

## Report of the Directors

The directors present their annual report and the audited financial statements for the year ended 31 December 2004 (the "Reporting Period").

### PRINCIPAL ACTIVITIES

The Group is principally engaged in the manufacture and sale of refrigerators and air-conditioners.

### RESULTS AND APPROPRIATIONS

Details of the results of the Group for the year are set out in the consolidated income statement on page 21.

The directors do not recommend the payment of a dividend.

### LIQUIDITY AND SOURCES OF FUNDS

Net cash inflow for operating activities was approximately RMB578,992,000 (2003: net cash outflow of approximately RMB6,495,000) for the year ended 31 December 2004.

As at 31 December 2004, the Company had bank deposits and cash (including pledged bank balances) amounting to approximately RMB2,320,121,000 (2003: RMB2,120,039,000), and bank loans amounting to approximately RMB3,368,168,000 (2003: RMB3,166,538,000).

Total capital expenditures for the year 2004 amounted to approximately RMB666,580,000 (2003: RMB289,412,000) and the major expenditure item was the purchase of new equipment for operating purpose and fixtures for promotion purpose. The capital expenditures were funded by the working capital of the Group.

### HUMAN RESOURCE AND EMPLOYEES' REMUNERATION

As at 31 December 2004, the Group had approximately 24,700 employees, mainly comprising 1,160 technical staff, 5,560 sales representatives, 450 financial staff, 1,310 administrative staff and 16,200 production staff. 18 of the Company's employees hold a doctorate degree while 460 and 2,970 hold a master degree and a bachelor degree respectively. There were 860 employees with an official title of middle rank or above. In addition, the Company currently has 73 resigned or retired staff. Staff cost for the year ended 31 December 2004 amounted to approximately RMB497,174,000 (2003: RMB412,227,000).

### CHARGES ON THE GROUP'S ASSETS

As at 31 December 2004, the Group's property, plant and equipment of approximately RMB726,597,000 (2003: RMB1,067,711,000) were pledged as security for the Group's bank borrowings.

### EXPOSURE TO EXCHANGE RATE FLUCTUATION

Since substantially all of the Group's sales and purchases were denominated in Renminbi, the Group had no significant exposure to exchange rate fluctuation and no financial instrument was used to hedge exchange rate risk.

## Report of the Directors

### **PUBLIC FLOAT**

As at 28 April 2005, the Directors acknowledge that based on publicly available information and within the knowledge of the Directors, 25% or above of the total issued share capital of the Company are held by the public. Therefore, the public float of the Company satisfies the requirements stipulated under the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (the "Listing Rules").

### **CONTINGENT LIABILITIES**

As at 31 December 2004, the Group had no material contingent liabilities (As at 31 December 2003, the Group had no material contingent liabilities).

### **MATERIAL LITIGATION**

As at 31 December 2004, the Group was not involved in any material litigation.

### **AUDIT COMMITTEE**

The Audit Committee of the Company has reviewed the final result announcement and report for the year ended 31 December 2004.

### **CAPITAL EXPENDITURE**

The Group expects that the capital expenditure for 2005 to be approximately RMB0.3675 billion, and the Group's capital resources are sufficient to finance its capital expenditure and day to day operating requirements.

### **TRUST DEPOSITS**

As at 31 December 2004, the Company did not own any trust deposit in any financial institution in the PRC. All of the Company's deposits are placed with the commercial banks in the PRC and Hong Kong and the Group has not encountered any difficulty in withdrawing the deposits.

### **LIQUIDITY, FINANCIAL RESOURCES AND CAPITAL STRUCTURE**

As at 31 December 2004, the Group had long-term bank borrowings of RMB16,723,000 (2003: RMB19,354,000) and cash and cash equivalents of RMB1,017,534,000 (2003: RMB726,905,000), of which over 90% are denominated in RMB.

### **GEARING RATIO**

As at 31 December 2004, there are no significant adverse changes to the Group's gearing ratio (total bank borrowing/ shareholders equity) as compared with last year. The gearing ratio of the Group was 122%.

## **PROPERTY, PLANT AND EQUIPMENT**

During the year, the Group spent approximately RMB667 million on acquisition of property, plant and equipment. The details of the movements in property, plant and equipment of the Group during the year are set out in note 14 to the financial statements.

## **PENSION SCHEMES**

Details of the Group's pension schemes for the year ended 31 December 2004 are set out in note 33 to the financial statements.

## **RESERVES**

Details of movements in reserves of the Group during the year 2004 are set out in page 24 of the financial statements.

## **DISTRIBUTABLE RESERVES**

Distributable reserves of the Company as at 31 December 2004 amounted to RMB105,265,000.

## **DIRECTORS AND SUPERVISORS**

The directors and supervisors of the Company during the year and up to the date of this report were as follows:

### **Executive directors:**

Gu Chu Jun, Chairman  
Liu Cong Meng  
Li Zhen Hua  
Yan You Song  
Zhang Hong  
Fang Zhi Guo

### **Independent non-executive directors:**

Chan Pei Cheong, Andy  
Li Kung Man  
Xu Xiao Lu

### **Supervisors:**

Jiang Bao Jun  
Zeng Jun Hong  
He Si  
Bai Yun Feng

Details of the profile of the directors, supervisors and senior management are set out on page 17 to page 20.

## Report of the Directors

### INDEPENDENCE OF THE INDEPENDENT NON-EXECUTIVE DIRECTORS

The Board of Directors have received written confirmations from all of the independent non-executive directors in respect of their independence in accordance with the requirements provided under Rule 3.13 of the Listing Rules, and consider that all the existing independent non-executive directors are in compliance with the relevant guidelines under Rule 3.13 of the Listing Rules and are still independent persons.

### INTERESTS IN CONTRACTS OF DIRECTORS AND SUPERVISORS

All Directors and Supervisors have entered into service contracts with the Company for a term of three years which may be renewed by re-engagement or re-election. The Company has not entered into any service contracts with the Directors or Supervisors who will be proposed for re-election at the Company's 2004 annual general meeting, which is not determinable by the Company within one year without payment of compensation (other than statutory compensation).

Save as disclosed in this annual report, as at 31 December 2004 or during the year 2004, no Director or Supervisor was materially interested, either directly or indirectly, in any contract of significance.

### DIRECTORS' AND SUPERVISORS' INTERESTS IN CONNECTED AND RELATED PARTY TRANSACTIONS

The independent non-executive directors have reviewed the related party transactions as set out in note 44 to the financial statements, and confirmed that these transactions had been transacted on normal commercial terms and in the ordinary course of business of the Group.

### MODEL CODE FOR SECURITIES TRANSACTIONS BY DIRECTORS AND SUPERVISORS

The Company has adopted the Model Code for Securities Transactions by Directors of Listed Issuers in Appendix 10 of the Listing Rules of the Stock Exchange as the code of securities transactions of the Directors and Supervisors; after specific enquiries made to all Directors and Supervisors, the Company found that all the Directors and Supervisors of the Company have complied with the code for securities transactions of the Directors in the reporting period.

### SHARE CAPITAL STRUCTURE

As of 31 December 2004, the share capital structure of the Company was as follows:

	Number of Shares	Percentage of total issued share capital (%)
Domestic shares	337,915,755	34.06
H shares	459,589,808	46.33
A shares	194,501,000	19.61
Total	992,006,563	100.00

**TOP TEN/SUBSTANTIAL SHAREHOLDERS**

- I. As at 31 December 2004, there were 70,520 shareholders in total, of which the top ten/substantial shareholders were as follows:

Names of Shareholders (full name)	Increase/decrease during the Period	Shareholdings at the end of the period	Proportion to total share capital (%)	Share class (listed or unlisted)	Nature of Shares
Guangdong Greencool Enterprise Development Company Limited	+57,436,439	262,212,194	26.43%	Unlisted	Domestic Legal Person Shares
The Hongkong and Shanghai Banking Corporation Ltd.	+433,537	109,957,896	11.08%	Listed	H Shares
Shunde Economic Consultancy Company	0	68,666,667	6.92%	Unlisted	Domestic Legal Person Shares
Guotai Junan Securities (Hong Kong) Limited	+2,755,000	47,864,000	4.82%	Listed	H Shares
HSBC NOMINEES (HONG KONG) LIMITED	+20,000	40,106,904	4.04%	Listed	H Shares
Shenyin Wanguo Securities (H.K.) Limited	+244,000	34,128,000	3.44%	Listed	H Shares
First Shanghai Securities Limited	+5,034,000	32,033,000	3.23%	Listed	H Shares
Standard Chartered Bank (HK) Ltd	-4,891,000	24,435,000	2.46%	Listed	H Shares
Bank of China (Hong Kong) Ltd	+8,179,000	18,692,000	1.88%	Listed	H Shares
Liu Chong Hing Bank Limited	+6,000,000	16,000,000	1.61%	Listed	H Shares

## Descriptions:

- (1) Except those held by top ten the legal person shareholders, all of the shares held by the above top ten shareholders has not been pledged or under freezing orders during the Period. The Company does not know whether any shares held by the other shareholders have been pledged or under freezing orders during the Period.
- (2) Among the top ten shareholders, none of the legal person shareholders is connected with any of the others or is a party acting in concert with any of the others as defined in Administrative Measures for Information Disclosure of the Shareholders of Listed Companies (上市公司股東持股變動信息管理辦法). Furthermore, the Company does not know whether any shareholders is connected with any of the others or is a party acting in concert with any of the others as defined in Administrative Measures for Information Disclosure of the Shareholders of Listed Companies.

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- (3) Foshan Shunde Xinhong Enterprise Company Limited (“Xinhong Enterprise”), a legal person shareholder who holds 5% of issued shares of the Company, entered into a “Legal Person Share Transfer Agreement” with Guangdong Greencool Enterprise Development Company Limited (“Greencool Enterprise”), the Company’s single substantial shareholder on 10 June 2004. Xinhong Enterprise transferred 57,436,439 legal person shares of the Company held by it. The transfer price was RMB1.7 per share, totalling RMB97,641,946.30. The registration procedure of this share transfer was completed on 14 October 2004. The “Share Registration Confirmation (過戶登記確認表)” and “Shareholding Statement (股東擁股信息報表)” from China Securities Depository & Clearing Corporation Limited Shenzhen Branch were received, confirming that the registration procedure of the share transfer of these two companies has been legally completed. After the completion of this share transfer, the number of share of our company held by Greencool Enterprise will increase from 204,775,755 before the transfer to 262,212,194 after the transfer. The percentage of shares held by Greencool Enterprise will also rise from 20.64% of the total issued shares of our company before the transfer to 26.43% after the transfer. Xinhong Enterprise will no longer hold any share of our company.
- (4) The name of the Company’s single major shareholder which was previously known as “順德市格林柯爾企業發展有限公司” has been changed to “廣東格林柯爾企業發展有限公司” on 20 April 2004 because of the change in plotting of administrative zone of Shunde.

### II. Introduction to the controlling shareholder

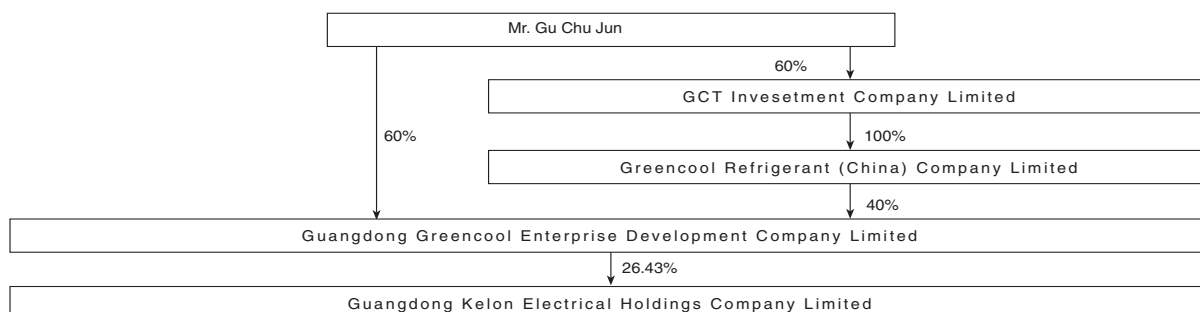
- (1) Greencool Enterprise Development Company Limited, the Company’s single substantial shareholder, was incorporated on 22 October 2001 with a registered capital of RMB 1,200,000,000. Its registered address is 8/F, Rongshan Building, Shunde District, Foshan, Guangdong. The company is primarily engaged in the development, manufacturing and sales of refrigeration equipments and parts and cholrofluorocarbon-free (CFC-free) refrigerants, research and development of refrigerating technology, and the development, manufacturing and sales of computer and broadband networking facilities.

Greencool Enterprise Development Company Limited is a limited corporation jointly invested by Mr. Gu Chu Jun and Greencool Refrigerant (China) Company Limited. Mr. Gu Chu Jun holds its 60% equity interests and Greencool Refrigerant (China) Company Limited holds its 40% equity interests.

Greencool Refrigerant (China) Company Limited is a foreign-invested company incorporated in Tianjin on 3 March 1995 by British Virgin Islands GCT Investment Company Limited, of which Mr. Gu Chu Jun is an absolute controlling shareholder. Greencool Refrigerant (China) Company Limited has a registered capital of US\$ 150,000,000. It is primarily engaged in the development, manufacturing and sales of Gushi refrigerants, various cholrofluorocarbon (CFC) substitutes, new refrigerants, thermal element, thermal cycling intermediate and their respective raw material, and the development, manufacturing and sales of the ancillary equipment and application equipment for the above products.

Mr. Gu Chu Jun, graduated from Tianjin University, the PRC with a master’s degree in engineering. Mr. Gu is the founder of the Greencool Group and the inventor and patent rights holder of Greencool Refrigerants. He is the chairman of Guangdong Greencool Enterprise Development Company Limited, Greencool Refrigerant (China) Company Limited, Yangzhou Yaxing Motor Coach Company Limited, Guangdong Kelon Electrical Holdings Company Limited, Hefei Meiling Company Limited and Greencool Technology Holdings Limited. Mr. Gu has over 20 years of experience in refrigeration engineering and the refrigerant industry. Prior to founding the Greencool Group, he taught at Tianjin University and devoted himself to the research of thermodynamics and refrigeration engineering.

## (2) Relationship between the Company and its Beneficial Controlling Shareholders



(3) There is no change to the controlling shareholders during the Reporting Period.

## III. Shareholdings of the top ten tradable shares shareholders (as at 31 December 2004)

Name of shareholders (full name)	Number of listed shares at the end of the year	Class (A, B, H share or others)
The Hongkong and Shanghai Banking Corporation Ltd.	109,957,896	H Shares
Guotai Junan Securities (Hong Kong) Limited	47,864,000	H Shares
HSBC NOMINEES (HONG KONG) LIMITED	40,106,904	H Shares
Shenyin Wanguo Securities (H.K.) Limited	34,128,000	H Shares
First Shanghai Securities Limited	32,033,000	H Shares
Standard Chartered Bank (HK) Ltd	24,435,000	H Shares
Bank of China (Hong Kong) Ltd	18,692,000	H Shares
Liu Chong Hing Bank Limited	16,000,000	H Shares
Dah Sing Bank, Ltd.	15,000,000	H Shares
Citibank, N.A.	10,471,484	H Shares

Description: The Company does not know whether any one of the top ten tradable shares shareholders is connected with any one of the other nine nor any one of them is a party acting in concert with any one of the other nine as defined in Administrative Measures for Information Disclosure of the Shareholders of Listed Companies.

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### SUBSTANTIAL SHAREHOLDERS

At 31 December 2004, as shown in the register of substantial shareholders kept according to Section 336 under the Securities and Futures Ordinance, the following shareholders maintain long positions in the issued shares of the Company:

Names of Shareholders	Nature of Shares	Number of issued ordinary shares held	Percentage of the Group's related issued shares	Proportion to total share capital
Guangdong Greencool Enterprise Development Company Limited	Domestic legal person shares	262,212,194	77.60%	26.43%
The Hongkong and Shanghai Banking Corporation Ltd.	H shares	109,957,896	23.93%	11.08%
Shunde Economic Consultancy Company	Domestic legal person shares	68,666,667	20.32%	6.92%
Guotai Junan Securities (Hong Kong) Limited	H shares	47,864,000	10.41%	4.82%
HSBC Nominees (Hong Kong) Limited	H shares	40,106,904	8.73%	4.04%
Shenyin Wanguo Securities (H.K.) Limited	H shares	34,128,000	7.43%	3.44%
First Shanghai Securities Limited	H shares	32,033,000	6.97%	3.23%
Standard Chartered Bank (HK) Ltd	H shares	24,435,000	5.32%	2.46%

Save as the abovementioned, the Company is not aware of other long or short positions in the issued shares of the Company being held as at 31 December 2004 as recorded in the register of substantial shareholders kept according to Section 336 of the Securities and Futures Ordinance.

### INTERESTS OF DIRECTORS, SUPERVISORS AND CHIEF EXECUTIVE

As at 31 December 2004, the interests and short positions of the directors, supervisors and the chief executive of the Company and their associates in the shares and underlying shares of the Company and its associated corporations, as recorded in the register maintained by the Company pursuant to Section 352 of the Securities and Futures Ordinance ("SFO"), or as otherwise notified to the Company and the Stock Exchange pursuant to the Model Code for Securities Transactions by Directors of Listed Companies, were as follows:



Name	Capacity	Number of issued ordinary shares held	Percentage of the relevant class of issued share capital of the Company	Percentage of the total issued share capital of the Company
Gu Chu Jun	Held by controlled corporation	262,212,194 legal person shares (note a)	77.60%	26.43%
	Held by controlled corporation	3,830,000 H shares (note b)	0.83%	0.39%
He Si	Beneficial owner	50,000 A shares	0.03%	0.005%

Notes:

- (a) Gu Chu Jun owns a 60% equity interest in Guangdong Greencool Enterprise Development Company Limited, a limited liability company established in the People's Republic of China and the single largest shareholder of the Company. Greencool owned 262,212,194 legal person shares in the Company as at 31 December 2004.
- (b) Gu Chu Jun owns approximately 62.5% of the issued share capital of Greencool Technology Holdings Limited ("Greencool Technology"), a company listed on the Growth Enterprise Market of the Stock Exchange. Two subsidiaries of Greencool Technology held together 3,830,000 H shares in the Company as at 31 December 2004.

Other than as disclosed above, none of the directors, supervisors, chief executive nor their associates had any interests or short positions in any shares, underlying shares or debentures of the Company or any of its associated corporations as at 31 December 2004.

## DIRECTORS' AND SUPERVISORS' RIGHTS TO ACQUIRE SHARES OR DEBENTURES

At no time during the year 2004 was the Company or any of its subsidiaries, a party to any arrangements to enable the directors and supervisors of the Company to acquire benefits by means of the acquisition of shares in, or debentures of, the Company or any other body corporate.

## MAJOR CUSTOMERS AND SUPPLIERS

Aggregate sales attributable to the Group's five largest customers were less than 30% of total turnover.

Aggregate purchases attributable to the Group's five largest suppliers were less than 30% of total purchases.

During the year ended 31 December 2004, the aggregate amount of the Company's purchases from the top five suppliers was 835,796,000, which represents 11 percent of total purchase amount of the Company for the year and the aggregate sales amount of the top five sales customers was 1,016,005,821, which represents 16 percent of total sales amount of the Company for the year.

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### PURCHASE, SALE OR REDEMPTION OF SHARES

During the year ended 31 December 2004, neither the Company nor any of its subsidiaries had purchased, sold, redeemed or cancelled any of the Company's listed shares.

### PRE-EMPTIVE RIGHTS

There is no provision for pre-emptive rights under the Company's Articles of Association.

### CORPORATE GOVERNANCE

The Company has complied throughout the year ended 31 December 2004 with the Code of Best Practice as set out in Appendix 14 of the Listing Rules then in force prior to 1 January 2005.

In accordance with Rules 3.13 of the Listing Rules and based on the independent confirmation received by the company from independent non-executive directors, the Company is of opinion that all independent non-executive directors were independent.

### TAX RELIEF AND EXEMPTION

The Company is not aware of any particulars of tax relief and exemption available to shareholders by reason of their holding of the Company's H shares.

### AUDITORS

Messrs. Deloitte Touche Tohmatsu Certified Public Accountants Ltd. and Messrs. Deloitte Touche Tohmatsu have acted as the auditors of the Company for the PRC and international reporting purposes respectively for the three years ended 31 December 2004.

### Operation during the period

#### 1. *Scope of primary operations and the operations*

The Company is principally engaged the development, manufacturing domestic and over-seas sales and provision of after-sales services of electrical home appliances and the relevant components and products of refrigerators, air conditioners, freezers and small size electrical home appliances.

#### 2. *Analysis of income and profit from the primary operations of the Group by geographic and product segments*

##### (1) Income and profit from primary operations by geographic segments

Operation indicators	Income from	(Unit: RMB)
	primary operations ( '000)	Increase (%)
Domestic market	5,096,240	20.75%
Overseas market	3,340,164	71.49%
Total	8,436,404	36.77%

**Operation during the period (continued)**2. *Analysis of income and profit from the primary operations of the Company by geographic and product segments (continued)*

## (2) Primary businesses and products

Primary products	Income from sale of products (‘000)	Cost of sale of products (‘000)	(Unit: RMB)
			Gross Profit Ratio (%)
Refrigerators	3,274,329	2,462,876	24.78%
Air Conditioners	4,501,234	3,584,784	20.36%
Freezers	335,890	278,588	17.06%
Others	324,951	286,028	11.98%

3. *Operations and results of the major controlling companies and associates*

Major controlling companies or associates	Interest (%)	Nature of business	Principal products or services	Registered capital	Scale of assets (RMB)	Net profit (loss) (RMB)
Guangdong Kelon Refrigerator Ltd.	100%	Manufacturing	Manufacture and sale of refrigerators	US\$26,800,000	1,996,416,633	95,170,944
Guangdong Kelon Air-Conditioner Co., Ltd.	60%	Manufacturing	Manufacture and sale of air-conditioners	US\$36,150,000	2,281,465,196	166,573,713
Guangdong Kelon Fittings Co., Ltd.	100%	Manufacturing	Manufacture and sale of components of air-conditioners and refrigerators	US\$5,620,000	372,646,876	8,770,592
Guangdong Kelon Mould Co., Ltd.	70%	Manufacturing	Manufacture of moulds	US\$15,000,000	170,151,962	9,056,365
Shunde Rongsheng Plastic Products Co., Ltd.	70%	Manufacturing	Manufacture of plastic components	US\$15,800,000	327,630,146	305,085
Guangdong Kelon Refrigerator Co., Ltd.	100%	Manufacturing	Manufacture and sale of refrigerators	RMB237,000,000	380,188,452	5,483,532
Shunde Jiake Electronic Company Limited	100%	Manufacturing	IT and communication technology, and micro-electronics technology development	RMB60,000,000	53,538,135	(4,500,915)
Shunde Wangao Import & Export Co., Ltd.	100%	Import and export	Import and export business	RMB3,000,000	118,616,490	(9,639,753)

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### Operation during the period (continued)

#### 3. Operations and results of the major controlling companies and associates (continued)

Major controlling companies or associates	Interest (%)	Nature of business	Principal products or services	Registered capital	Scale of assets RMB	Net profit RMB
Shunde Kelon Household Electrical Appliance Company Limited	100%	Manufacturing	Manufacture and Electrical Appliance household appliances	RMB10,000,000	87,259,809	(13,837,114)
Huayi Compressor Holdings Company Limited	22.725%	Manufacturing	Manufacture and sale of compressors	RMB260,854,000	1,743,974,567	7,729,965

### Investments of the Company during the period

- During the period, there was no application of raised funds nor was there an application of raised funds in the previous period that continued through to the period.
- Progress on and revenue from significant investments made by the Company without raising funds
  - As at the end of the period, Hangzhou Kelon Electric Co. Ltd. (杭州科龍電器有限公司) and Kaifeng Kelon Air-conditioners Co. Ltd. (開封科龍空調有限責任公司) commenced production.
  - As at the end of the period, the second phase expansion project of Shangqiu Kelon Electric Co. Ltd. (商丘科龍電器有限公司) was in progress.
  - As at the end of the period, over half of the projected investment of Zhuhai Kelon Development Co. Ltd. (珠海科龍實業發展有限公司) was completed and its trial production is expected to be commenced in June 2005.
  - As at the end of the period, the first phase infrastructure project of Yangzhou Kelon Electrical Company Limited (揚州科龍電器有限公司) was entirely completed. The production equipment is gradually entering into the trial production stage.
  - As at the end of the period, Jiangxi Kelon Industrial Development Co., Ltd. (江西科龍實業發展有限公司) duly commenced production.
  - On 27 October 2004, the Company and its wholly owned subsidiary, Kelon Development Company Limited ("Kelon Development") entered into a Joint Venture Contract with Zhongshan Municipal 阜沙鎮順暢工業有限公司 ("順暢公司") at Zhongshan Municipal, Guangdong Province in order to jointly establish 廣東科龍威力電器有限公司 ("科龍威力公司"). Thereafter, the Company entered into the field of washing machines. As at the end of the period, 科龍威力公司 was still at the start-up production stage.

**Financial position and operation results during the period**

(Prepared in accordance with PRC GAAP)

Item	31 December 2004	31 December 2003	<i>Unit: RMB</i> <b>Increase/ Decrease</b> (%)
Total assets	11,361,393,597	9,501,441,214	19.58%
Shareholders' equity	2,803,156,761	2,808,730,941	(0.20)%
Profit derived from primary operations	1,823,967,815	1,684,544,880	8.28%
Net (loss) profit	(64,160,206)	202,180,248	(131.73)%
Net increase in cash and cash equivalents	290,628,826	40,266,536	621.76%

**Deloitte Touche Tohmatsu has issued an auditors' report for the Company which contains its qualified opinions. The Board of the Company explained the matters relating to the auditors' opinion in detail as follows:**

The Company's sales for the year 2004 is RMB8,400,000,000, including sales of inventory of approximately RMB 570,000,000 (approximately RMB59,000,000 of refrigerators and RMB511,000,000 of air-conditioners) recognized after adjustment for auditing purpose. These products were delivered before 31 December 2004 according to the sales contracts. The customers will pay the receivables by stages in credit terms of six months as agreed in the sales contracts. As a practice of the previous years, the Company has adjusted delivered inventories (goods delivered to customers) out of warehouse before 31 December 2004 as sales revenue for the year 2004.

Based on the average gross margin, the effect of these delivered goods on the gross profit is about RMB 123,000,000.

The auditor of the Company considers that the sale amounting to RMB0.57 billion was generated from two customers within the territory of the PRC, of which RMB0.427 billion occurred in December 2004 and one of the above new customers confirmed the revenue from sale of products amounting to RMB0.297 billion. The auditor failed to receive any direct reply and confirmation from these two customers and failed to confirm the truthfulness of those transactions with such a new customer. Among the entire revenue from sale of products to these two customers in 2004, there existed outstanding receivables amounting RMB0.576 billion and RMB0.556 billion respectively as at 31 December 2004 and on the date of the audit report. Therefore, the auditor was incapable to obtain any sufficient evidence to prove the truthfulness of such revenue or the truthfulness of the trade receivables relating to such revenue of the Company in its combined balance sheet as at 31 December 2004 and was not able to confirm whether there existed no significant errors in the income from the combined principal operations and the trade receivables of the Company as at 31 December 2004.

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The Company's auditor made an actual site inspection to one of the customers on 23 March 2005. Regarding the confirmation issued by the auditor, another customer failed to return to the auditor prior to the completion of auditing by postal cause. The Company had arranged the auditor to resend such confirmation and it is expected that the confirmation will be collected in short period upon the end of preparation of the financial statement for 2004.

Due to the requirements from the expansion of sales channels, the Company attempts to cultivate a group of large scale customers, the risks generated from which may be under control of the Company. The grant of sales credit within a certain limits by the Company is a kind of comprehensive credit for the major customers in the region. It is a general custom practice and a successful mean in the industry and is critical and essential to the rapid growth of the Company.

The Board of Directors of the Company considers that the Company has provided such documents as sales contracts, out-of-warehouse documents and market analysis upon request of the auditor in accordance with the practice of the Company and sales practice in the industry, and that no risk or mistake is involved in the sales to such customers. Furthermore, this mode of sales was recognized in the previous years. As such, the Board of Directors cannot understand such judgment.

Since these are sales on credit in which the Company provides its customers with credit terms of 6 months, most of the account receivables were undue at the date of the 2004 financial statement. As the amounts become due and are recovered by stages, the sales will complete and their effect and the related amount RMB 570,000,000 as at December 2004 can be confirmed. The Company believes that the qualified opinion can be removed accordingly.

In 2004 the total amount of returned goods to the Company was RMB0.2 billion, approximately RMB0.12 billion of which was attributable to a single customer. This sum of RMB0.2 billion had offset the full amount of the 2004 sales revenue.

In view of the returned goods of RMB0.2 billion, the auditor of the Company, concerned about the possibility that in 2005 large amounts of goods sold in 2004 would be returned, has requested for the provision for returned goods.

The Board has noted that in 2004 the total amount of returned goods to the Company was RMB0.2 billion, RMB0.12 billion of which was attributable to a single customer. The returned goods of the customer resulted from the commission by the Company to repurchase products of the Company which flooded the market, in an attempt of the Company to stabilize regional prizes. Besides the amount attributable to the above-mentioned customer, the ratio of other returned goods was 0.9%. For the period from 1 January 2005 to 20 April 2005, the total amount of returned goods to the Company was only RMB12 million. Moreover, in the new year of sales, the Company has strengthened its monitoring over market prices. Therefore, the Board considers it not necessary to make provision for returned goods.

## Work progress of the Board of Directors

### 1. Meetings held by the board of directors during the period

During the period, the board of directors of the Company has held four meetings.

- (1) The Company held a meeting at the Conference Room at the Company's head office on 19 April 2004. The meeting was attended by all of the nine directors of the Company, 2 of which attended the meeting by way of telephone conference. During which the Company's audited financial statements for the year 2003, the text and the summary of the Company's annual report for the year 2003, the profit distribution proposal of the Company for the year 2003, the reappointment of Messrs. Deloitte Touche Tohmatsu Certified Public Accountants Ltd. and Messrs. Deloitte Touche Tohmatsu as the Company's domestic and offshore auditors for the 2004 financial year, the proposed amendments to the Company's Articles of Association, the «The Rules and Regulations Governing Directors' Meetings» and «The Rules and Regulations Governing Shareholders' Meetings», the convening date for the 2003 AGM was fixed on 19 June 2004 and the agenda and notice of AGM, the Company's first quarterly report for the year 2004 had been considered and approved.
- (2) The Company held a meeting at the conference room at the head office of the Company on 20 August 2004. All nine directors of the Company attended the meeting, amongst them, the executive directors Mr. Gu Chu Jun, Mr. Fang Zhi Guo and Mr. Zhang Hong attended and voted at the meeting by way of telephone conference. During which, the text and summary of the 2004 interim results and the profit distribution proposal for the interim period of 2004 were considered and approved.
- (3) The Company held a meeting at the conference room at the head office of the Company on 27 October 2004. All nine directors of the Company attended the meeting, amongst them, the independent non-executive directors Mr. Chan Pei Cheong, Mr. Li Kung Man and Mr. Xu Xiao Lu attended and voted at the meeting by way of telephone conference. During which, the third quarter report of 2004 and the "Joint Venture Agreement of Guangdong Kelon Weili Electrical Home Appliances Company Limited" were considered and approved.
- (4) The Company held a board meeting by way of written resolutions on 26 November 2004. All nine directors of the Company attended the meeting. During which the resolutions for the re-election of the board of directors and the nominees for the members of the fifth session of the board of directors, the resolution to be submitted to the first 2005 extraordinary general meeting for the authorization of the board of directors to use internal resources to repurchase H Shares, notices for the convening of the first 2005 extraordinary general meeting, the first 2005 extraordinary general meeting for domestic shares and the first 2005 extraordinary general meeting for H shares were considered and approved.

## Report of the Directors

### 2. *The execution of the resolutions by the board of directors*

During the reporting period, the board of directors of the Company has fully implemented the resolutions passed at the shareholders' meeting by strictly adhering to the Articles of Association, the Company Law and powers conferred by the Shareholders' meeting of the Company.

### **Other discloseable matters**

#### 1. Specific explanation of 德勤華永會計師事務所有限公司 on the use of funds by the contoured shareholders of the Company and other related parties:

Specific explanation on the use of funds by the controlling shareholders of Guangdong Kelon Electrical Holdings Company Limited and other related parties

To the Board of Directors of Guangdong Kelon Electrical Holdings Company Limited

We have been appointed to carry out the audit of the balance sheets of Guangdong Kelon Electrical Holdings Company Limited (the "Company") and the Group as at 31 December 2004 and the Statement of Income and Profit Appropriation and Cash Flow Statement of the Company and the Group for the year 2004 in accordance with Independent Auditing Standards for Chinese Certificated Public Accountants and issued an qualified auditor's report, document number De Shi Bao (Shen) Zi (05) P5Z004 on 28 April 2005.

According to the requirements of "Notice of Issues in Relation to Regulating Capital Exchange between Listed Companies and Related Parties and Listed Companies' Guarantee for Other Parties" promulgated by the China Securities Regulatory Commission and the State-owned Assets Regulatory Commission under State Council Regulatory Commission, the Company prepared a report on the Company's use of fund (the "Report") for the year ended 31 December 2004 annexed in this letter.

The Company is responsible for the preparation and the disclosure of the Report and shall ensure its accuracy, legality and the completeness. We have reconciled the information provided in the Report with the accounting information reviewed in connection with our audit of the Company's financial statements for the year 2004 and the relevant information as stated in the audited financial reports, no significant discrepancy is found. Save as the audit on the related parties transactions carried out in connection with our audit to the financial statements for the year 2004, we did not carry out additional audit procedures for the information provided in the Report.

This letter is solely prepared for the purpose of reporting to China Securities Regulatory Commission in relation to the use of funds by the controlling shareholders of the Company and other related parties for the year of 2004 and shall not be used for any other purpose without our prior written consent.



## Appendix I Report on the use of fund by Guangdong Kelon Electrical Holdings Company Limited

Amount: in ten thousand

Use of fund	Name of related parties	Relationship	Amount	Accounting category	Year-end balance	Remarks
Assigned loan	Nil	Nil	Nil	Nil	Nil	Nil
Assigned investments by related parties	Nil	Nil	Nil	Nil	Nil	Nil
Issue of commercial bills of acceptance with no substantial transactions	Nil	Nil	Nil	Nil	Nil	Nil
Repayment of loans	Nil	Nil	Nil	Nil	Nil	Nil
Others (such as advances)	Nil	Nil	Nil	Nil	Nil	Nil

Deloitte Touche Tohmatsu  
CPA Ltd.  
Shanghai, China  
28 April 2005

### 2. Specific independent opinions by the independent non-executive directors of the Company regarding external guarantees

Specific independent opinions

By the independent non-executive directors of Guangdong Kelon Electrical Holdings Company Limited  
Regarding the accumulated and current external guarantees of the Company.

In accordance with the regulations and requirements of the "Notice Concerning the Regulation on the Flow of Funds between Listed Companies and their Connected Parties and the Provision of Security by Listed Companies to external Parties" (Zhengjian 2003 No.56) issued by the China Securities Regulatory Commission, we, have carried out a bona fides due diligence and careful investigation on the security provided by Guangdong Kelon Electrical Holdings Company Limited to external parties, details of which are reported as follows:

- (1) During the reporting period, the Company did not provided guarantees to its controlling shareholders, other related parties in which the Company held less than 50% interests, non legal entities or individuals;

## Report of the Directors

- (2) During the reporting period, the aggregated guarantees provided by the Company to external parties did not exceed 50% of the amount of net assets as stated in the latest published combined financial statements;
- (3) The accumulated and current external security of the Company amounted to RMB11,121,600. The total accumulated external security of RMB48,940,000 was provided in favour of Jiaxipera (加西貝拉壓縮機有限公司), the subsidiary of Huayi Compressor Holding Company Limited in which the Company holds a 22.725% equity interest. Therefore, the external security of the Company amounted to RMB11,121,600; and
- (4) The Company has amended the Articles of Association in response to the demand of the securities regulatory authorities. New articles were added to govern the procedures, powers and limitation regarding the grants of external guarantees, and the assets and liabilities level of the beneficiaries of guarantees. The amended Articles of Association also provided that any guarantees granted to external parties shall obtain the consent and signed by more than two-third of all the members of the board of directors or shall be approved at the general meeting and no guarantees shall be provided to any entities with an asset-liability ratio of over 70%, so as to minimize the exposure of external guarantees.

*Independent non-executive directors: Mr. Chan Pei Cheong Andy, Mr. Li Kung Man and Mr. Xu Xiao Lu*

By Order of the Board

**Gu Chu Jun**

*Chairman*

Shunde District, Foshan City, Guangdong Province, the PRC, 28 April 2005