

# Report of the Directors

The directors would like to present their report together with the audited accounts for the year ended 31 December 2005.

## PRINCIPAL ACTIVITIES AND GEOGRAPHICAL ANALYSIS OF OPERATIONS

The Company is an investment holding company. The principal activities of the Company and its subsidiaries (collectively the "Group") comprise the manufacturing and sale of portable electronics products. The principal activities of the major subsidiaries are set out in note 8 to the accounts.

An analysis of the Group's performance for the year by business and geographical segments is set out in note 5 to the accounts.

## RESULTS AND APPROPRIATIONS

The results of the Group for the year are set out in the consolidated income statement on page 28 of the annual report.

The directors recommended the payment of a final dividend of HK\$0.02 per share to shareholders whose names appear on the register of members on 19 May 2006.

## PROPERTY, PLANT AND EQUIPMENT

Details of the movements in property, plant and equipment of the Group and of the Company are set out in note 6 to the accounts.

## SHARE CAPITAL

Details of the movements in share capital of the Company are set out in note 12 to the accounts.

## RESERVES

Movements in the reserves of the Group and of the Company during the year are set out in note 13 to the accounts.

## DISTRIBUTABLE RESERVES

Distributable reserves of the Company at 31 December 2005 as calculated under the laws in Bermuda and the Company's bye-laws amounted to HK\$96,374,000 (2004: Nil).

## FIVE YEAR FINANCIAL SUMMARY

A summary of the results and of the assets and liabilities of the Group for the last five financial years is set out on page 68.

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## SHORT-TERM LOANS

Particular of the short-term loans of the Group are set out in note 15 to the accounts.

## BORROWING COSTS

No interest was capitalised by the Group during the year (2004: Nil).

## DIRECTORS

The directors during the year were:

*Non-executive directors*

Yang Xiaotang (*Chairman*)

Tong Baoan (*Vice Chairman*)

*Executive directors*

Fan Qingwu (*Managing Director*)

Hua Longxing

*Independent non-executive directors*

Chan Kay Cheung

Wong Po Yan

Yin Yongli

In accordance with Bye-law 87(1) of the Company's bye-laws, Messrs. Chan Kay Cheung and Wong Po Yan will retire by rotation at the forthcoming annual general meeting and, being eligible, offer themselves for re-election.

The Company has received confirmation from each of the independent non-executive directors as regards their independence to the Company, and considers them to be independent.

None of the directors proposed for re-election at the forthcoming annual general meeting has a service contract which is not determinable by the Company within one year without payment of compensation, other than statutory compensation.

## BIOGRAPHICAL DETAILS OF DIRECTORS

Brief biographies of the directors of the Company are set out on page 13 of the annual report.

## DIRECTORS' AND CHIEF EXECUTIVE'S INTERESTS AND SHORT POSITIONS IN SHARES, UNDERLYING SHARES AND DEBENTURES

As at 31 December 2005, the interests and short positions of the directors and chief executive of the Company in the shares, underlying shares or debentures of the Company or any of its associated corporations (within the meaning of Part XV of the Securities and Futures Ordinance (the "SFO")) as recorded in the register maintained by the Company pursuant to Section 352 of the SFO, or as otherwise notified to the Company and The Stock Exchange of Hong Kong Limited (the "Stock Exchange") pursuant to the Model Code for Securities Transactions by Directors of Listed Companies, were as follows:

### Long position in shares of the Company

| Name of directors | Capacity         | Interest in underlying shares pursuant to share options | Total interest | Approximate percentage of the issued share capital of the Company |
|-------------------|------------------|---------------------------------------------------------|----------------|-------------------------------------------------------------------|
| Yang Xiaotang     | Beneficial owner | 4,000,000                                               | 4,000,000      | 0.37%                                                             |
| Tong Baoan        | Beneficial owner | 3,800,000                                               | 3,800,000      | 0.35%                                                             |
| Fan Qingwu        | Beneficial owner | 3,600,000                                               | 3,600,000      | 0.33%                                                             |
| Hua Longxing      | Beneficial owner | 3,600,000                                               | 3,600,000      | 0.33%                                                             |

Saved as disclosed above, as at 31 December 2005, none of the directors nor the chief executive of the Company and their respective associates had any interests or short positions in the shares, underlying shares or debentures of the Company or any of its associated corporations (within the meaning of Part XV of the SFO) which were recorded in the register maintained by the Company pursuant to Section 352 of the 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.

## SHARE OPTION SCHEME

Pursuant to an ordinary resolution passed on 20 June 2002, the Company adopted a new share option scheme ("Share Option Scheme") to replace an old option scheme. According to the Share Option Scheme, the board of directors of the Company may grant options to any executive and non-executive directors of the Company, full time employees and part-time employees of the Group, advisors, consultants, distributors, suppliers, agents, customers, partners, joint venture partners, promoters, service providers to the Group. The purpose is to provide the participants with the opportunity to acquire proprietary interests in the Company and to encourage participants to work towards enhancing the value of the Company.

The total number of shares which may be issued upon exercise of all options granted and to be granted under the Share Option Scheme must not exceed 108,356,000 ordinary shares, representing 10% of the issued share capital as at the date of the annual report. The number of shares which might be issued upon exercise of all outstanding options granted and yet to be exercised under the Share Option Scheme and any other share option schemes adopted by the Company must not, in aggregate, exceed 30% of the issued share capital of the Company from time to time. The maximum entitlement of each participant in any 12 month period must not exceed 1% of the shares in issue from time to time. No share options were outstanding under the old option scheme.

## Report of the Directors

### SHARE OPTION SCHEME (CONTINUED)

There was no requirement for a grantee to hold the option for a certain period before exercising the option unless otherwise determined by the directors. The exercise period should be any period determined by the board of directors but in any event the exercise period should not later than 10 years from the date of grant. The grantee must accept an option within 21 days from the date of offer by making a non-refundable payment of HK\$1 to the Company.

The subscription price shall be at the discretion of the board of directors provided that it shall be not less than the highest of (i) the closing price of the shares on the date of grant; (ii) the average of the closing prices of the shares for the five business days immediately preceding the date of grant; and (iii) the nominal value of a share on the date of grant. The Share Option Scheme remains in force until 19 June 2012.

Details of the options outstanding during the year were as follows:

| Name                                          | Options outstanding<br>as at 1/1/2005 | Options granted | Options outstanding<br>as at 31/12/2005 |
|-----------------------------------------------|---------------------------------------|-----------------|-----------------------------------------|
| <i>Directors</i>                              |                                       |                 |                                         |
| Yang Xiaotang                                 | –                                     | 4,000,000       | 4,000,000                               |
| Tong Baoan                                    | –                                     | 3,800,000       | 3,800,000                               |
| Fan Qingwu                                    | –                                     | 3,600,000       | 3,600,000                               |
| Hua Longxing                                  | –                                     | 3,600,000       | 3,600,000                               |
| Total                                         | –                                     | 15,000,000      | 15,000,000                              |
| Aggregate of employees and other participants | –                                     | 13,450,000      | 13,450,000                              |
|                                               | –                                     | 28,450,000      | 28,450,000                              |

The options were all granted on 25 October 2005 under the Share Option Scheme. The closing share price immediately before the date of grant was HK\$1.46. The options represent personal interest held by the directors as beneficial owners. Grantees of such options are entitled to exercise the options at a price of HK\$1.488 per share in the following periods:

- (i) in respect of 40% of the options granted, from 1 November 2005 to 31 October 2008;
- (ii) in respect of a further 30% of the options granted, from 1 November 2006 to 31 October 2009; and
- (iii) in respect of the remaining 30% of the options granted, from 1 November 2007 to 31 October 2010.

No options granted under the Share Option Scheme were exercised, lapsed or cancelled during 2005.

The average fair value of the options granted during the year, determined using the Black-Scholes valuation model, was HK\$0.571 per share. The significant inputs into the model were share price of HK\$1.45 at the grant date, exercise price shown above, standard deviation of expected share price returns of 63.6%, average expected life of options of 2.4 years, and annual risk-free interest rate of approximately 4%. The volatility measured at the standard deviation of expected share price returns is based on statistical analysis of daily share prices over one years immediately preceding the grant date. Changes in these subjective input assumptions could materially affect the estimation of the fair value of the options.

## DIRECTORS' RIGHTS TO ACQUIRE SHARES OR DEBENTURES

Save as disclosed above, at no time during the year was the Company, its holding company or any of its subsidiaries or fellow subsidiaries a party to any arrangements to enable the directors of the Company or their respective associates (as defined under the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (the "Listing Rules") to acquire benefits by means of the acquisition of shares in, or debentures of, the Company or any other body corporate.

## DIRECTORS' INTERESTS IN CONTRACTS

No contracts of significance to which the Company, its holding company or any of its subsidiaries or fellow subsidiaries was a party and in which a director of the Company had a material interest, whether directly or indirectly, subsisted at the end of the year or at any time during the year.

## CONNECTED TRANSACTIONS

Details of the connected transactions entered into by the Group during the year are set out below:

### Continuing connected transactions

| <i>Type of transactions</i>                                                                        | <i>Note</i> | <i>Amount<br/>HK\$'000</i> |
|----------------------------------------------------------------------------------------------------|-------------|----------------------------|
| Sales of products, samples and materials and provision of after sales service to the Philips Group | i           | 3,694,588                  |
| Purchases of raw materials from the Philips Group                                                  | ii          | 438,378                    |
| Sales of products, samples and materials to the CEC Group                                          | iii         | 4,804                      |
| Purchases of raw materials from the CEC Group                                                      | iv          | 8,317                      |
| After sales repair and maintenance services by the CEC Group                                       | v           | 1,493                      |
| Provision of canteen services by the CEC Group                                                     | vi          | 11,273                     |
| Fitment and decoration services from the CEC Group                                                 | vii         | 2,459                      |
| Rental arrangement with the CEC Group                                                              | viii        | 7,283                      |
| Processing arrangements with the CEC Group                                                         | ix          | 8,974                      |

Note:

- (i) Koninklijke Philips Electronics N.V. together with its group companies (the "Philips Group"), is a connected person of the Company by virtue of being a substantial shareholder of Shenzhen Sang Fei Consumer Communications Company Limited ("Sang Fei"), the principal operating subsidiary of the Company.

Members of the Philips Group are the major customers of the Group. Sales to the Philips Group were based on a long-term agreement in which the Philips Group was entitled to purchase goods from the Group at a price determined using a "cost plus" basis and with reference to market rates.

- (ii) Members of the Philips Group are the major suppliers of raw materials. Purchases of raw materials from the Philips Group were based on a long term agreement and were carried out in the ordinary course of business and on commercial terms and conditions and with reference to market rates.

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### CONNECTED TRANSACTIONS (CONTINUED)

- (iii) China Electronics Corporation together with its subsidiaries (the "CEC Group") is a connected person of the Company by virtue of being the controlling shareholder of the Company.

Members of the CEC Group are the major customers of the Group. Sales to the CEC Group were based on a business service agreement and were carried out on commercial terms and conditions and with reference to market rates.

- (iv) The Group from time to time purchases raw materials from members of the CEC Group. Purchases of raw materials from the CEC Group were based on a business service agreement and were carried out in the ordinary course of business and on commercial terms and conditions and with reference to market rates.

- (v) The Group engaged Shenzhen SED ARC Co., Ltd. for after sales product repair and maintenance services in respect of its own-branded products. The repair and maintenance services were based on a business service agreement and carried out on commercial terms and conditions and with reference to market rates.

- (vi) Shenzhen Sang Da Baili Electronics Co., Ltd. provides canteen services to the staff of the Group. The canteen services were based on a business service agreement and the fee were calculated by reference to actual consumption and an agreed fixed premium and were on commercial terms and conditions and with reference to market rates.

- (vii) The Group engaged members of the CEC Group to undertake renovation works in connection with the expansion of the Group's production premises. The fitment and decoration services were based on a business service agreement and were on commercial terms and conditions and with reference to market rates.

- (viii) The production facilities and some of the staff quarters of the Group were located within an industrial complex owned by members of the CEC Group. The rentals were based on lease agreements entered into by the relevant parties and the Group and were calculated on commercial terms and conditions and with reference to market rates.

- (ix) The Group secured dedicated processing services of surface mount assembly production lines from members of the CEC Group. The processing services were based on service contracts entered into by the relevant parties and the Group and were carried out on commercial terms and conditions and with reference to market rates.

Pursuant to the resolutions passed in the Company's special general meeting on 14 July 2004 and the written approval obtained from CEC, details of which were included in the circular dated 11 August 2005, the above connected transactions were approved by the independent shareholders of the Company. The Company has subsequently revised the cap in relation to the provision of canteen services from Shenzhen Sang Da Baili Electronics Co., Ltd. Details of which were included in the announcement of the Company dated 6 January 2006.

In the opinion of the independent non-executive directors of the Company, the above transactions were carried out in the ordinary and usual course of business of the Group, on normal commercial terms and were in accordance with the relevant agreements governing them on terms that were fair and reasonable and in the interests of the Group and the shareholders of the Company as a whole.

The auditors have confirmed that the above transactions:

- had been approved by the board of directors of the Company;
- were in accordance with the pricing policies of the Group;
- were entered into in accordance with the terms of the relevant agreements governing such transactions; and
- had not exceeded the cap approved by the board of directors of the Company as described in the circulars of the Company dated 21 June 2004 and 11 August 2005 and the announcement dated 6 January 2006.

## DIRECTORS' INTERESTS IN COMPETING BUSINESS

During the year and up to the date of this report, the following directors of the Company are considered to have interests in businesses which compete or are likely to compete, either directly or indirectly, with the businesses of the Group:

| Name of director          | Name of entity                                  | Principal business of the entity            | Nature of director's interest in the entity |
|---------------------------|-------------------------------------------------|---------------------------------------------|---------------------------------------------|
| Yang Xiaotang<br>(note c) | China Electronics Corporation (note a)          | Investment holdings                         | President and legal representative          |
| Tong Baoan                | China Electronics Corporation (note a)          | Investment holdings                         | Director                                    |
|                           | China Electronics Industry Corporation (note b) | Investment holdings                         | President and legal representative          |
|                           | Shenzhen SED Industry Co., Ltd. (note b)        | Investment holdings                         | Chairman                                    |
| Fan Qingwu                | China Electronics Industry Corporation (note b) | Investment holdings                         | Vice president                              |
|                           | CEC Wireless R&D Co. Ltd. (note d)              | Research and development of mobile handsets | Director                                    |

Note:

- (a) China Electronics Corporation ("CEC") is the controlling shareholder of the Company. CEC is a state-owned nationwide electronics and information technology conglomerate established under the laws of the People's Republic of China, and has other subsidiaries and associates engaged in mobile handset related businesses which compete or are likely to compete with the business of the Group.
- (b) China Electronics Industry Corporation and Shenzhen SED Industry Co., Ltd. have subsidiaries or associates engaged in the mobile handset related businesses which compete or are likely to compete with the business of the Group. China Electronics Industry Corporation is wholly owned by CEC. Shenzhen SED Industry Co., Ltd. is a company whose A shares are listed on the Shenzhen Stock Exchange and is indirectly owned as to approximately 55.34% by CEC as at the date of this report.
- (c) Mr. Yang has ceased to be the president of CEC as at the date of this report.
- (d) CEC Wireless R&D Co. Ltd. has ceased to be a subsidiary of CEC as at the date of this report.

The abovementioned competing businesses are operated and managed by independent management and administration. In addition, the directors of the Company consider that the business model of and markets served by the Group are different from those companies. The board of the Company can exercise independent judgement and is always acting for the interests of the Company and its shareholders as a whole. Accordingly, the Group is capable of carrying on its businesses independently of, and at arm's length from, the competing businesses mentioned above.

# Report of the Directors

## SUBSTANTIAL SHAREHOLDERS

As at 31 December 2005, the register of substantial shareholders maintained by the Company pursuant to Section 336 of the SFO showed that the following shareholders had notified the Company of relevant interests in the issued capital of the Company.

| Name of shareholder                                                      | Number of shares held | Percentage of shareholding |
|--------------------------------------------------------------------------|-----------------------|----------------------------|
| China Electronics Corporation (BVI) Holdings Company Limited ("CEC BVI") | 812,500,000           | 74.98%                     |
| CEC (Note 1)                                                             | 812,500,000           | 74.98%                     |
| Devon Fortune Limited ("Devon Fortune")                                  | 91,421,608            | 8.43%                      |
| Chan Chak Shing (Note 2)                                                 | 95,546,608            | 8.81%                      |

Note:

- (1) CEC holds 100% interest in CEC BVI and is deemed to be interested in the shares held by CEC BVI. The directors regard CEC as being the ultimate holding company of the Group.
- (2) This number of shares represents the aggregate of (i) Mr. Chan Chak Shing's family interest of 4,125,000 shares and (ii) corporate interest of 91,421,608 shares held by Devon Fortune. As Mr. Chan Chak Shing holds 100% interest in Devon Fortune, the interests of Devon Fortune are deemed to be the interests of Mr. Chan Chak Shing.

All the interests disclosed above represent long position in the shares of the Company.

Save as disclosed above, as at 31 December 2005, no person or corporation had any interest or short position in the shares or underlying shares of the Company as recorded in the register required to be kept under Section 336 of the SFO.

## PRE-EMPTIVE RIGHTS

There is no provision for pre-emptive rights under the Company's bye-laws or the laws in Bermuda.

## PURCHASE, SALE OR REDEMPTION OF SECURITIES

The Company has not redeemed any of its shares during the year. Neither the Company nor any of its subsidiaries has purchased or sold any of the Company's shares during the year.

## MAJOR CUSTOMERS AND SUPPLIERS

During the year, the percentages of sales for the year attributable to the Group's major customers are as follows:

|       |                                 |     |
|-------|---------------------------------|-----|
| Sales |                                 |     |
| –     | the largest customer            | 38% |
| –     | five largest customers combined | 83% |



The percentages of purchases for the year attributable to the Group's major suppliers are as follows:

Purchases

|                                   |     |
|-----------------------------------|-----|
| – the largest supplier            | 9%  |
| – five largest suppliers combined | 36% |

Philips Group is the beneficial owner of four of the five largest customers and one of the five largest suppliers of the Group. Details of the transactions are set out in the section headed "Connected Transactions" above.

None of the directors, their associates or any shareholder (which to the knowledge of the directors owns more than 5% of the Company's share capital) had an interest in the major customers or suppliers noted above.

### DISCLOSURE PURSUANT TO RULE 13.20 OF THE LISTING RULES

As at 31 December 2005, the Group had in aggregate approximately HK\$947 million (RMB985 million) due from members of the Philips Group. The receivables were mainly trade balances which arose from sales of products including goods, samples and materials in the ordinary course of business of the Group with a small amount which represented reimbursement for taxation and administrative expenses paid during the year by the Group. Such amounts are to be settled in accordance with normal trade credit terms ranging from 45 to 60 days after invoice and are interest-free within credit period. The receivables are mainly covered then by bank guarantee or by documents against acceptance arrangements.

The Philips Group is a connected person of the Company by virtue of being a substantial shareholder of the Sang Fei, the principal operating subsidiary of the Company. Details of the transactions are set out in the section headed "Connected Transactions" above.

Save as disclosed above, there is no other disclosure required to be made by the Company pursuant to Rule 13.20 of the Listing Rules.

### PUBLIC FLOAT

Based on the information that is publicly available to the Company and within the knowledge of the directors of the Company, as at the date of this report, the Company has maintained the prescribed public float under the Listing Rules.

# Report of the Directors

## AUDIT COMMITTEE

The audit committee comprises Messrs. Chan Kay Cheung, Wong Po Yan and Yin Yongli, who are independent non-executive directors of the Company. The audit committee examined the accounting principles and practices adopted by the Group and discussed with management its internal controls and accounts. During the year, the audit committee has reviewed the unaudited interim accounts for the six months ended 30 June 2005 and the audited accounts for the year ended 31 December 2005.

## AUDITORS

The accounts have been audited by PricewaterhouseCoopers who retire and, being eligible, offer themselves for reappointment.

On behalf of the Board

**Yang Xiaotang**

*Chairman*

Hong Kong, 10 April 2006