

Report of the Directors

The directors ("Directors") of Haier Electronics Group Co., Ltd. ("Company") present their report and the audited financial statements of the Company and its subsidiaries (collectively the "Group") for the year ended 31 December 2005.

PRINCIPAL ACTIVITIES

The principal activity of the Company is investment holding. The principal activities of its subsidiaries are (i) the manufacture and sale of mobile handsets; and (ii) the manufacture and sale of washing machines.

RESULTS AND DIVIDENDS

The Group's loss for the year ended 31 December 2005 and the state of affairs of the Company and the Group at that date are set out in the financial statements on pages 30 to 82.

The directors do not recommend the payment of any dividends in respect of the year.

SUMMARY FINANCIAL INFORMATION

A summary of the financial results and assets, liabilities and minority interests of the Group for the last five financial years, as extracted from the financial statements and restated as appropriate, is set out on page 83. This summary does not form part of the audited financial statements.

PROPERTY, PLANT AND EQUIPMENT

Details of movements in the property, plant and equipment of the Group during the year are set out in note 16 to the financial statements.

SHARE CAPITAL, SHARE OPTIONS, WARRANTS AND CONVERTIBLE NOTES

Details of movements in the Company's share capital, share options, warrants and convertible notes during the year, are set out in notes 31, 32 and 28 to the financial statements.

PRE-EMPTIVE RIGHTS

There are no provisions for pre-emptive rights under the Company's bye-laws or the laws of Bermuda which would oblige the Company to offer new shares on a pro rata basis to existing shareholders.

PURCHASE, REDEMPTION OR SALE OF LISTED SECURITIES OF THE COMPANY

Neither the Company, nor any of its subsidiaries purchased, sold or redeemed any of the listed securities of the Company during the year.

RESERVES

Details of movements in the reserves of the Company and the Group during the year are set out in note 33(b) to the financial statements and in the consolidated statement of changes in equity, respectively.

DISTRIBUTABLE RESERVES

At 31 December 2005, the Company had no reserve (2004: HK\$120,691,000) available for distribution in accordance with the provisions of the Companies Act 1981 of Bermuda (as amended).

Report of the Directors (cont'd)**MAJOR CUSTOMERS AND SUPPLIERS**

The information in respect of the Group's sales and purchases attributable to the major customers and suppliers, respectively, during the year is as follows:

	Percentage of the Group's total			
	Sales		Purchases	
	2005 %	2004 %	2005 %	2004 %
The largest customer	32	87	-	-
Five largest customers in aggregate	55	98	-	-
The largest supplier	-	-	50	55
Five largest suppliers in aggregate	-	-	78	74

During the year, Haier Group Corporation ("Haier Corp") and Qingdao Haier Investment and Development Co., Ltd. ("Haier Investment") (collectively referred to as "Haier Group"), the substantial shareholders of the Company, had beneficial interest in two of the five largest customers and four of the five largest suppliers of the Group, respectively.

Save as disclosed above, none of the directors or any of their associates or any shareholders of the Company (which, to the best knowledge of the directors, owns more than 5% of the Company's issued share capital) had any beneficial interest in the Group's five largest customers or suppliers.

DIRECTORS

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

Executive directors:

Yang Mian Mian	(appointed on 28 January 2005)
Wu Ke Song	
Chai Yong Sen	
Liang Hai Shan	
Cao Chun Hua	(appointed on 28 January 2005)
Cui Shao Hua	
Song Chun Guang	(appointed on 28 January 2005)
Mak Shiu Tong, Clement	(resigned on 28 January 2005)
Tam Ngai Hung, Terry	(resigned on 28 January 2005)
Man Wei Dong	(resigned on 28 January 2005)

Independent non-executive directors:

Lam Kin Kau, Mark	
Fung Hoi Wing, Henry	
Lau Ho Wai, Lucas	
Wu Yinong	(appointed on 28 January 2005)

In accordance with the bye-laws of the Company, Chai Yong Sen, Cui Shao Hua, Lam Kin Kau, Mark and Fung Hoi Wing, Henry will retire and, being eligible, will offer themselves for re-election at the forthcoming annual general meeting of the Company.

The independent non-executive directors of the Company are not appointed for any specific terms and are subject to retirement by rotation and re-election at the annual general meeting of the Company in accordance with the bye-laws of the Company.

The Company has received annual confirmations of independence from each of Lam Kin Kau, Mark, Fung Hoi Wing, Henry, Lau Ho Wai, Lucas and Wu Yinong, and, on the basis on such confirmations, still considers them to be independent as at the date of this report.

DIRECTORS' AND SENIOR MANAGEMENT'S BIOGRAPHIES

Biographical details of the directors of the Company and the senior management of the Group are set out on pages 9 to 11 of this annual report.

DIRECTORS' SERVICE CONTRACTS

During the year, no director had a service contract with the Company which is not determinable by the Company within one year without payment of compensation, other than statutory compensation.

DIRECTORS' INTERESTS IN CONTRACTS

No director had a material interest, either directly or indirectly, in any contract of significance to the business of the Group to which the Company, or its holding company, or any of its subsidiaries or fellow subsidiaries was a party during the year.

DIRECTORS' INTERESTS AND SHORT POSITIONS IN SHARES AND UNDERLYING SHARES

At 31 December 2005, except for the interests in share options of the Company as disclosed in note 32 to the financial statements, none of the Directors has any interests and short positions in the ordinary share(s) ("Share(s)") or underlying shares of the Company or its associated corporations (within the meaning of Part XV of the Securities and Futures Ordinance (the "SFO")), as recorded in the register required to be kept 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 Issuers as set out in Appendix 10 of the Listing Rules.

DIRECTORS' RIGHTS TO ACQUIRE SHARES OR DEBENTURES IN THE COMPANY

Save as disclosed in note 32 to the financial statements regarding the share option scheme of the Company, at no time during the year were rights to acquire benefits by means of the acquisition of Shares in or debentures of the Company granted to any director of the Company or their respective spouse or minor children, or were any such rights exercised by them; or was the Company, its holding company, or any of its subsidiaries or fellow subsidiaries a party to any arrangement to enable the directors of the Company to acquire such rights in any other body corporate.

SUBSTANTIAL SHAREHOLDERS' INTERESTS IN SHARES AND UNDERLYING SHARES

As at 31 December 2005, the following shareholders interested in 5% or more of the issued shares and/or underlying shares of the Company were recorded in the register of substantial shareholders required to be kept by the Company pursuant to Section 336 of the SFO:

Long positions in Shares:

Name	Notes	Number of Shares interested	Number of Shares under equity derivatives	Nature of interests	Total number of Shares interested	Approximate percentage of the Company's issued share capital
Qingdao Haier Group Holdings (BVI) Limited	1	4,176,706,667	1,294,444,444	Beneficial owner	9,441,445,930	56.63
		3,970,294,819	-	Interests of parties acting in concert		
Haier Group Corporation	2	9,441,445,930	-	Interests of controlled corporation	13,633,945,930	81.78
		4,192,500,000	-	Interests of parties acting in concert		

Report of the Directors (cont'd)

SUBSTANTIAL SHAREHOLDERS' INTERESTS IN SHARES AND UNDERLYING SHARES (cont'd)

Long positions in Shares: (cont'd)

Name	Notes	Number of Shares interested	Number of Shares under equity derivatives	Nature of interests	Total number of Shares interested	Approximate percentage of the Company's issued share capital
Qingdao Haier Investment and Development Co., Ltd.	3	3,366,000,000	-	Beneficial owner	13,633,945,930	81.78
		826,500,000	-	Interests of controlled corporation		
		9,441,445,930	-	Interests of parties acting in concert		
Qingdao Haier Collective Asset Management Association	4	13,633,945,930	-	Interests of controlled corporation	13,633,945,930	81.78
Deutsche Bank AG	5	3,970,294,819	-	Beneficial owner	12,189,501,486	73.12
		8,219,206,667	-	Interests of parties acting in concert		
Greatway International Corp.	6	880,172,486	-	Beneficial owner	880,172,486	5.28
Soaring Profit Holdings Limited	7	3,926,774,819	-	Interests of controlled corporation	3,926,774,819	23.55
CCT Telecom Holdings Limited	8	3,926,774,819	-	Interests of controlled corporation	3,926,774,819	23.55

Short positions in Shares:

Name	Notes	Number of Shares interested	Number of Shares under equity derivatives	Nature of interests	Total number of Shares interested	Approximate percentage of the Company's issued share capital
Deutsche Bank AG	5	-	3,926,774,819	Beneficial owner	3,926,774,819	23.55
CCT Telecom Holdings Limited	8	3,926,774,819	-	Interests of controlled corporation	3,926,774,819	23.55

SUBSTANTIAL SHAREHOLDERS' INTERESTS IN SHARES AND UNDERLYING SHARES (cont'd)

Notes:

1. Qingdao Haier Group Holdings (BVI) Limited ("Haier BVI") held 4,176,706,667 Shares. Haier BVI was also interested in 1,294,444,444 underlying Shares under the convertible notes ("Convertible Notes") issued to it as part of the consideration pursuant to an agreement dated 5 March 2004 entered into between Haier Group Corporation ("Haier Corp"), Qingdao Haier Investment and Development Co., Ltd. ("Haier Investment") and the Company.

In addition, Haier BVI was acting in concert with Deutsche Bank AG ("Deutsche Bank") pursuant to an undertaking letter ("Undertaking Letter") dated 5 January 2006 executed by Haier BVI and Deutsche Bank, pursuant to which Deutsche Bank agreed that, unless otherwise agreed and subject to the exceptions set out therein, Deutsche Bank will not sell or dispose of any of the 3,926,774,819 Shares acquired by Deutsche Bank pursuant to an agreement ("Sale and Purchase Agreement") dated 16 November 2005 entered into between Deutsche Bank and CCT Telecom Holdings Limited ("CCT"). Furthermore, Deutsche Bank held another 43,520,000 Shares. Accordingly, Haier BVI was deemed to be interested in the said 3,926,774,819 Shares and 43,520,000 shares held by Deutsche Bank pursuant to the SFO.

2. Haier Corp was interested in 4,176,706,667 Shares held by Haier BVI and the 1,294,444,444 underlying shares under the Convertible Notes referred to in note (1) in which Haier BVI were interested. Haier BVI is a non-wholly owned subsidiary of Haier Corp. In addition, Haier Corp was taken to be interested in 43,520,000 Shares and 3,926,774,819 Shares held by Deutsche Bank which Haier BVI were deemed to be interested pursuant to the SFO as stated in note (1).

Furthermore, Haier Corp was acting in concert with Haier Investment. As Haier Investment held 3,366,000,000 Shares and was interested in 826,500,000 Shares held by its non-wholly owned subsidiary as stated in note (3), Haier Corp was also taken to be interested in the 3,366,000,000 Shares held by Haier Investment and the 826,500,000 Shares which Haier Investment was taken to be interested.

3. Haier Investment held 3,366,000,000 Shares and was interested in (i) 826,500,000 Shares held by an indirect non-wholly owned subsidiary; and, by reason of its acting in concert with Haier Corp as set out in note (2), the following Shares in which Haier Corp were deemed to be interested pursuant to the SFO: (ii) the 4,176,706,667 Shares held by Haier BVI and the 1,294,444,444 underlying shares under the Convertible Notes referred to in note (1) in which Haier BVI was interested; and (iii) the 43,520,000 Shares and 3,926,774,819 Shares held by Deutsche Bank which Haier BVI were deemed to be interested pursuant to the SFO as stated in note (1).
4. Qingdao Haier Collective Asset Management Association was interested in (i) 3,366,000,000 Shares held by its non-wholly owned subsidiary, Haier Investment; (ii) 826,500,000 Shares held by Haier Investment's indirect non-wholly owned subsidiary as stated in note (3); (iii) 4,176,706,667 Shares held by Haier BVI and the 1,294,444,444 underlying shares under the Convertible Notes referred to in note (1) in which Haier BVI were interested; and (iv) 43,520,000 Shares and 3,926,774,819 Shares held by Deutsche Bank which Haier BVI were deemed to be interested pursuant to the SFO.
5. Deutsche Bank held 43,520,000 Shares. In addition, it held another 3,926,774,819 Shares acquired pursuant to the Sale and Purchase Agreement referred to in note (1). Furthermore, Deutsche Bank was acting in concert with Haier BVI pursuant to the Undertaking Letter referred to in note (1) above and is deemed to be interested in the 8,219,206,667 Shares in which Haier BVI was interested.

Pursuant to a subscription agreement dated 16 November 2005 entered into between Deutsche Bank and Haier BVI, Haier BVI agreed to issue and Deutsche Bank agreed to subscribe for put warrants (the "Warrant(s)") in respect of 3,926,774,819 Shares at an issue price of HK\$0.03 per Warrant. Upon exercise, the holders of the Warrants are entitled to put the Shares to Haier BVI. The exercise price of the Warrants is fixed at HK\$0.1975 per Warrant. The number of Shares under the Warrants is equal to the number of Shares acquired by Deutsche Bank from CCT pursuant to the Sale and Purchase Agreement referred to in note (1) above.

6. Greatway International Corp. ("Greatway") held 880,172,486 Shares.
7. Soaring Profit Holdings Limited ("Soaring Profit") was interested in 479,002,333 Shares held by Info-net International Corp. ("Info-net"), 880,172,486 Shares held by Greatway, 810,000,000 Shares held by Clear Access Agents Limited ("Clear Access"), 733,600,000 Shares held by Super Control Investments Limited ("Super Control"), 700,000,000 Shares held by Invest Paradise Group Limited ("Invest Paradise") and 324,000,000 Shares held by Full Elite Assets Limited ("Full Elite"). Info-net, Clear Access, Super Control, Invest Paradise and Full Elite were wholly-owned subsidiaries of Soaring Profit Holdings Limited ("Soaring Profit").

Pursuant to the Sale and Purchase Agreement referred to in note (1), CCT is under an obligation to deliver 3,926,774,819 Shares (including the 479,002,333 Shares held by Info-net, the 880,172,486 Shares held by Greatway, 810,000,000 Shares held by Clear Access, 733,600,000 Shares held by Super Control, 700,000,000 Shares held by Invest Paradise and 324,000,000 Shares held by Full Elite) to Deutsche Bank upon completion of the Sale and Purchase Agreement.

8. CCT was interested in 3,926,774,819 Shares in which Soaring Profit were taken to be interested through the subsidiaries as disclosed in note (7). Soaring Profit is a wholly-owned subsidiary of CCT.

Report of the Directors (cont'd)**SUBSTANTIAL SHAREHOLDERS' INTERESTS IN SHARES AND UNDERLYING SHARES (cont'd)**

Subsequent to the balance sheet date, on 5 January 2006, CCT and its subsidiaries disposed of their 3,926,774,819 Shares to Deutsche Bank, details of which were set out in the Company's announcements dated 22 November 2005 and 5 January 2006.

Save as disclosed above, as at 31 December 2005, no other person, other than the directors of the Company, whose interests are set out in the section headed "Directors' interests and short positions in shares and underlying shares" above, had registered an interest or short position in the Shares or underlying shares of the Company that was required to be recorded pursuant to Section 336 of the SFO.

CONNECTED TRANSACTIONS AND CONTINUING CONNECTED TRANSACTIONS

- (a) During the year, the Company's subsidiary, Pegasus Telecom (Qingdao) Co., Ltd. ("Pegasus Qingdao"), had the following continuing connected transactions with Haier Corp, Haier Investment, their subsidiaries and associates:

		2005	Group
	<i>Notes</i>	HK\$'000	2004 HK\$'000
Sales of mobile handset products	<i>(i)</i>	1,523,428	2,747,869
Purchases of materials	<i>(ii)</i>	606,607	1,786,847
Utility service fee expenses	<i>(iii)</i>	5,745	4,657
Interest expenses	<i>(iv)</i>	3,594	3,442
Interest income	<i>(iv)</i>	165	143
Other service fee expenses	<i>(v)</i>	1,286	174

Notes:

- (i) For the year ended 31 December 2005, the sales of mobile handset products were made at selling prices based on the costs of raw materials plus a processing fee which is not less than the industry standard.
- For the year ended 31 December 2004, the sales of mobile phones were made at selling prices based on the cost of materials plus processing fees ranging from 5% to 40% of the purchase price of the materials.
- (ii) The purchases were charged no more than the average market price or the consolidated and integrated tender and bidding price plus a 2.6% commission.
- (iii) Utility service fee expenses were charged based on the state-prescribed prices plus actual administrative costs.
- (iv) Interest expenses/income was determined with reference to the standard rates published by the People's Bank of China.
- (v) Other service fee expenses included legal consulting service fee, general security service fee, human resources service fee which were determined with reference to actual costs incurred.

CONNECTED TRANSACTIONS AND CONTINUING CONNECTED TRANSACTIONS (cont'd)

(a) (cont'd)

Since Qingdao Haier Washing Machine Co., Ltd., Foshan Shunde Haier Electric Co., Ltd. and Hefei Haier Washing Machine Co., Ltd. have become the Company's subsidiaries on 28 January 2005, they, together with Qingdao Jiaonan Haier Washing Machine Co., Ltd. and Qingdao Haier Electronics Sales Co., Ltd., had the following continuing connected transactions with Haier Corp, Haier Investment, their subsidiaries and associates:

	<i>Notes</i>	Group From 28 January 2005 to 31 December 2005 HK\$'000
Sales of washing machines	<i>(vi)</i>	310,782
Purchases of materials	<i>(vii)</i>	2,405,228
Printing and packaging fee expenses	<i>(viii)</i>	1,730
Mould charges	<i>(ix)</i>	57,719
Utility service fee expenses	<i>(x)</i>	10,776
Logistics charges	<i>(xi)</i>	112,042
Promotion fee expenses	<i>(xii)</i>	19,231
Other service fee expenses	<i>(xiii)</i>	13,845
Interest income	<i>(xiv)</i>	525
Trademark licence fee expenses	<i>(xv)</i>	23,847

Notes:

- (vi) The sales of washing machines were made to Haier Electrical Appliances Co., Ltd. ("Haier Electrical"), a subsidiary of Haier Investment, at selling prices representing differences between the selling prices of washing machines mutually agreed and the selling expenses of Haier Electrical not exceeding 2.5% of the selling prices of washing machines.
- (vii) The purchases of materials were determined based on the lower of the average market price or the consolidated and integrated tender and bidding price plus 2.6% commission.
- (viii) Printing and packaging fee expenses were charged on an actual cost basis plus a processing fee of not higher than those charged by independent third parties.
- (ix) Moulds were charged with reference to the average market tender and bidding price plus actual administrative costs.
- (x) Utility service fee expenses were charged based on the state-prescribed prices plus actual administrative costs.
- (xi) Logistics charges were charged based on an actual costs basis and on terms more favourable than those offered by independent third parties.
- (xii) Promotion fee expenses were determined at the lower of 1.2% of the domestic sales of washing machines and RMB20 million (equivalent to HK\$19,231,000).
- (xiii) Other service fee expenses included legal consulting service fee, catering and travel agency service fee, human resources service fee, general security service fee, product certification service fee and equipment repair and maintenance service fee which were determined with reference to actual costs incurred.
- (xiv) Interest income was determined with reference to the standard rates published by the People's Bank of China.
- (xv) Trademark licence fee expenses were charged at a rate of 0.8% (2004: 0.5%) of certain sales made by Qingdao Haier Washing Machine Co., Ltd., Foshan Shunde Haier Electric Co., Ltd., Hefei Haier Washing Machine Co., Ltd. and Qingdao Jiaonan Haier Washing Machine Co., Ltd..

Except for the trademark licence fee expenses, the above transactions were defined as MH Continuing Connected Transactions and Non-exempt Continuing Connected Transactions in the circulars to the shareholders of the Company dated 17 December 2004 and 4 October 2005, respectively, and were approved by the shareholders at special general meetings of the Company on 4 January 2005 and 24 October 2005, respectively.

Report of the Directors (cont'd)**CONNECTED TRANSACTIONS AND CONTINUING CONNECTED TRANSACTIONS (cont'd)****(a) (cont'd)**

The Stock Exchange has granted conditional waivers to the Company from strict compliance with the connected transactions requirements as set out in the Listing Rules for the three financial years ended 31 December 2007.

The independent non-executive directors of the Company have reviewed MH Continuing Connected Transactions and Non-exempt Continuing Connected Transactions set out above and have confirmed that they were:

- (i) less than the cap amounts which were set out in the relevant agreements;
 - (ii) entered into the usual and ordinary course of business of the Group;
 - (iii) entered into either on normal commercial terms or, if there is not sufficient comparable transactions to judge whether they are on normal commercial terms, on terms no less favourable to the Group than terms available to or from (as appropriate) independent third parties; and
 - (iv) entered into in accordance with the relevant agreements governing them on terms that were fair and reasonable and in the interest of the Group's shareholders as a whole.
- (b) On 25 June 2005, Haier Corp provided a corporate guarantee of RMB70,000,000 (equivalent to HK\$67,308,000) to Haier Group Finance Co., Ltd. ("Haier Finance"), a subsidiary of Haier Corp and a financial institution approved by the People's Bank of China, as a security for banking facilities granted to Pegasus Qingdao for the period from 25 June 2005 to 24 June 2006. As at 31 December 2005, Pegasus Qingdao has utilised all of the above banking facilities.
- (c) On 30 December 2005, Haier Corp provided a corporate guarantee of RMB30,000,000 (equivalent to HK\$28,846,000) to Haier Finance as a security for banking facilities granted to Qingdao Jiaonan Haier Washing Machine Co., Ltd. ("Jiaonan Washing Machine") for the period from 30 December 2005 to 29 December 2006. As at 31 December 2005, Jiaonan Washing Machine has utilised RMB15,000,000 of the above banking facilities.

SUFFICIENCY OF PUBLIC FLOAT

Based on information that is publicly available to the Company and within the knowledge of the directors, at least 25% of the Company's total issued share capital was held by the public as at the date of this report.

AUDITORS

Ernst & Young will retire and a resolution for their reappointment as auditors of the Company will be proposed at the forthcoming annual general meeting of the Company.

ON BEHALF OF THE BOARD

Yang Mian Mian

Chairman

Hong Kong

19 April 2006