



The board of directors of AviChina Industry & Technology Company Limited presents its report of the directors together with the audited financial statements of the Group for the year ended 31st December 2005.

## BUSINESS OF THE GROUP

The Group is principally engaged in the research, development, manufacture and sale of vehicles and civil aviation products.

## RESULTS AND DIVIDEND

The results of the Group in 2005 are set out in the Consolidated Income Statement on page 52 of the annual report.

The Board recommended the payment of a final dividend of RMB0.0105 per share for 2005, subject to the approval of the shareholders at the annual general meeting to be held on 16th June 2006.

## SHARE CAPITAL

In 2005 there were no changes in the share capital of the Company.

The Company's capital structure as at 31st December 2005 was as follows:

Class of shares	Number of shares as at 31st December 2005	Percentage of total number of shares in issue as at 31st December 2005
Domestic shares	2,963,808,000	63.83%
Overseas listed foreign invested shares (H shares)	1,679,800,500	36.17%
Total	<u>4,643,608,500</u>	<u>100.00%</u>

## SHAREHOLDINGS OF SUBSTANTIAL SHAREHOLDERS

As at 31st December 2005, pursuant to the register kept under Section 336 the Securities and Futures Ordinance (the "SFO"), shareholders holding more than 5% equity interests in the Company and associated corporations were as follows:

Name of Shareholders	Class of shares	Number of shares	Percentage of shareholdings to the same class of shares	Percentage of shareholdings to share capital in issue	Nature of share held
AVIC II	Domestic shares	2,835,305,636	95.66%	61.06%	Long position
EADS	H shares	232,180,425	13.82%	5%	Long position

Save as disclosed above, as at 31st December 2005, the Company had not been notified of any interests and short positions in 5% or more than 5% of shares and underlying shares of the Company which had been recorded in the register kept under section 336 of the Securities and Futures Ordinance.



## FINAL DIVIDEND

The Board recommended the payment of a final dividend of RMB0.0105 per share for 2005, subject to the approval at the annual general meeting of the Company (the "AGM") to be held on 16th June 2006. The final dividend will be paid to those shareholders whose names appear on the Company's register of members at the close of business on 16th June 2006. The Company's register of shareholders will be close from 17th May 2006 to 16th June 2006 (both days inclusive). To register for the transfer of shares, all transfer instruments accompanied by the relevant share certificates must be lodged with Computershare Hong Kong Investor Services Limited by not later than 4:00 p.m. on 16th May 2006. The final dividend is proposed to be paid on or about 4th July 2006.

In accordance with Article 149 of the Company's Articles of Association, the dividends will be declared in Renminbi to the shareholders. The dividends for domestic shares will be paid in Renminbi within three months after the declaration date while the dividends for H shares, calculated and declared in Renminbi, will be paid in Hong Kong dollars within three months after the declaration date. This amount denominated in Hong Kong dollars will be converted based on the average conversion rate between Renminbi and Hong Kong dollars issued by the People's Bank of China for the five working days prior to the declaration of dividends at the AGM to be held on 16th June 2006.

## PURCHASE, SALE AND REDEMPTION OF SHARES

Neither the Company nor any of its subsidiaries has purchased, sold or redeemed any of the Company's shares for the year ended 31st December 2005.

## PRE-EMPTIVE RIGHTS

There are no provisions for pre-emptive rights under the Company's Articles of Association and the laws of the People's Republic of China.

## DESIGNATED DEPOSITS AND OVERDUE FIXED DEPOSITS

As at 31st December 2005, the Group did not have designated deposits or overdue fixed deposits.

## PROPERTY, PLANT AND EQUIPMENT

Details of the property, plant and equipment are set out in note 15 to the financial statements.



## RESERVES

Details of movement in reserves of the Group for the year are set out in the Consolidated Statement of Changes in Equity.

## DISTRIBUTABLE RESERVES

Distributable reserves of the Company as at 31st December 2005, determined in accordance with International Financial Reporting Standards amounted to RMB52,322,000.

## MAJOR CUSTOMERS AND SUPPLIERS

During the period of this report, the Group's total purchases from the five largest suppliers accounted for 12.01% of the Group's total purchases, of which purchases from the largest supplier accounted for approximately 4.24% of the Group's total purchases. The Group's sales to the five largest customers accounted for 28.05% of the Group's total sales, of which, sales to the largest customer accounted for 16.01% of the Group's total sales.

Purchases from the five largest suppliers accounted for 41.59% of the total purchases in the Group's aviation segment, of which, purchases from the largest supplier accounted for 18.30% of the total purchases in the Group's aviation segment. Sales in the aviation segment to the five largest customers accounted for 76.82% of the total sales in the Group's aviation segment, of which, sales to the largest customer accounted for 64.35% of the total sales in the Group's aviation segment.

Purchases from the five largest suppliers accounted for 7.48% of the total purchases in the Group's automobile segment, of which, purchases from the largest supplier accounted for 2.98% of the total purchases in the Group's automobile segment. Sales in the automobile segment to the five largest customers accounted for 16.60% of the total sales in the Group's automobile segment, of which, sales to the largest customer accounted for 5% of the total sales in the Group's automobile segment.

During the period of this report, save for the connected transactions with AVIC II Group, as disclosed in the section of Connected Transactions in this annual report, none of the Directors, their associates or any shareholder holding more than 5% in the share capital of the Company has any interest in the above major suppliers and customers.

## SUBSIDIARIES AND ASSOCIATES

Details of subsidiaries and associates are set out in note 44 to the financial statements.

## WELFARE PLANS AND SOCIAL INSURANCE FOR STAFF

Details of the welfare plans and social insurance for staff are set out in note 14 to the financial statements.

Up to 31st December 2005, the Group has 645 retired employees, all of them have participated in the basic social pension plans in various provinces in accordance with the government policies of the PRC. Basic pension funds are being paid from the social plan funds.



### CONNECTED TRANSACTIONS

The connected transactions of the Company in the year in respect of which waivers have been granted by the Stock Exchange were as follows:

1. On 2nd October 2003, the Company entered into a product and ancillary services mutual supply agreement ("Mutual Supply Agreement") with AVIC II whereby the AVIC II Group has agreed to provide certain products and services to the Group and the Group has agreed to provide certain products and services to AVIC II Group for a term of three years.
2. On 2nd October 2003, the Company entered into a comprehensive services agreement ("Comprehensive Services Agreement") with AVIC II whereby AVIC II Group has agreed to provide certain social welfare and logistics services to the Group for a term of three years.
3. On 2nd October 2003, the Company entered into a land use rights leasing agreement ("Land Use Rights Leasing Agreement") with AVIC II whereby the AVIC II Group has agreed to lease to the Group 48 pieces of lands, with an aggregate area of approximately 2.9 million square metres at the annual rent of approximately RMB37.6 million. The lands are used by the Group as workshops, warehouses, administrative office and ancillary facilities. The term of the lease is 20 years and the Company is entitled to require AVIC II to renew the terms of the lease by giving AVIC II a written notice at least 6 months before the expiry of the lease.
4. On 2nd October 2003, the Company entered into a properties leasing agreement ("Properties Leasing Agreement") with AVIC II whereby the AVIC II Group has agreed to lease to the Group 54 buildings with an aggregate gross floor area of approximately 110,000 square metres at an annual rent of approximately RMB24 million. Similarly, the Company has agreed to lease to the AVIC II Group certain properties with an aggregate gross floor area of approximately 37,000 square meters at an annual rent of approximately RMB1.1 million. These properties are used by the Group as workshops, warehouses and ancillary facilities. These properties are leased for a term of 10 years and the Company is entitled to require AVIC II to renew the term of the lease by giving AVIC II a written notice at least 6 months before the expiry of the lease.
5. On 2nd October 2003, the Company entered into a technology cooperation framework agreement ("Technology Cooperation Agreement") with AVIC II for a term of three years whereby the AVIC II Group has agreed to transfer or grant a licence to the Group to use certain existing technology required for the Group's business in connection with the production of aircraft and automobiles. The agreement has also provided for future cooperation between the AVIC II Group and the Group in respect of development of new technology.
6. On 30th June 1999, Dongan Engine entered into a technology transfer agreement ("Mitsubishi Technology Transfer Agreement") with Mitsubishi, a connected person by virtue of it being a substantial shareholder of Dongan Engine, whereby Mitsubishi has agreed to grant to Dongan Engine licence to use the industrial properties rights, patent and technology documents relating to the 4G1 series engines, gearboxes and the respective assemblies, parts and components.
7. As part of the joint venture establishment agreement of Dongan Engine dated 16th June 1998, the CKD spare parts supply agreement between Dongan Engine and Mitsubishi ("Mitsubishi CKD Agreement") states that Dongan Engine agrees to purchase parts and components from Mitsubishi.



8. On 24th June 1998, Changhe Suzuki entered into a technology transfer and joint development agreement (“Joint Development Agreement”) with Suzuki, a connected person by virtue of it being a substantial shareholder of Changhe Suzuki for a term of eight years, whereby Changhe Suzuki shall pay an one-off payment to Suzuki and thereafter, for the CH6350 series automobiles produced by Changhe Suzuki, Changhe Suzuki shall pay to Suzuki a total fee (including royalty fees) calculated as a percentage of the ex-factory price (after deducting the price of imported KD parts and purchase price of engines).
9. During 2003, Changhe Suzuki and OKAYA & Co., Ltd. (“OKAYA”) had from time to time entered into contracts for the supply of KD parts from OKAYA in the ordinary course of business and on normal commercial terms. OKAYA is a connected person by virtue of it being a substantial shareholder of Changhe Suzuki.
10. During 2003, Hafei Auto entered into contracts for the purchase of parts and components for vehicles from Wenzhou Tianou Automobile Parts Manufacturing Company Limited (“Wenzhou Tianou”) from time to time in the ordinary course of business and on normal commercial terms. Wenzhou Tianou is a connected person by virtue of it being a substantial shareholder of Harbin Hafei Tianou Automobile Parts Company Limited (“Hafei Tianou”), which is an indirect non-wholly owned subsidiary of the Company.
11. During 2003, Hafei Auto entered into contracts for the purchase of gears from Jiangsu Feichuan Company Limited (“Jiangsu Feichuan”) from time to time in the ordinary course of business and on normal commercial terms. Jiangsu Feichuan is a connected person by virtue of it being a substantial shareholder of Harbin Hafei Automobile Rear-bridge Manufacturing Company Limited (“Hafei Rear-bridge”) which is an indirect non-wholly owned subsidiary of the Company.
12. On 2nd October 2003, the Company and various members of the Group entered into an internal connected transaction agreement (“Internal CT Agreement”) which set out the general principles of the transactions between the Company (or its wholly-owned subsidiaries) and the non-wholly owned subsidiaries of the Company and transactions between the non-wholly owned subsidiaries of the Company. During 2004, subsidiaries of the Company had, from time to time, provided goods and services to Dongan Engine and Hafei Auto and vice versa.

Besides, certain subsidiaries of the Company had, from time to time, provided guarantees to Dongan Engine and Hafei Auto. During 2005 Hafei Auto had not provided any guarantee for Harbin Aviation Group.

The Board of Directors (including independent non-executive Directors) has confirmed that the above transactions had been entered into under the following conditions:

- (a) The transactions were entered into in the ordinary and usual course of business of the Group;
- (b) The transactions were entered into: i) on normal commercial terms; or ii) in accordance with the relevant agreements governing such transactions, or if no agreements are available, on terms no less favourable than those available from/to independent third parties; or iii) where there is no available comparison for the purpose of determining whether (i) or (ii) above is satisfied, on terms that are fair and reasonable so far as the shareholders of the Company are concerned;



## Report of the Board of Directors

(c) The aggregate value of the respective transactions had not exceeded the following limits:

	<b>Cap (If expressed as a % of turnover or cost of sales, it means % of the total turnover or cost of sales of the Group respectively in the year when the relevant transactions take place)</b>
<b>The transactions</b>	
<b>Mutual Supply Agreement</b>	
(i) Annual expenditures in respect of products and services provided by the AVIC II Group	30% of the cost of sales
(ii) Annual revenue in respect of products and services provided by the Group	20% of the total turnover
<b>Comprehensive Services Agreement</b>	
Annual expenditures for the provision of services by the AVIC II Group	1.4% of the cost of sales
<b>Land Use Rights Leasing Agreement and Properties Leasing Agreement</b>	
Annual rents payable by the Group	RMB61,600,000
Annual rents receivable by the Group	RMB1,100,000
<b>Technology Cooperation Agreement</b>	
(i) Annual expenditure of the Group	0.6% of the cost of sales
(ii) Annual amount received by the Group	0.6% of the total turnover
<b>Mitsubishi Technology Transfer Agreement</b>	
Annual expenditure of the Group	0.1% of the cost of sales
<b>Mitsubishi CKD Agreement</b>	
Annual expenditure of the Group	5.5% of the cost of sales
<b>Joint Development Agreement</b>	
Annual expenditure of the Group	0.3% of the cost of sales
<b>Transaction regarding supply of KD parts between Changhe Suzuki and OKAYA</b>	
Annual expenditure of the Group	2.9% of the cost of sales





**Cap (If expressed as a % of turnover or cost of sales, it means % of the total turnover or cost of sales of the Group respectively in the year when the relevant transactions take place)**

### The transactions

#### Transactions regarding Hafei Tianou

Annual expenditure of the Group 0.12% of the cost of sales

#### Transactions regarding Hafei Rear-bridge

Annual expenditure of the Group 0.34% of the cost of sales

#### Internal CT Agreement

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|--|----------------------------|
| (i) Annual expenditure of Dongan Engine and Hafei Auto (to the extent the transactions do not fall within any exemption under the Listing Rules), except guarantee       | 19.5% of the cost of sales |
| (ii) Annual revenue received by Dongan Engine and Hafei Auto (to the extent the transactions do not fall within any exemption under the Listing Rules), except guarantee | 7% of the total turnover   |
| (iii) Amount of guarantee provided by the subsidiaries of the Company in favour of Dongan Engine and Hafei Auto as at the end of each financial year                     | RMB2,700 million           |
| (iv) Amount of guarantee provided by Hafei Auto in favour of Harbin Aviation Group as at the end of each financial year  | RMB500,000                 |

The Company's auditors have reviewed the relevant transactions, and have confirmed in a letter to the Directors stating that:

- (a) The transactions have received the approval of the Board;
- (b) The transactions have been entered into in accordance with the pricing policies as stated in the relevant agreements, or if no such policies or agreements are available, on terms no less favourable than those available from/to independent third parties;
- (c) The transactions have been entered into in accordance with the terms of the respective agreements and documents governing the transactions, or if no such agreements or documents are available, on terms no less favorable than those available from/to independent third parties;
- (d) The aggregate amounts of the transactions have not exceeded the respective caps as set out above.

In addition to the above, Harbin Aviation Group (a subsidiary of the Company) also entered into certain connected transactions in 2005. For the purpose of focusing on the main business and reducing costs in response to the intensive market competition, Harbin Aviation Group entered into separate agreements with Harbin Aircraft Industry (Group) Co., Ltd. and Harbin Dongan Engine (Group) Co., Ltd., both are subsidiaries of AVIC II, respectively to transfer part of Harbin Aviation Group's assets and its equity interests in its subsidiaries to these fellow subsidiaries. Please refer to the Announcement of Connected Transactions issued on 7th December 2005.



# Report of the Board of Directors

## CORPORATE GORVENANCE

The Company has strictly complied with the applicable laws and regulations in the jurisdiction in which it is listed and the Articles of Association of the Company to solidify operation and standarnize actions. The Board has reviewed the corporate governance practices adopted by the Company and is of the view that the Company has complied with most principles and code provisions and some recommended best practices set out in the Code on Corporate Governance Practices (the "Code") of the Listing Rules, except for several deviations. Details of corporate governance adopted by the Company are set out in the section of "Corporate Governance Report" of the Annual Report.

## THE INDEPENDENCE OF INDEPENDENT NON-EXECUTIVE DIRECTORS

The Board have received letters from all the independent non-executive directors confirming their independence according to Rule 3.13 of the Listing Rules. The Board believes that all the independent non-executive directors have complied with the requirements of Rule 3.13 of the Listing Rules and they remain as independent persons.

## PUBLIC FLOAT

Based on the information that is available to the Company and within the knowledge of the Board, as at the date of this report, there is a sufficient public float of more than 25% of the Company's issued shares as required under the Listing Rules.

## AUDITORS

The financial statements for the year ended 31st December 2005, prepared under International Financial Reporting Standards, have been audited by PricewaterhouseCoopers. In the forthcoming annual general meeting, a resolution for the re-appointment of PricewaterhouseCoopers as the international auditors for the financial year of 2006 will be presented.

## CHANGES OF DIRECTORS, SUPERVISORS AND SENIOR MANAGEMENT

During the year of 2005, there had been changes to the Directors, and no changes to the Supervisors and senior management.

Ex-non-executive directors Mr. Xu Tongxing, Mr. Cui Xuewen, Mr. Yang Jinhuai and Ms. Hu Jiarui had resigned due to changes of duties. Mr. Tan Ruisong, Mr. Wang Bin and Mr. Wang Yong has been appointed as non-executive directors. The change of directors had obtained approval at the annual general meeting of the Company held on 16th June 2005.

## SERVICE CONTRACTS OF DIRECTORS AND SUPERVISORS

Each of the Directors (except the independent non-executive directors) and Supervisors has entered into service contract with the Company. None of the Directors and Supervisors has entered into service contracts which are not terminable by the Company within one year without payment of compensation (other than statutory compensation).

## DIRECTORS' AND SUPERVISORS' INTERESTS IN CONTRACTS

During the year, none of the Directors or Supervisors had a material interest, directly or indirectly, in any contract of significance to which the Company or its subsidiaries was a party.





## THE INTERESTS OF DIRECTORS, SUPERVISORS AND CHIEF EXECUTIVES IN THE SECURITIES OF THE COMPANY

As at 31st December 2005, interests of the Directors, Supervisors and chief executives of the Company in the shares of the Company and its associated corporations (within the meaning of Part XV of the SFO), which are required to be recorded and kept in the register pursuant to section 352 of the SFO, or which were notified to the Company and the Stock Exchange pursuant to the Model Code were as follows:

Name of Company or its associated corporation	Name of Director/ Supervisor/ chief executive	Number and class of securities held	Capacity in holding interest	Type of interests held	Approximate % of shareholding in the same class of securities
The Company	David Li Kwok-Po	2,000,000 H Shares	Beneficial owner	Long position	0.12%
Dongan Motor	Tan Ruisong	5,070 A Shares	Beneficial owner	Long position	0.0011%

Except to those disclosed above, as 31st December 2005, none of the Directors, Supervisors and chief executive of the Company had interests or held short position in shares of the Company and/or shares, relative shares and/or securities of its associated corporations (within the meaning of Part XV of the SFO), which are required to be recorded and kept in the register pursuant to section 352 of the SFO and be notified to the Company and the Stock Exchange pursuant to Part XV, Part 7 and Part 8 of the SFO.

## REMUNERATION OF DIRECTORS, SUPERVISORS AND SENIOR MANAGEMENT

Details of remuneration of the existing Directors, Supervisors and senior management are set out in note 12 to the financial statements.

## MANAGEMENT CONTRACTS

No contracts concerning the management and administration of the whole or any substantial part of the business of the Company were entered into or existed during the year.