered meaningful.

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; and

(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 dividends payment is based on the lesser of (i) the net profit determined in accordance with the PRC GAAP; and (ii) the net profit determined in accordance with IFRS.

14. APPROPRIATIONS (continued)

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

15. EARNINGS PER SHARE

The calculation of basic earnings per share for the year ended 31 December 2004 is based on the net profit attributable to equity holders of the parent for the year ended 31 December 2004 of approximately RMB2,385,964,000, and the weighted average of approximately 6,618,795,915 shares in issue during the year on the assumption that the 6,500,000,000 shares issued as at 30 September 2004 had been in issue throughout the year ended 31 December 2004, and as adjusted to reflect the new issue of 2,550,618,182 shares by way of placing and public offering in connection with the public listing of the Company's H shares on 15 December 2004.

The calculation of basic earnings per share for the year ended 31 December 2003 is based on the net profit attributable to equity holders of the parent for the year ended 31 December 2003 of approximately RMB159,604,000, and the number of shares in issue during 2003 on the assumption that the 6,500,000,000 shares issued as at 30 September 2004 had been in issue throughout the year ended 31 December 2003.

The calculation of diluted earnings per share is based on the net profit attributable to equity holders of the parent for the year ended 31 December 2004 of approximately RMB2,385,964,000. The weighted average number of ordinary shares used in the calculation is the 6,618,795,915 shares in issue during the year, as used in the basic earnings per share calculation and the weighted average of 556,132 ordinary shares assumed to have been issued at no consideration on the deemed exercise of all over-allotment options granted to international underwriters to subscribe for the H shares of the Company during the year.

Diluted earnings per share for the year ended 31 December 2003 has not been calculated because no diluting events existed during 2003.

NOTES TO FINANCIAL STATEMENTS

31 December 2004

16. PROPERTY, PLANT AND EQUIPMENT

Group

	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 1 January 2003, net of accumulated depreciation	38,631,760	2,447,368	930,637	263,866	82,644	519,894	42,876,169
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	(2,987,834)	(122,486)	(169,733)	(80,058)	(17,361)	—	(3,377,472)
At 31 December 2003 and 1 January 2004, net of accumulated depreciation	37,789,877	2,715,540	1,051,602	293,144	90,268	483,489	42,423,920
Establishment of a joint venture *(note 45 (b))*	(267,119)	(186,169)	(86,932)	(21,673)	—	(3,947)	(565,840)
Additions	4,479,459	42,515	109,019	135,909	77,244	734,028	5,578,174
Disposals	(424,064)	(49,111)	(28,705)	(7,170)	(22,315)	—	(531,365)
Transfer from CIP	164,788	285,156	91,393	5,177	206	(546,720)	—
Depreciation charge for the year	(3,024,078)	(123,071)	(172,910)	(89,845)	(53,348)	—	(3,463,252)
At 31 December 2004, net of accumulated depreciation	**38,718,863**	**2,684,860**	**963,467**	**315,542**	**92,055**	**666,850**	**43,441,637**
At 31 December 2003 and 1 January 2004							
Cost	61,008,650	3,605,551	2,027,910	1,031,027	192,815	483,489	68,349,442
Accumulated depreciation	(23,218,773)	(890,011)	(976,308)	(737,883)	(102,547)	—	(25,925,522)
Net carrying amount	37,789,877	2,715,540	1,051,602	293,144	90,268	483,489	42,423,920
At 31 December 2004							
Cost	63,813,626	3,674,146	2,045,002	1,068,502	223,531	666,850	71,491,657
Accumulated depreciation	(25,094,763)	(989,286)	(1,081,535)	(752,960)	(131,476)	—	(28,050,020)
Net carrying amount	**38,718,863**	**2,684,860**	**963,467**	**315,542**	**92,055**	**666,850**	**43,441,637**

16. PROPERTY, PLANT AND EQUIPMENT (continued)

Company

	Aircraft and flight equipment RMB'000	Buildings RMB'000	Machinery RMB'000	Transportation equipment RMB'000	Office equipment RMB'000	Construction in progress RMB'000	Total RMB'000
Transferred to the Company upon its incorporation *(note 1)*	38,595,577	1,858,577	784,743	182,711	76,724	583,635	42,081,967
Additions	372,799	—	25,547	42,916	27,182	308,493	776,937
Disposals	(9,216)	(32)	(31,158)	(1,650)	(148)	—	(42,204)
Transfer from CIP	—	219,934	17,770	176	—	(237,880)	—
Depreciation charge for the period	(804,864)	(23,307)	(29,053)	(20,021)	(31,027)	—	(908,272)
At 31 December 2004, net of accumulated depreciation	**38,154,296**	**2,055,172**	**767,849**	**204,132**	**72,731**	**654,248**	**41,908,428**
At 31 December 2004							
Cost	61,842,914	2,820,374	1,520,769	830,178	131,321	654,248	67,799,804
Accumulated depreciation	(23,688,618)	(765,202)	(752,920)	(626,046)	(58,590)	—	(25,891,376)
Net carrying amount	**38,154,296**	**2,055,172**	**767,849**	**204,132**	**72,731**	**654,248**	**41,908,428**

Certain of the Group's and the Company's bank loans are secured by certain of the Group's and the Company's aircraft and flight equipment, which has an aggregate carrying amount of approximately RMB16,586 million as at 31 December 2004 (2003: RMB16,422 million) (note 34).

The carrying amount of aircraft held under finance leases as at 31 December 2004 is approximately RMB11,999 million (2003: RMB13,310 million) (note 33). Leased assets are pledged as security for the related finance lease liabilities.

As at 31 December 2004, the Group is in the process of applying to obtain the title certificates of certain of its buildings with an aggregate carrying amount of approximately RMB2,178 million, further details of which are set out in note 1 to these financial statements. The Directors of the Company are of the view that the Group is entitled to lawfully and validly occupy and use the above-mentioned 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 31 December 2004.