Notes to Financial Statements

31 December 2005

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

Air China Limited (the "Company") was incorporated on 30 September 2004 in Beijing, the People's Republic of China (the "PRC" or "Mainland China"), as a joint stock limited company as part of the restructuring (the "Restructuring") of CNAHC, a PRC state-owned enterprise under the supervision of the State Council, in preparation for the listing of the Company's H shares on The Stock Exchange of Hong Kong Limited (the "Hong Kong Stock Exchange") and the London Stock Exchange as described below.

As disclosed in the Company's prospectus dated 3 December 2004, pursuant to the Restructuring, CNAHC and through its wholly-owned subsidiaries, effected the transfer of the following to the Company upon its incorporation:

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

(b) the shareholding interests in certain subsidiaries, joint ventures and associates which principally engage in airline operations, the provision of aircraft engineering services, air catering services, airport ground handling services and other airline-related businesses (the "Relevant Companies").

The principal activities of the Company, its subsidiaries and joint ventures (collectively the "Group") and associates are airline and airline-related services, including aircraft engineering services, air catering services and airport ground handling services conducted mainly in Mainland China, Hong Kong and Macau.

The registered office of the Company is located at 9th Floor, Blue Sky Mansion, 28 Tianzhu Road, Zone A, Tianzhu Airport Industrial Zone, Shunyi District, Beijing 101312, the PRC.

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

As CNAHC controlled the Relevant Businesses and the Relevant Companies before the Restructuring and continues to control the Company after the Restructuring, the consolidated financial statements of the Group prior to the incorporation of the Company on 30 September 2004 had been prepared as a reorganisation of companies under common control in a manner similar to a pooling-of-interests.

The consolidated results and consolidated cash flows for the year ended 31 December 2004 include the Group's results of operations and cash flows as if the Relevant Businesses and interests in the Relevant Companies had been transferred to the Group at 1 January 2001, which is the earliest date for the preparation of the financial information in relation to the listing of the Company's H shares. The Company's Directors are of the opinion that the consolidated income statement and consolidated cash flow statement prepared on this basis present fairly the consolidated results and consolidated cash flows of the Group as a whole.

Notes to Financial Statements

Year ended 31 December 2005

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of preparation

The consolidated financial statements of the Group have been prepared in accordance with International Financial Reporting Standards ("IFRSs") which comprise standards and interpretations approved by the International Accounting Standards Board, and International Accounting Standards ("IAS") and Standing Interpretations Committee interpretations approved by the International Accounting Standards Committee that remain in effect. The consolidated financial statements are presented in Renminbi ("RMB") and all values are rounded to the nearest thousand (RMB'000) except when otherwise indicated.

The consolidated financial statements of the Group have been prepared on a historical cost basis, except for the measurement at fair value of financial instruments in accordance with IAS 39 (amended 2004) *Financial Instruments: Recognition and Measurement*.

The principal accounting policies used in the preparation of the consolidated financial statements of the Group are consistent with those used in the annual audited financial statements of the Group for the year ended 31 December 2004, except that the Group has adopted the following new/revised standards mandatory for financial years beginning on or after 1 January 2005.

(a) IFRS 2 *Share-based Payment* requires the Group to recognise share-based payment transactions in its financial statements, including transactions with employees or other parties to be settled in cash, other assets, or equity instruments of the Group. For equity-settled share-based payment transactions, IFRS 2 requires an entity to measure the goods or services received, and the corresponding increase in equity, directly, at the fair value of the goods or services received, unless that fair value cannot be estimated reliably. If the Group cannot estimate reliably the fair value of the goods or services received, the Group is required to measure their value, and the corresponding increase in equity, indirectly, by reference to the fair value of the equity instruments granted. For cash-settled share-based payment transactions, IFRS 2 requires an entity to measure the goods or services acquired and the liability incurred at the fair value of the liability. Until the liability is settled, the Group is required to re-measure the fair value of the liability at each reporting date and at the date of settlement, with any changes in value recognised in the income statement for the period. For share-based payment transactions in which the terms of the arrangement provide either the Group or the supplier of goods or services with a choice of whether the Group settles the transaction in cash or by issuing equity instruments, the Group is required to account for that transaction, or the components of that transaction, as a cash-settled share-based payment transaction if, and to the extent that, the Group has incurred a liability to settle in cash (or other assets), or as an equity settled share-based payment transaction if, and to the extent that, no such liability has been incurred. The provisions of IFRS 2 apply to grants of shares, share options or other equity instruments that were granted after 7 November 2002 and had not yet vested on or after 1 January 2005. The adoption of IFRS 2 did not give rise to any adjustment to the opening balances of retained earnings of the current and prior years or to any change in comparatives.

Notes to Financial Statements

Year ended 31 December 2005

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Basis of preparation (Continued)

(b) IAS 16 (amended 2004) *Property, Plant and Equipment* replaces IAS 16 (revised 1998), *Property, Plant and Equipment*. There are a number of differences between the amended standard and the previous version. Firstly, the amended standard requires an entity to evaluate under the general recognition principle all property, plant and equipment costs at the time they are incurred. Those costs include costs incurred initially to acquire or construct an item of property, plant and equipment and costs incurred subsequently to add to, replace part of, or service an item. The previous version of IAS 16 contained specific recognition principles for the accounting of subsequent costs. Secondly, the amended standard requires that the cost of an item of property, plant and equipment includes the costs of its dismantlement, removal or restoration, and the obligation for which an entity incurs as a consequence of installing the item. Its cost also includes the costs of its dismantlement, removal or restoration, and the obligation for which an entity incurs as a consequence of using the item during a particular period for purposes other than to produce inventories during that period. The previous version of the standard included within its scope only the costs incurred as a consequence of installing the item. Thirdly, under the amended standard an entity is required to determine the depreciation charge separately for each significant part of an item of property, plant and equipment, a requirement which was not clearly set out in the previous version. In addition, under the amended standard, an entity is required to measure the residual value of an item of property, plant and equipment as the amount that it estimates it would currently receive for the asset if the asset was already of the age and in the condition expected at the end of its useful life. The previous version of IAS 16 did not specify whether the residual value was to be this amount or the amount, inclusive of the effects of inflation, that an entity expected to receive at the asset's actual retirement date. Furthermore, the amended standard requires major inspection and overhaul costs to be recognised in the carrying amount of an item of property, plant and equipment when such services are performed.

The adoption of the revised treatment of IAS 16 (amended 2004) has been accounted for prospectively, which resulted in the following:

(i) In prior years, the aircraft were depreciated over their estimated useful lives of 20 years. With effect from 1 January 2005, the estimated useful lives of certain components within the aircraft which are subject to replacement during major overhauls have been reduced to the life of the overhaul cycle. The change in accounting estimate has increased the Group's depreciation charge for the year ended 31 December 2005 by approximately RMB899 million. As a result, the profit after tax of the Group for the year ended 31 December 2005 has decreased by approximately RMB604 million.

(ii) Major overhaul costs incurred for the year ended 31 December 2005 of approximately RMB1,639 million have been capitalised and depreciated over the life of the overhaul cycle. Prior to 1 January 2005, such costs have been charged to the income statement on an incurred basis. In this respect, the costs of aircraft maintenance, repair and overhaul of the Group charged to the income statement for the year ended 31 December 2005 decreased by RMB1,639 million. In addition, the Group has derecognised and charged to the income statement for the year ended 31 December 2005 the carrying amount of certain components of approximately RMB430 million which have been replaced during the major overhaul. As a result, the profit after tax of the Group for the year ended 31 December 2005 has increased by approximately RMB824 million.

(c) IAS 24 (revised 2003) *Related Party Disclosures* replaces IAS 24 *Related Party Disclosures* (reformatted in 1994). The main objective of such revision was to provide additional guidance and clarity in the scope of IAS 24 for the definition and the disclosures for related parties. The wording of IAS 24's objective was amended to clarify that the Group's financial statements should contain the disclosures necessary to draw attention to the possibility that the financial position and the income statement may have been affected by the existence of related parties and by transactions and outstanding balances with them. Since IAS 24 is a standard for disclosure requirements only, there is no material effect on the Group's results of operations and financial position upon adoption.

Notes to Financial Statements

Year ended 31 December 2005

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Basis of preparation (Continued)

IFRSs and International Financial Reporting Interpretation Committee Interpretations ("IFRIC Interpretations") not yet effective

The Group has not applied the following new and revised IFRSs and IFRIC interpretations that have been issued but are not yet effective in these financial statements:

IAS 1 Amendment	*Capital Disclosures*
IAS 19 Amendment	*Actuarial Gains and Losses, Group Plans and Disclosures*
IAS 39 Amendment	*Cash Flow Hedge Accounting of Forecast Intragroup Transactions*
IAS 39 Amendment	*The Fair Value Option*
IAS 39 and IFRS 4 Amendments	*Financial Guarantee Contracts*
IFRS 1 and IFRS 6 Amendments	*First-time Adoption of International Financial Reporting Standards and Exploration for and Evaluation of Mineral Resources*
IFRS 6	*Exploration for and Evaluation of Mineral Resources*
IFRS 7	*Financial Instruments: Disclosures*
IFRIC – Int 4	*Determining whether an Arrangement contains a Lease*
IFRIC – Int 5	*Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds*
IFRIC – Int 6	*Liabilities arising from Participating in a Specific Market – Waste Electrical and Electronic Equipment*

The above standards and interpretations are required to be applied for annual periods beginning on or after 1 January 2006.

The IAS 1 Amendment shall be applied for annual periods beginning on or after 1 January 2007. The revised standard will affect the disclosures about qualitative information about the Group's objective, policies and procedures for managing capital; quantitative data about what the Company regards as capital and compliance with any capital requirements and the consequences of any non-compliance.

IFRS 7 will replace IAS 32 and has modified the disclosure requirements of IAS 32 relating to financial instruments. The IFRS shall be applied for annual periods beginning on or after 1 January 2007.

In accordance with the amendments to IAS 39 and IFRS 4 regarding financial guarantee contracts, financial guarantee contracts are initially recognised at fair value and are subsequently measured at the higher of (i) the amount determined in accordance with IAS 37 and (ii) the amount initially recognised less cumulative amortisation, when appropriate, recognised in accordance with IAS 18.

The IAS 19 Amendment, IAS 39 Amendments regarding cash flow hedge accounting of forecast intragroup transactions and the fair value option, IFRSs 1 and 6 Amendments, IFRS 6, IFRIC-Int 4, IFRIC-Int 5 and IFRIC-Int 6 do not apply to the activities of the Group. IFRIC-Int 6 shall be applied for annual periods beginning on or after 1 December 2005.

Except as stated above, the Group expects that the adoption of the other pronouncements listed above will not have any significant impact on the Group's financial statements in the period of initial application.

Notes to Financial Statements

Year ended 31 December 2005

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Basis of consolidation

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

Subsidiaries are fully consolidated from the date on which control is transferred to the Group and cease to be consolidated from the date on which control is transferred out of the Group. This control is normally evidenced when the Group owns, either directly or indirectly, more than 50% of the voting rights of a company's share or registered capital, is able to govern the financial and operating policies of an enterprise so as to benefit from its activities. All significant inter-company transactions and balances within the Group are eliminated on consolidation.

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

Foreign currency translation

The consolidated financial statements are presented in RMB, which is the Company's functional and presentation currency. Each entity in the Group determines its own functional currency and items included in the financial statements of each entity are measured using that functional currency. Transactions in foreign currencies are initially recorded in the functional currency rate ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are retranslated at the functional currency rate of exchange ruling at the balance sheet date. All differences are taken to the income statement. Non-monetary items that are measured in terms of historical cost in a foreign currency are translated using the exchange rates as at the dates of the initial transactions. Non-monetary items measured at fair value in a foreign currency are translated using the exchange rates at the date when the fair value was determined.

As at the reporting date, the assets and liabilities of the foreign entities are translated into the presentation currency of the Group which is RMB at the rate of exchange ruling at the balance sheet date and, their income statements are translated at the weighted average exchange rates for the year. The exchange differences arising on the translation are taken directly to a separate component of equity. On the disposal of a foreign entity, the deferred cumulative amount recognised in equity relating to that particular foreign entity is recognised in the income statement.

Subsidiaries

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

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

Interests in joint ventures

The Group has interests in certain joint ventures which are jointly-controlled entities. A joint venture is a contractual arrangement whereby two or more parties undertake an economic activity that is subject to joint control, and a jointly-controlled entity is a joint venture that involves the establishment of a separate entity in which each venturer has an interest.

Notes to Financial Statements

Year ended 31 December 2005

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Interests in joint ventures (Continued)

The Group recognises its interests in the joint ventures using proportionate consolidation. The Group combines its share of each of the assets, liabilities, income and expenses of the joint ventures with the similar items, line by line, in its consolidated financial statements. The financial statements of the joint ventures are prepared for the same reporting year as the parent, using consistent accounting policies. Adjustments are made to bring into line any dissimilar accounting policies that may exist.

When the Group contributes or sells assets to the joint ventures, any portion of gain or loss from the transaction is recognised based on the substance of the transaction. When the Group purchases assets from the joint ventures, the Group does not recognise its share of the profits of the joint ventures from the transaction until it resells the assets to an independent party.

The joint ventures are proportionately consolidated until the date on which the Group ceases to have joint control over the joint ventures.

Interests in associates

The Group's interests in its associates is accounted for under the equity method of accounting. An associate is an entity in which the Group has significant influence and which is neither a subsidiary nor a joint venture of the Group.

Under the equity method, the interests in associates are carried in the consolidated balance sheet at cost plus post-acquisition changes in the Group's share of net assets of the associates. Goodwill relating to the associates is included in the carrying amount of the investment and is not amortised. After application of the equity method, the Group determines whether it is necessary to recognise any additional impairment loss with respect to the Group's net investment in the associates. The consolidated income statement reflects the share of the results of operations of the associates. Where there has been a change recognised directly in the equity of the associates, the Group recognises its share of any changes and disclose this, when applicable, in the consolidated statement of changes in equity.

The reporting dates of the associates and the Group are identical and the associates' accounting policies conform to those used by the Group for like transactions and events in similar circumstances. Adjustments are made to bring into line any dissimilar accounting policies that may exist.

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

Property, plant and equipment

Property, plant and equipment, other than construction in progress ("CIP"), are stated at cost, excluding the costs of day-to-day servicing, less accumulated depreciation and accumulated impairment in value. Such costs include the costs of replacing part of such property, plant and equipment when the costs are incurred if the recognition criteria are met.

CIP represents office buildings and various infrastructure projects under construction and equipment pending installation in the aircraft and is stated at cost less any impairment losses, and is not depreciated. Costs comprise the direct costs of construction, the cost of equipment as well as finance charges from borrowings used to finance these assets during the construction or installation period. CIP is reclassified to the appropriate categories of property, plant and equipment when completed and ready for use.

Notes to Financial Statements

Year ended 31 December 2005

2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Property, plant and equipment (Continued)

Depreciation is calculated on a straight-line basis over the useful life of the asset, after taking into account its estimated residual value, as follows:

	Depreciation life	Residual value
Aircraft and flight equipment	4 to 20 years	Nil-5%
Buildings	15 to 35 years	5%
Machinery, transportation equipment and office equipment	4 to 20 years	5%

An item of property, plant and equipment is derecognised upon disposal or when no future economic benefits are expected from its use or disposal. Any gain or loss arising on derecognition of the asset (calculated as the difference between the new disposal proceeds and the carrying amount of the asset) is included in the income statement in the year the asset is derecognised.

The carrying values of property, plant and equipment are reviewed for impairment when events or changes in circumstances indicate that the carrying value may not be recoverable. The asset's residual value, useful life and methods are reviewed, and adjusted if appropriate, at each year end.

When each major inspection is performed, its cost is recognised in the carrying amount of the property, plant and equipment as a replacement if the recognition criteria are satisfied.

Lease prepayments

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

Leases

The determination of whether an arrangement is, or contains, a lease is based on the substance of the arrangement and requires an assessment of whether the fulfillment of the arrangement is dependent on the use of a specific asset or assets and the arrangement conveys a right to use the asset.

Finance leases, which transfer to the Group substantially all the risks and benefits incidental to ownership of the leased item, are capitalised at the inception of the lease at the fair value of the leased asset or, if lower, at the present value of the minimum lease payments. Lease payments are apportioned between the finance charges and reduction of the lease liability so as to achieve a constant rate of interest on the remaining balance of the liability. Finance charges are charged directly against income.

Capitalised leased assets are depreciated over the shorter of the estimated useful life of the asset and the lease term, if there is no reasonable certainty that the Group will obtain ownership by the end of the lease term.

Leases where the lessor retains substantially all the risks and benefits of ownership of the asset are classified as operating leases. Where the Group is the lessor, assets leased by the Group under operating leases are included in non-current assets and rentals receivables under the operating leases are credited to the income statement on the straight-line basis over the lease terms. Where the Group is the lessee, rentals payable under the operating leases are charged to the income statement on the straight-line basis over the lease terms.

Notes to Financial Statements

Year ended 31 December 2005

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Goodwill

Goodwill acquired in a business combination is initially measured at cost being the excess of the cost of the business combination over the Group's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities. Following initial recognition, goodwill is measured at cost less any accumulated impairment losses. Goodwill is reviewed for impairment, annually or more frequently if events or changes in circumstances indicate that the carrying value may be impaired.

For the purpose of impairment testing, goodwill acquired in a business combination is, from the acquisition date, allocated to each of the Group's cash-generating units, or groups of cash-generating units, that are expected to benefit from the synergies of the combination, irrespective of whether other assets or liabilities of the Group are assigned to those units or groups of units. Each unit or group of units to which the goodwill is so allocated:

- represents the lowest level within the Group at which the goodwill is monitored for internal management purposes; and

- is not larger than a segment based on either the Group's primary or the Group's secondary reporting format determined in accordance with IAS 14 *Segment Reporting*.

Impairment is determined by assessing the recoverable amount of the cash-generating unit (group of cash-generating units), to which the goodwill relates. Where the recoverable amount of the cash-generating unit (group of cash-generating units) is less than the carrying amount, an impairment loss is recognised. Where goodwill forms part of a cash-generating unit (group of cash-generating units) and part of the operation within that unit is disposed of, the goodwill associated with the operation disposed of is included in the carrying amount of the operation when determining the gain or loss on disposal of the operation. Goodwill disposed of in this circumstance is measured based on the relative values of the operation disposed of and the portion of the cash-generating unit retained.

Advance payments for aircraft and related equipment

Advance contract payments to aircraft manufacturers to secure deliveries of aircraft and related equipment in future years, including attributable finance costs, are included in assets. The advances are accounted for as part of the costs of property, plant and equipment upon delivery of the aircraft.

Investments and other financial assets

Financial assets in the scope of IAS 39 are classified as either financial assets at fair value through profit or loss, loans and receivables, held-to-maturity investments, and available-for-sale financial assets, as appropriate. When financial assets are recognised initially, they are measured at fair value, plus, in the case of investments not at fair value through profit or loss, directly attributable transactions costs. The Group determines the classification of its financial assets after initial recognition and, where allowed and appropriate, re-evaluates this designation at each financial year end.

All regular way purchases and sales of financial assets are recognised on the trade date i.e. the date that the Group commits to purchase the asset. Regular way purchases or sales are purchases or sales of financial assets that require delivery of assets within the period generally established by regulation or convention in the marketplace.

Notes to Financial Statements

Year ended 31 December 2005

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Investments and other financial assets (Continued)

Financial assets at fair value through profit or loss

Financial assets classified as held for trading are included in the category "financial assets at fair value through profit or loss". Financial assets are classified as held for trading if they are acquired for the purpose of selling in the near term. Derivatives are also classified as held for trading unless they are designated and effective hedging instruments. Gains or losses on investments held for trading are recognised in income.

Held-to-maturity investments

Non-derivative financial assets with fixed or determinable payments and fixed maturity are classified as held-to-maturity when the Group has the positive intention and ability to hold to maturity. Investments intended to be held for an undefined period are not included in this classification. Other long-term investments that are intended to be held-to-maturity, such as bonds, are subsequently measured at amortised cost. This cost is computed as the amount initially recognised minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between the initially recognised amount and the maturity amount. This calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate, transaction costs and all other premiums and discounts. For investments carried at amortised cost, gains and losses are recognised in income when the investments are derecognised or impaired, as well as through the amortisation process.

Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. Such assets are carried at amortised cost using the effective interest method. Gains and losses are recognised in income when the loans and receivables are derecognised or impaired, as well as through the amortisation process.

Available-for-sale financial assets

Available-for-sale financial assets are those non-derivative financial assets that are designated as available for sale or are not classified as financial assets at fair value through profit or loss, held-to-maturity investments and loans and receivables. After initial recognition, available-for-sale financial assets are measured at fair value with gains or losses being recognised as a separate component of equity until the investment is derecognised or until the investment is determined to be impaired at which time the cumulative gain or loss previously reported in equity is included in the income statement.

The fair value of investments that are actively traded in organised financial markets is determined by reference to quoted market bid prices at the close of business on the balance sheet date. For investments where there is no active market, fair value is determined using valuation techniques. Such techniques include using recent arm's length market transactions, reference to the current market value of another instrument, which is substantially the same, discounted cash flow analysis and option pricing models.

Inventories

Inventories, which consist primarily of expendable spare parts and supplies, are stated at cost less any provision for obsolescence, and are expensed when consumed in operations. Cost is determined on the weighted average basis.

Notes to Financial Statements

Year ended 31 December 2005

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Inventories (Continued)

Work in progress represents material costs, labour costs and overhead costs capitalised for the provision of aircraft engineering services and is stated at the lower of cost, calculated on a weighted average basis, and net realisable value. Net realisable value is determined on the basis of anticipated sales proceeds less estimated costs to be incurred to completion and disposal.

Cash and cash equivalents

Cash and cash equivalents in the balance sheets comprise cash at banks and on hand and short-term deposits with an original maturity of three months or less, which are not restricted as to use.

For the purpose of the consolidated cash flow statement, cash and cash equivalents consist of cash and cash equivalents as defined above.

Manufacturers' credits

In connection with the acquisition of certain aircraft and related equipment, the Group receives various credits from the manufacturers. Such credits are deferred until the aircraft and related equipment are delivered, at which time they are applied as a reduction of the cost of acquiring the aircraft and related equipment.

Provisions

Provisions are recognised when the Group has a present obligation (legal or constructive) as a result of a past event and it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and a reliable estimate can be made of the amount of the obligation. The expense relating to any provision is presented in the income statement. If the effect of the time value of money is material, provisions are discounted using a current pre-tax rate that reflects, where appropriate, the risks specific to the liability. Where discounting is used, the increase in the provision due to the passage of time is recognised as a borrowing cost.

Employee benefits

(a) Pension obligations

The full-time employees of the Group are covered by various government-sponsored pension plans under which the employees are entitled to a monthly pension based on certain formulae. Certain government agencies are responsible for the pension liability to these retired employees. The Group contributes on a monthly basis to these pension plans. Under these plans, the Group has no legal or constructive obligation for retirement benefits beyond the contributions made. Contributions to these plans are expensed as incurred.

(b) Termination and early retirement benefits

Termination benefits are payable whenever an employee's employment is voluntary terminated before the normal retirement date or whenever an employee accepts voluntary redundancy in exchange for these benefits. The Group recognises termination benefits when it is demonstrably committed to either terminating the employment of current employees according to a detailed formal plan without possibility of withdrawal or to providing termination benefits as a result of an offer made to encourage voluntary redundancy.

Notes to Financial Statements

Year ended 31 December 2005

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Employee benefits (Continued)

(c) Housing benefits

In prior years, the Group sold staff quarters to its employees, subject to a number of eligibility requirements, at below market prices. When staff quarters are identified as being subject to sale under these arrangements, the carrying value of the staff quarters is written down to the net recoverable amount. Upon sale, any difference between sales proceeds and the carrying amount of the staff quarters is charged to the income statement. The above staff quarters' allocation scheme was phased out before the incorporation of the Company in accordance with the policies of the PRC government.

In 1998, the State Council of the PRC issued a circular, which stipulated that the sale of quarters to employees at preferential prices should be withdrawn. In 2000, the State Council further issued a circular stating that cash subsidies should be made to the employees following the withdrawal of allocation of staff quarters. However, the specific timetable and procedures to implement these policies are to be determined by the individual provincial or municipal government based on the particular situation of the province or municipality.

Based on the relevant detailed local government regulations promulgated, certain entities within the Group have adopted cash housing subsidy plans, whereby, for those eligible employees who have not been allocated with any quarters or who have not been allocated with quarters up to the prescribed standards before the staff quarters' allocation scheme was terminated, the Group will pay them one-off cash housing subsidies based on their years of service, position and other criteria. These cash housing subsidies are charged to the income statement in the year in which it was determined that the payment of such subsidies is probable and the amounts can be reasonably estimated.

In addition, all full-time employees of the Group are entitled to participate in various government-sponsored housing funds. The Group contributes on a monthly basis to these funds based on certain percentages of the salaries of the employees. The Group's liability in respect of these funds is limited to the contributions payable in each year.

Maintenance and overhaul costs

In respect of aircraft and engines under operating leases, the Group has the responsibility to fulfil certain return conditions under the relevant operating leases. In order to fulfil these return conditions, major overhauls are required to be conducted on a regular basis. Accordingly, estimated costs of major overhauls for aircraft and engines under operating leases are accrued and charged to the income statement over the estimated period between overhauls using the ratios of actual flying hours/cycles and estimated flying hours/cycles between overhauls. The costs of major overhauls comprise mainly labour and materials. Differences between the estimated costs and the actual costs of overhauls are included in the income statement in the period of overhaul.

In respect of aircraft and engines owned by the Group or held under finance leases, costs of major overhauls are recognised in the carrying amount of the property, plant and equipment as a replacement if the recognition criteria are satisfied.

All other routine repair and maintenance costs incurred in restoring such property, plant and equipment to their normal working condition are charged to the income statement as and when incurred.

Notes to Financial Statements

Year ended 31 December 2005

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Frequent flyer programme

For Air China Companion Club member accounts that have sufficient mileage credits to claim the lowest level of free travel, the Group records a liability for the estimated incremental costs associated with providing travel awards that are expected to be redeemed. Incremental costs include the costs of incremental fuel, meals and insurance but do not include any costs for aircraft ownership, maintenance, labour or overhead allocation. The liability is adjusted periodically based on awards earned, awards redeemed, changes in the incremental costs and changes in the Air China Companion Club programme, and is included in the balance sheet as a current liability.

Revenue recognition

Revenue is recognised to the extent that it is probable that the economic benefits will flow to the Group and the revenue can be reliably measured. The following specific recognition criteria must also be met before revenue is recognised:

(a) *Provision of airline and airline-related services*

Passenger revenue is recognised either when transportation services are provided or when a ticket expires unused rather than when a ticket is sold. Unused tickets generally expire one year from the date the ticket was sold, or for partially used tickets, the date of first flight. Ticket sales for transportation not yet provided are included in current liabilities as air traffic liabilities. In addition, the Group has code-sharing agreements with other airlines under which a carrier's flights can be marketed under the two-letter airline designator code of another carrier. Revenue earned under these arrangements are allocated between the code share partners based on existing contractual agreements and airline industry standard pro-ratio formulae and are recognised as passenger revenue when the transportation services are provided.

Cargo and mail revenue is recognised when transportation services are provided.

Revenue from airline-related services is recognised when services are rendered.

Revenue is stated net of business tax.

(b) *Sale of goods*

Revenue is recognised when the significant risks and rewards of ownership of the goods have been passed to the buyer.

(c) *Trading of investments*

Revenue is recognised on a trade date basis.

(d) *Interest income*

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

(e) *Dividends*

Revenue is recognised when the Group's right to receive payments is established.

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

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

Notes to Financial Statements

Year ended 31 December 2005

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Government grants

Government grants are recognised where there is reasonable assurance that the grant will be received and all attaching conditions will be complied with. When the grant relates to an expense item, it is recognised as income over the period necessary to match the grant on a systematic basis to the costs that it is intended to compensate. Where the grant relates to an asset, the fair value is credited to a deferred income account and is released to the income statement over the expected useful life of the relevant asset by equal annual instalments.

Related parties

Parties are considered to be related if one party has the ability, directly or indirectly, to control the other party or exercise significant influence over the other party in making financial and operating decisions. Parties are also considered to be related if they are subject to common control or common significant influence. Related parties may be individuals or corporate entities.

Taxes

Current tax

Current tax assets and liabilities for the current and prior periods are measured at the amount expected to be recovered from or paid to the taxation authorities. The tax rates and tax laws used to compute the amount are those that are enacted or substantively enacted by the balance sheet date.

Deferred tax

Deferred income tax is provided, using the liability method on temporary differences at the balance sheet date between the tax bases of assets and liabilities and their carrying amounts for financial reporting purposes.

Deferred income tax liabilities are recognised for all taxable temporary differences, except:

- where the deferred income tax liability arises from the initial recognition of goodwill or an asset or liability in a transaction that is not a business combination and, at the time of the transaction, affects neither the accounting profit nor taxable profit or loss; and

- in respect of taxable temporary differences associated with investments in subsidiaries, associates and interests in joint ventures, where the timing of the reversal of the temporary differences can be controlled and it is probable that the temporary differences will not reverse in the foreseeable future.

Deferred income tax assets are recognised for all deductible temporary differences, carry-forward of unused tax assets and unused tax losses, to the extent that it is probable that taxable profit will be available against which the deductible temporary differences, and the carry-forward of unused tax credits and unused tax losses can be utilised, except:

- where the deferred income tax asset relating to the deductible temporary difference arises from the initial recognition of an asset or liability in a transaction that is not a business combination and, at the time of the transaction, affects neither the accounting profit nor taxable profit or loss; and

- in respect of deductible temporary differences associated with investments in subsidiaries, associates and interests in joint ventures, deferred income tax assets are recognised only to the extent that it is probable that the temporary differences will reverse in the foreseeable future and taxable profit will be available against which the temporary differences can be utilised.

Notes to Financial Statements

Year ended 31 December 2005

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Taxes (Continued)

Deferred tax (Continued)

The carrying amount of deferred income tax assets is reviewed at each balance sheet date and reduced to the extent that it is no longer probable that sufficient taxable profit will be available to allow all or part of the deferred income tax asset to be utilised. Unrecognised deferred income tax assets are reassessed at each balance sheet date and are recognised to the extent that it has become probable that future taxable profit will allow the deferred income tax asset to be recovered.

Deferred income tax assets and liabilities are measured at the tax rates that are expected to apply to the period when the asset is realised or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted at the balance sheet date.

Income tax relating to items recognised directly in equity is recognised in equity and not in the income statement.

Deferred income tax assets and deferred income tax liabilities are offset, if a legally enforceable right exists to set off current tax assets against current tax liabilities and the deferred taxes relate to the same taxable entity and the same taxation authority.

Trade and other receivables

Trade receivables, which generally have terms of 30 to 90 days, are recognised and carried at original invoice amount less an allowance for any uncollectible amounts. Provision is made when there is objective evidence that the Group will not be able to collect the debts. Bad debts are written off when identified.

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

Derivative financial instruments and hedging

The Group uses derivative financial instruments to hedge its exposure to jet fuel prices. Such derivative financial instruments are initially recognised at fair value on the date on which a derivative contract is entered into and are subsequently re-measured at fair value. Derivatives are carried as assets when the fair value is positive and as liabilities when the fair value is negative.

Any gains or losses arising from changes in fair value on derivatives that do not qualify for hedge accounting are taken directly to the income statement for the year.

For the purposes of hedge accounting, hedges are classified as follows:

- fair value hedges, when hedging the exposure to changes in the fair value of a recognised asset or liability;

- cash flow hedges, when hedging exposure to variability in cash flows that is either attributable to a particular risk associated with a recognised asset or liability or a forecast transaction; or

- hedges of a net investment in a foreign operation.

Hedges which meet the strict criteria for hedge accounting are accounted for as follows:

Notes to Financial Statements

Year ended 31 December 2005

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Derivative financial instruments and hedging (Continued)

Fair value hedges

Fair value hedges are hedges of the Group's exposure to changes in the fair value of a recognised asset or liability or an unrecognised firm commitment, or an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect profit or loss. For fair value hedges, the carrying amount of the hedged item is adjusted for gains and losses attributable to the risk being hedged, the derivative is re-measured at fair value and gains and losses from both are taken to profit or loss.

For fair value hedges relating to items carried at amortised cost, the adjustment to carrying value is amortised through profit or loss over the remaining term to maturity. Any adjustment to the carrying amount of a hedged financial instrument for which the effective interest method is used is amortised to profit or loss.

Amortisation may begin as soon as an adjustment exists and shall begin no later than when the hedged item ceases to be adjusted for changes in its fair value attributable to the risk being hedged.

When an unrecognised firm commitment is designated as a hedged item, the subsequent cumulative change in the fair value of the firm commitment attributable to the hedged risk is recognised as an asset or liability with the corresponding gain or loss recognised in profit or loss. The changes in the fair value of the hedging instrument are also recognised in profit or loss.

The Group discontinues fair value hedge accounting if the hedging instrument expires or is sold, terminated or exercised; the hedge no longer meets the criteria for hedge accounting; or the Group revokes the designation. Any adjustment to the carrying amount of a hedged financial instrument for which the effective interest method is used is amortised to profit or loss. Amortisation may begin as soon as an adjustment exists and shall begin no later than when the hedged item ceases to be adjusted for changes in its fair value attributable to the risk being hedged.

Cash flow hedges

Cash flow hedges are a hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with a recognised asset or liability or a highly probable forecast transaction and could affect profit or loss. The effective portion of the gain or loss on the hedging instrument is recognised directly in equity, while the ineffective portion is recognised in profit or loss.

Amounts taken to equity are transferred to the income statement when the hedged transaction affects profit or loss, such as when hedged financial income or financial expense is recognised or when a forecast sale or purchase occurs. Where the hedged item is the cost of a non-financial asset or liability, the amounts taken to equity are transferred to the initial carrying amount of the non-financial asset or liability.

If the forecast transaction is no longer expected to occur, amounts previously recognised in equity are transferred to the profit or loss. If the hedging instrument expires or is sold, terminated or exercised without replacement or rollover, or if its designation as a hedge is revoked, amounts previously recognised in equity will remain in equity until the forecast transaction occurs. If the related transaction is not expected to occur, the amount is taken to profit or loss.

Notes to Financial Statements

Year ended 31 December 2005

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Derivative financial instruments and hedging (Continued)

Hedges of a net investment

Hedges of a net investment in a foreign operation, including a hedge of a monetary item that is accounted for as part of the net investment, are accounted for in a way similar to cash flow hedges. Gains or losses on the hedging instrument relating to the effective portion of the hedge are recognised directly in equity while any gains or losses relating to the ineffective portion are recognised in profit or loss. On disposal of the foreign operation, the cumulative value of any such gains or losses recognised directly in equity is transferred to profit or loss.

Borrowing costs

Borrowing costs directly attributable to the acquisition of aircraft, construction or production of qualifying assets, i.e. assets that necessarily take a substantial period of time to get ready for their intended use, are capitalised as part of the costs of those assets. The capitalisation of aircraft borrowing costs ceases when the aircraft is placed into revenue earning services and the capitalisation of other assets' borrowing costs ceases when the assets are substantially ready for their intended use or sale.

Where funds have been borrowed generally, and used for the purpose of obtaining qualifying assets, a capitalisation rate of 4.5% (2004: ranging between 5.6% and 5.8%) has been applied to the expenditure on the individual asset.

All other borrowing costs are recognised as an expense when incurred.

Interest-bearing loans and borrowings

All loans and borrowings are initially recognised at the fair value of the consideration received less directly attributable transaction costs.

After initial recognition, interest-bearing loans and borrowings are subsequently measured at amortised cost using the effective interest rate method.

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

Impairment of assets

The Group assesses at each reporting date whether there is an indication that an asset may be impaired. If any such indication exists, or when annual impairment testing for an asset is required, the Group makes an estimate of the asset's recoverable amount. An asset's recoverable amount is the higher of an asset's or cash-generating unit's fair value less costs to sell and its value in use, and is determined for an individual asset, unless the asset does not generate cash inflows that are largely independent of those from other assets or groups of assets. Where the carrying amount of an asset exceeds its recoverable amount, the asset is considered impaired and is written down to its recoverable amount. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset. Impairment losses of continuing operations are recognised in the income statement in those expense categories consistent with the function of the impaired asset.

Notes to Financial Statements

Year ended 31 December 2005

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Impairment of assets (Continued)

An assessment is made at each reporting date as to whether there is any indication that previously recognised impairment losses may no longer exist or may have decreased. If such indication exists, the recoverable amount is estimated. A previously recognised impairment loss is reversed only if there has been a change in the estimates used to determine the asset's recoverable amount since the last impairment loss was recognised. If that is the case the carrying amount of the asset is increased to its recoverable amount. That increased amount cannot exceed the carrying amount that would have been determined, net of depreciation, had no impairment loss been recognised for the asset in prior years. Such reversal is recognised in profit or loss. After such a reversal the depreciation charge is adjusted in future periods to allocate the asset's revised carrying amount, less any residual value, on a systematic basis over its remaining useful life.

Derecognition of financial assets and liabilities

Financial assets

A financial asset (or, where applicable a part of a financial asset or part of a group of similar financial assets) is derecognised where:

- the rights to receive cash flows from the asset have expired;
- the Group retains the right to receive cash flows from the asset, but has assumed an obligation to pay them in full without material delay to a third party under a "pass-through" arrangement; or
- the Group has transferred its rights to receive cash flows from the asset and either (a) has transferred substantially all the risks and rewards of the asset, or (b) has neither transferred nor retained substantially all the risks and rewards of the asset, but has transferred control of the asset.

Where the Group has transferred its rights to receive cash flows from an asset and has neither transferred nor retained substantially all the risks and rewards of the asset nor transferred control of the asset, the asset is recognised to the extent of the Group's continuing involvement in the asset. Continuing involvement that takes the form of a guarantee over the transferred asset is measured at the lower of the original carrying amount of the asset and the maximum amount of consideration that the Group could be required to repay.

Where continuing involvement takes the form of a written and/or purchased option (including a cash-settled option or similar provision) on the transferred asset, the extent of the Group's continuing involvement is the amount of the transferred asset that the Group may repurchase, except that in the case of a written put option (including a cash-settled option or similar provision) on an asset measured at fair value, the extent of the Group's continuing involvement is limited to the lower of the fair value of the transferred asset and the option exercise price.

Financial liabilities

A financial liability is derecognised when the obligation under the liability is discharged or cancelled or expires.

Where an existing financial liability is replaced by another from the same lender on substantially different terms, or the terms of an existing liability are substantially modified, such an exchange or modification is treated as a derecognition of the original liability and the recognition of a new liability, and the difference in the respective carrying amounts is recognised in profit or loss.

Notes to Financial Statements

Year ended 31 December 2005

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Impairment of financial assets

The Group assesses at each balance sheet date whether a financial asset or group of financial assets is impaired.

Available-for-sale financial assets

If an available-for-sale asset is impaired, an amount comprising the difference between its cost (net of any principal payment and amortisation) and its current fair value, less any impairment loss previously recognised in profit or loss, is transferred from equity to the income statement. Reversals of impairment loss in respect of equity instruments classified as available-for-sale are not recognised in profit or loss. Reversals of impairment losses on debt instruments are reversed through profit or loss, if the increase in fair value of the instruments can be objectively related to an event occurring after the impairment loss was recognised in profit or loss.

Significant accounting estimates

Estimation uncertainty

The key assumptions concerning the future and other key sources of estimation uncertainty at the balance sheet date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next year are discussed below.

(a) Impairment of goodwill

The Group determines whether goodwill is impaired at least on an annual basis. This requires an estimation of the value in use of the cash-generating units to which the goodwill is allocated. Estimating the value in use requires the Group to make an estimate of the expected future cash flows from the cash-generating unit and also to choose a suitable discount rate in order to calculate the present value of those cash flows. The carrying amount of goodwill at 31 December 2005 was RMB1,444 million (2004: RMB1,405 million). More details are given in note 19 to these financial statements.

Notes to Financial Statements

Year ended 31 December 2005

3. SEGMENT INFORMATION

Segment information of the Group is presented by way of two segment formats: (i) on a primary segment reporting basis, by business segment; and (ii) on a secondary segment reporting basis, by geographical segment.

The Group's operating businesses are structured and managed separately, according to the nature of their operations and the services they provide. Each of the Group's business segments represents a strategic business unit that offers services which are subject to risks and returns that are different from those of the other business segments.

Currently, the Group's business segment information is divided into the following four business segments:

(a) the airline operations segment comprises the provision of air passenger and air cargo services;

(b) the engineering services segment comprises the provision of aircraft engineering services which include aircraft maintenance, repair and overhaul services;

(c) the airport terminal services segment comprises the provision of ground services which include check-in service, boarding service, premium class lounge service, ramp service, luggage handling service, loading and unloading services, cabin cleaning and transit services; and

(d) the "others" segment comprises the provision of air catering services and other airline-related services.

The profit before tax of a segment represents revenue less expenses directly attributable to a segment and the relevant portion of enterprise revenue less expenses that can be allocated on a reasonable basis to a segment, whether from external transactions or from transactions with other segments of the Group.

Segment assets and liabilities mainly comprise operating assets and liabilities that are directly attributable to the segment or can be allocated to the segment on a reasonable basis.

In determining the Group's geographical segments, revenue is attributed to the segments based on the origin and destination of each flight segment. Assets, which consist principally of aircraft and ground equipment, supporting the entire worldwide transportation system, are mainly located in Mainland China. An analysis of assets and capital expenditure of the Group by geographical distribution has therefore not been included.

Intersegment sales and transfers are transacted with reference to the selling prices used for sales made to third parties at the then prevailing market prices.

Notes to Financial Statements

Year ended 31 December 2005

3. SEGMENT INFORMATION (Continued)

Business segments

The following tables present revenue, profit and certain asset, liability and expenditure information for the Group's business segments for the years ended 31 December 2005 and 2004:

For the year ended 31 December 2005

	Airline operations RMB'000	Engineering services RMB'000	Airport terminal services RMB'000	Others RMB'000	Eliminations RMB'000	Total RMB'000
REVENUE						
Sales to external customers	37,380,669	376,437	320,477	213,383	–	38,290,966
Intersegment sales	–	619,098	–	108,873	(727,971)	–
Total revenue	37,380,669	995,535	320,477	322,256	(727,971)	38,290,966
PROFIT FROM OPERATIONS						
Segment results	3,367,949	772,877	123,679	137,282	(727,971)	3,673,816
Finance revenue	1,231,986	8,512	37	8,072	–	1,248,607
Finance costs	(1,762,481)	(7,504)	(2,320)	(794)	–	(1,773,099)
Share of profits less losses from associates	81,645	(8,628)	148,096	3,817	–	224,930
Profit before tax	2,919,099	765,257	269,492	148,377	(727,971)	3,374,254
Tax						(903,874)
Minority interests						(64,124)
Net profit attributable to equity holders of the parent						2,406,256
ASSETS						
Segment assets	63,703,084	1,046,799	122,474	668,200	(1,630,942)	63,909,615
Interests in associates	3,312,608	18,700	192,084	270,565	–	3,793,957
Unallocated assets						498,371
Total assets						68,201,943
LIABILITIES						
Segment liabilities	(46,191,851)	(489,320)	(404,229)	(775,802)	1,630,942	(46,230,260)
Unallocated liabilities						(421,077)
Total liabilities						(46,651,337)
OTHER INFORMATION						
Capital expenditures						
– property, plant and equipment	13,222,058	37,219	855	30,836	–	13,290,968
Depreciation of property, plant and equipment	4,409,021	38,381	61,303	3,975	–	4,512,680
Amortisation of lease prepayments	19,555	–	–	–	–	19,555
Increase in fair value of financial assets, net	(125,868)	–	–	–	–	(125,868)
Provision/(write-back of provision) for doubtful debts, net	14,836	118	–	(231)	–	14,723

Notes to Financial Statements

Year ended 31 December 2005

3. SEGMENT INFORMATION (Continued)

Business segments (Continued)

For the year ended 31 December 2004

	Airline operations RMB'000	Engineering services RMB'000	Airport terminal services RMB'000	Others RMB'000	Eliminations RMB'000	Total RMB'000
REVENUE						
Sales to external customers	32,766,164	296,775	287,905	169,913	–	33,520,757
Intersegment sales	–	731,589	–	131,299	(862,888)	–
Total revenue	32,766,164	1,028,364	287,905	301,212	(862,888)	33,520,757
PROFIT FROM OPERATIONS						
Segment results	4,146,402	824,858	203,133	173,746	(862,888)	4,485,251
Finance revenue	73,943	278	–	5,140	–	79,361
Finance costs	(1,859,139)	(14,819)	(1,978)	(3,298)	–	(1,879,234)
Dilution gains on investments	330,222	–	–	79,915	–	410,137
Share of profits less losses from associates	331,530	(5,083)	130,661	6,936	–	464,044
Profit before tax	3,022,958	805,234	331,816	262,439	(862,888)	3,559,559
Tax						(1,010,864)
Minority interests						(162,731)
Net profit attributable to equity holders of the parent						2,385,964
ASSETS						
Segment assets	62,308,593	1,077,748	160,087	379,390	(2,014,154)	61,911,664
Interests in associates	3,589,574	25,539	186,056	200,352	–	4,001,521
Unallocated assets						776,084
Total assets						66,689,269
LIABILITIES						
Segment liabilities	(48,845,870)	(652,749)	(312,765)	(677,442)	2,014,154	(48,474,672)
Unallocated liabilities						(186,055)
Total liabilities						(48,660,727)
OTHER INFORMATION						
Capital expenditures – property, plant and equipment	6,046,355	32,697	25,912	33,641	–	6,138,605
Depreciation of property, plant and equipment	3,395,049	35,797	19,247	13,159	–	3,463,252
Amortisation of lease prepayments	4,884	–	–	–	–	4,884
Decrease in fair value of financial assets, net	28,000	–	–	–	–	28,000
Provision/(write-back of provision) for doubtful debts, net	(4,483)	2,642	–	853	–	(988)
Provision/(write-back of provision) against inventories, net	12,492	(24,000)	–	–	–	(11,508)

Notes to Financial Statements

Year ended 31 December 2005

3. SEGMENT INFORMATION (Continued)

Geographical segments

The following tables present consolidated revenue by geographical segments for the years ended 31 December 2005 and 2004:

For the year ended 31 December 2005	Domestic	HK/ Macau	Europe	North America	Japan/ Korea	Asia Pacific, others	Total
	RMB'000	*RMB'000*	*RMB'000*	*RMB'000*	*RMB'000*	*RMB'000*	*RMB'000*
REVENUE							
Sales to external customers and total revenue	**20,490,055**	**2,269,256**	**5,081,774**	**2,964,247**	**4,250,255**	**3,235,379**	**38,290,966**

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

4. AIR TRAFFIC REVENUE

Air traffic revenue comprises revenue from the airline operations business and is stated net of business tax. An analysis of air traffic revenue is as follows:

	Group	
	2005	2004
	RMB'000	*RMB'000*
Passenger	**31,584,426**	27,665,018
Cargo and mail	**3,716,400**	3,169,804
	35,300,826	30,834,822

Pursuant to various PRC business tax rules and regulations, the Group is required to pay business tax to the local tax bureaus at the following rates:

Type of revenue	Applicable business tax rate
Air traffic revenue	3% of air traffic revenue (all inbound international and Hong Kong and Macau regional flights are exempted from business tax)
Other operating revenue *(note 5)*	3% to 5% of other operating revenue

PRC business tax incurred for the years ended 31 December 2005 and 2004, netted against air traffic revenue, amounted to approximately RMB846 million and RMB711 million, respectively.

Notes to Financial Statements

Year ended 31 December 2005

5. OTHER OPERATING REVENUE

	Group	
	2005	2004
	RMB'000	*RMB'000*
Bellyhold income from a joint venture *(note 46)*	**1,496,302**	1,384,457
Aircraft engineering income	**376,437**	296,775
Ground services income	**320,477**	287,905
General aviation income	**155,521**	159,990
Air catering income	**109,591**	118,140
Government grants:		
(i) Recognition of deferred income *(note 36)*	**76,943**	70,593
(ii) Fixed cash subsidy	**–**	37,500
(iii) Others	**41,250**	44,853
Service charges on return of unused flight tickets	**97,951**	63,821
Cargo handling service income	**67,822**	49,850
Sale of materials	**11,899**	33,008
Import and export service income	**12,311**	29,767
Training service income	**19,029**	23,761
Aircraft and related equipment lease income	**7,072**	11,516
Gain on disposal of property, plant and equipment, net	**74,474**	–
Others	**123,061**	73,999
	2,990,140	2,685,935

6. PROFIT FROM OPERATIONS

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

	Group	
	2005	2004
	RMB'000	*RMB'000*
Repair and maintenance costs	**2,078,382**	3,608,348
Depreciation *(note 15)*	**4,512,680**	3,463,252
Amortisation of lease prepayments *(note 16)*	**19,555**	4,884
Employee compensation costs *(note 7)*	**3,406,825**	2,921,322
Minimum lease payments under operating leases:		
Aircraft and engines	**1,530,754**	1,071,256
Land and buildings	**211,177**	187,471
(Gain)/loss on disposal of property, plant and equipment, net	**(74,474)**	33,872
Loss on derecognition of property, plant and equipment *(note 2 (b) (ii))*	**430,010**	–
Auditors' remuneration	**11,029**	7,206
Provision/(write-back of provision) for doubtful debts, net	**14,723**	(988)
Write-back of provision against inventories, net	**–**	(11,508)

Notes to Financial Statements

Year ended 31 December 2005

7. EMPLOYEE COMPENSATION COSTS

	Group	
	2005	2004
	RMB'000	*RMB'000*
Employee compensation costs (including Directors', supervisors' and management's emoluments):		
Wages, salaries and social security costs	**3,200,391**	2,732,927
Retirement benefit costs *(note 11)*	**206,434**	188,395
	3,406,825	2,921,322

8. FINANCE REVENUE AND FINANCE COSTS

Finance revenue

	Group	
	2005	2004
	RMB'000	*RMB'000*
Exchange gains, net	**918,297**	–
Interest income	**108,481**	33,703
Gains on fuel derivatives, net	**221,661**	41,036
Dividend income from available-for-sale investments	**168**	4,622
	1,248,607	79,361

Finance costs

	Group	
	2005	2004
	RMB'000	*RMB'000*
Interest expense	**1,792,408**	1,827,002
Less: Interest capitalised	**(19,309)**	(2,610)
	1,773,099	1,824,392
Exchange losses, net	**–**	54,842
	1,773,099	1,879,234

The interest capitalisation rate represents the cost of capital from raising the related borrowings and is approximately 4.5% (2004: ranging from 5.6% to 5.8%) per annum.

Notes to Financial Statements

Year ended 31 December 2005

9. DILUTION GAINS ON INVESTMENTS

	Group	
	2005	2004
	RMB'000	*RMB'000*
Dilution gain on investment in Air Cargo Business *(note 9(a))*	–	330,222
Dilution gains on investments in BACL and SWACL *(note 9(b))*	–	79,915
	–	410,137

Notes:

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

(b) In accordance with the basis of presentation as set out in note 1 to these financial statements, a 60% shareholding interest in Beijing Air Catering Co., Ltd. ("BACL") and a 75% shareholding interest in Southwest Air Catering Company Limited ("SWACL") were deemed to be held by the Group prior to being transferred during 2004.

During 2004, the Group transferred its entire 60% shareholding interest in BACL and a 60% shareholding interest in SWACL to Fly Top Limited, a wholly-owned subsidiary of China National Aviation Company Limited ("CNAC"), a subsidiary of the Company, for considerations of RMB294 million and RMB67 million, respectively.

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

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

Notes to Financial Statements

Year ended 31 December 2005

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

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

	Group	
	2005	2004
	RMB'000	*RMB'000*
Fees	**150**	29
Basic salaries, housing benefits, other allowances and benefits in kind	**4,443**	4,279
Discretionary bonuses	**787**	636
Retirement benefits	**69**	43
	5,449	4,987

	Fees	Basic salaries, housing benefits, other allowances and benefits in kind	Discretionary bonuses	Retirement benefits	Total emoluments
	RMB'000	RMB'000	RMB'000	RMB'000	RMB'000
Year ended 31 December 2005					
Directors					
Mr. Li Jiaxiang	–	–	–	–	–
Mr. Kong Dong	–	2,132	–	–	2,132
Mr. Wang Shixiang	–	–	–	–	–
Mr. Yao Weiting	–	–	–	–	–
Mr. Ma Xulun	–	124	245	16	385
Mr. Cai Jianjiang	–	124	232	16	372
Mr. Fan Cheng	–	113	153	16	282
Dr. Hu Hung Lick, Henry	50	63	–	–	113
Mr. Wu Zhipan	50	–	–	–	50
Mr. Zhang Ke	50	–	–	–	50
Mr. David Turnbill	–	–	–	–	–
	150	2,556	630	48	3,384
Supervisors					
Mr. Zhang Xianlin	–	1,770	–	–	1,770
Mr. Liao Wei	–	–	–	–	–
Ms. Zhang Huilan	–	–	–	–	–
Mr. Liu Feng	–	93	132	16	241
Mr. Liu Guoqing	–	24	25	5	54
	–	1,887	157	21	2,065
	150	4,443	787	69	5,449

Notes to Financial Statements

Year ended 31 December 2005

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

	Fees RMB'000	Basic salaries, housing benefits, other allowances and benefits in kind RMB'000	Discretionary bonuses RMB'000	Retirement benefits RMB'000	Total emoluments RMB'000
Year ended 31 December 2004					
Directors					
Mr. Li Jiaxiang	–	–	–	–	–
Mr. Kong Dong	–	2,172	–	–	2,172
Mr. Wang Shixiang	–	–	–	–	–
Mr. Yao Weiting	–	–	–	–	–
Mr. Ma Xulun	–	103	259	14	376
Mr. Cai Jianjiang	–	101	240	14	355
Mr. Fan Cheng	–	16	45	1	62
Dr. Hu Hung Lick, Henry	4	–	–	–	4
Mr. Wu Zhipan	13	–	–	–	13
Mr. Zhang Ke	12	–	–	–	12
	29	2,392	544	29	2,994
Supervisors					
Mr. Zhang Xianlin	–	1,804	–	–	1,804
Mr. Liao Wei	–	–	–	–	–
Ms. Zhang Huilan	–	–	–	–	–
Mr. Liu Feng	–	83	92	14	189
	–	1,887	92	14	1,993
	29	4,279	636	43	4,987

Fees of approximately RMB150,000 (2004: RMB29,000) are wholly payable to the independent non-executive Directors. Except for other emoluments of RMB63,000 paid to Dr. Hu Hung Lick, Henry, there were no other emoluments payable to other independent non-executive Directors during the year (2004: Nil).

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

	Group	
	2005 ***Number of individuals***	2004 *Number of individuals*
Director	**1**	1
Supervisor	**1**	1
Employees	**3**	3

Notes to Financial Statements

Year ended 31 December 2005

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

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

	Group	
	2005	2004
	RMB'000	*RMB'000*
Basic salaries, housing benefits, other allowances and benefits in kind	**4,729**	5,360
Discretionary bonuses	**–**	–
Retirement benefits	**216**	164
	4,945	5,524

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

	Group	
	2005	2004
	Number of individuals	*Number of individuals*
HK$1,000,001 to HK$1,500,000 (equivalent to RMB1,051,701 to RMB1,575,550)	**2**	1
HK$1,500,001 to HK$2,000,000 (equivalent to RMB1,575,551 to RMB2,103,400)	**1**	2
	3	3

There was no arrangement under which a Director or a supervisor or any of the five highest paid individuals waived or agreed to waive any remuneration during the year (2004: Nil).

There was no emolument paid by the Group to any of the Directors or supervisors or any of the five highest paid individuals as an inducement to join or upon joining the Group or as compensation for loss of office during the year (2004: Nil).

Notes to Financial Statements

Year ended 31 December 2005

11. RETIREMENT BENEFITS

All of the Group's full-time employees in Mainland China are covered by a government-regulated defined contribution retirement scheme, and are entitled to an annual pension determined by their basic salaries upon their retirement. The PRC government is responsible for the pension liabilities to these retired employees. The Group is required to make annual contributions to the government-regulated defined contribution retirement scheme at rates ranging from 15% to 20% of the employees' basic salaries during the year and has no further obligation for post-retirement benefits in respect of the above. This defined contribution plan continues to be available to the Group's employees after the Restructuring. The related pension costs are expensed as incurred.

Prior to the Restructuring, the Group also paid certain supplementary pension benefits (the "Supplementary Pension Benefits") to its employees who retired before the incorporation of the Company. Pursuant to the Restructuring, CNAHC has agreed to assume past payments and future liabilities in respect of the Supplementary Pension Benefits for those employees who retired before the incorporation of the Company for nil consideration. The pension payments relating to the Supplementary Pension Benefits borne by CNAHC was approximately RMB39 million for the year ended 31 December 2004 *(note 46 (d))*. These pension payments were relating to the period from 1 January 2004 to the date immediately before the incorporation of the Company. The Group's employees who retire after the incorporation of the Company are not entitled to the Supplementary Pension Benefits. CNAHC has agreed to indemnify the Group against losses from any claims for the Supplementary Pension Benefits.

Besides, the Group also implemented an early retirement plan for certain employees in addition to the benefits under the government-regulated defined contribution retirement scheme described above. The benefits of the early retirement plan are calculated based on factors including the remaining number of years of services from the date of early retirement to the normal retirement date and the salary amount on the date of early retirement of the employees. The costs of early retirement benefits were recognised in the period when employees opted for early retirement. Where the effect of discounting is material, the amount recognised for early retirement benefits is the present value at the balance sheet date of the future cash flows expected to be required to settle the obligation. The increase in the discounted present value amount arising from the passage of time is included in finance costs in the income statement.

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

	Group	
	2005	2004
	RMB'000	*RMB'000*
Contributions to PRC government-regulated defined contribution retirement scheme	**202,535**	179,740
Early retirement benefits	**3,899**	8,655
Total *(note 7)*	**206,434**	188,395

Forfeited contributions totalling RMB1,633,000 (2004: RMB1,579,000) was utilised during the year. At 31 December 2005, the Group had no forfeited contributions available to reduce its contributions to the pension scheme in future years (2004: Nil).

Notes to Financial Statements

Year ended 31 December 2005

12. TAX

According to the PRC Enterprise Income Tax Law, the Company, its subsidiaries, joint ventures and associates established in the PRC are subject to enterprise income tax at rates ranging from 15% to 33% (2004: 15% to 33%) on their taxable income.

Hong Kong profits tax has been provided at the rate of 17.5% (2004: 17.5%) on the estimated assessable profits arising in Hong Kong during the year.

The Group is subject to income tax on an entity basis on profits arising in or derived from the jurisdictions in which members of the Group are domiciled and operate. In accordance with an approval document issued by the relevant tax authorities, the filing of tax returns of the Relevant Businesses and all wholly-owned PRC-established subsidiaries of the Company prior to its incorporation on 30 September 2004 was handled by CNAHC on a consolidated group basis. The share of the income tax liability of the Relevant Businesses and all wholly-owned PRC-established subsidiaries of the Company prior to its incorporation was calculated at the applicable tax rates on their profits determined in accordance with PRC accounting principles and after the relevant adjustments made under the prevailing PRC Enterprise Income Tax Law as applicable to domestic enterprises. Such tax was payable to CNAHC which in turn would settle the tax liability with the relevant tax bureau. Similarly, the net profit attributable to CNAHC for the period from 1 January 2004 to 30 September 2004 (the date of incorporation of the Company) referred to in note 13(b) to these financial statements was calculated after deducting the amount of income tax payable to CNAHC, which in turn would settle any tax liability on profits arising during that period with the relevant tax bureau.

Following the incorporation of the Company, the Company will settle its tax liability by itself with the respective tax bureau.

In accordance with the PRC Enterprise Income Tax Law and an approval document issued by the relevant tax bureau on 28 November 2005 (the "Approval Document"), Air China Cargo was approved to be subject to a enterprise income tax rate of 24% on its taxable income as reported in its statutory financial statements for the year ended 31 December 2005 and was fully exempted from corporate income tax for the year ended 31 December 2005 and followed by a 3-year 50% reduction in corporate income tax in the period between 1 January 2006 and 31 December 2008. In addition, pursuant to the Approval Document, Air China Cargo has been granted a 4-year local income tax exemption in the period between 1 January 2005 and 31 December 2008 and followed by a 5-year 50% reduction in local income tax in the period between 1 January 2009 and 31 December 2013.

Notes to Financial Statements

Year ended 31 December 2005

12. TAX (Continued)

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

		Group	
		2005	2004
		RMB'000	*RMB'000*
Current income tax			
Current income tax charge	– Mainland China	**614,313**	398,944
	– Hong Kong	**11,848**	4,096
Deferred income tax			
Relating to origination and reversal of temporary differences *(note 22)*		**277,713**	607,824
Income tax charge for the year		**903,874**	1,010,864

Share of tax attributable to associates amounting to RMB33,640,000 (2004: RMB96,974,000) is included in the "Share of profit less losses from associates" on the face of the consolidated income statement.

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

	Group			
	2005		2004	
	RMB'000	***%***	*RMB'000*	*%*
Profit before income tax	**3,374,254**		3,559,559	
At statutory income tax rate of 33%	**1,113,504**	**33.0**	1,174,654	33.0
Profits and losses attributable to associates	**(74,227)**	**(2.2)**	(153,135)	(4.3)
Lower income tax rates of other territories	**(15,024)**	**(0.5)**	(20,455)	(0.6)
Tax exemption	**(49,558)**	**(1.4)**	–	–
Income not subject to tax	**(115,131)**	**(3.4)**	(211,035)	(5.9)
Expenses not deductible for tax purposes	**26,941**	**0.8**	220,835	6.2
Tax losses not recognised	**12,537**	**0.4**	–	–
Effect on opening deferred income tax assets due to decrease in other territories' income tax rates	**4,832**	**0.1**	–	–
Tax charge at Group's effective income tax rate	**903,874**	**26.8**	1,010,864	28.4

At 31 December 2005, there was no significant unrecognised deferred tax liability (2004: Nil) for taxes that would be payable on the unremitted earnings of certain of the Group's subsidiaries and joint ventures as the Directors of the Company do not have intention to remit any significant amount of earnings to the Company in the foreseeable future.

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

Notes to Financial Statements

Year ended 31 December 2005

13. APPROPRIATIONS

Set out below are the details of distributions made by the Company for the two years ended 31 December 2005:

	Group	
	2005	2004
	RMB'000	*RMB'000*
Declared during the year		
Carved-out of net assets *(note 13(c))*	–	39,136
Dividend paid *(note 13(c))*	–	29,074
Distribution to CNAHC *(note 13(a))*	–	377,550
Distribution to CNAHC *(note 13(b))*	–	2,025,105
Distribution to CNACG *(note 13(b))*	–	118,680
Total	–	2,589,545
Proposed for approval (not recognised as a liability as at 31 December)		
Final dividend for 2005: RMB0.2383 (2004: Nil) per 10 shares *(note 13(d))*	**224,793**	–

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

(i) a share purchase agreement with Air China International Corporation in relation to the acquisition of 60% of the equity interest in BACL (the "BACL Agreement") for a consideration of RMB294 million; and

(ii) a share purchase agreement with Air China International Corporation in relation to the acquisition of 60% of the equity interest in SWACL (the "SWACL Agreement") for a consideration of RMB67 million.

On 12 November 2004, all the pre-completion undertakings of the BACL Agreement and the SWACL Agreement were completed and these two acquisition agreements were effective on that date accordingly.

On 20 April 2004, Air China International Corporation entered into a stock transfer agreement with HKSACL (the "HKSACL Agreement"), the minority shareholder of SWACL, pursuant to which, Air China International Corporation disposed of 15% of the equity interest in SWACL to HKSACL for a consideration of approximately RMB17 million. On 12 November 2004, all the pre-completion undertakings of the HKSACL Agreement were completed and this agreement was effective on that date accordingly.

Immediately after the completion of the BACL Agreement, SWACL Agreement and HKSACL Agreement, the Group's effective shareholding interests in BACL and SWACL were diluted from 60% and 75%, respectively, to approximately 41%.

As a result of the completion of the BACL Agreement, SWACL Agreement and HKSACL Agreement, the Group made a payment of approximately RMB378 million to CNAHC, representing the total consideration payable by CNAC and HKSACL for the acquisitions of the entire shareholding interests held by the Group in BACL and SWACL pursuant to the Restructuring as set out in note 1 to these financial statements. This payment has been made to CNAHC and accounted for as a special distribution to CNAHC by the Company.

Notes to Financial Statements

Year ended 31 December 2005

13. APPROPRIATIONS (Continued)

(b) In accordance with the (財政部關于印發《企業公司制改建有關國有資本管理与財務處理的暫行規定》的通知) "Provisional Regulations Relating to Corporate Reorganisation of Enterprises and Related Management of State-owned Capital and Financial Treatment" notice issued by the Ministry of Finance, which became effective from 27 August 2002, and pursuant to the Restructuring, after the Company's incorporation, the Company is required to make a distribution to CNAHC, which represents an amount equal to the net profit attributable to shareholders, as determined based on the audited accounts prepared in accordance with the accounting principles and the financial regulations applicable in the PRC ("PRC GAAP"), generated during the period from 1 January 2004 to 30 September 2004 (the date of incorporation of the Company) by the businesses and operations (excluding those of CNAC) contributed to the Group by CNAHC after giving effect to relevant necessary adjustments. The net profit attributable to shareholders mentioned above for the said period is calculated after deducting the amount of income tax payable to CNAHC of approximately RMB191,721,000 which in turn will settle the tax liability on profit arisen during that period with the relevant tax bureau as detailed in note 12 to these financial statements.

In addition, in accordance with (財政部關于印發《企業公司制改建有關國有資本管理与財務處理的暫行規定》的通知) "Provisional Regulations Relating to Corporate Reorganisation of Enterprises and Related Management of State-owned Capital and Financial Treatment" notice issued by the Ministry of Finance and pursuant to the Restructuring, after the Company's incorporation, the Company is required to make a distribution to CNACG, which represents an amount equal to the net profit attributable to shareholders, as determined based on audited accounts prepared in accordance with PRC GAAP, generated during the period from 1 January 2004 to 30 September 2004 (the date of incorporation of the Company) by the businesses and operations (excluding those directly contributed by CNAHC) contributed to the Group by the CNAC group, less the 2003 final dividend and 2004 interim dividend amounts already paid by CNAC to CNACG.

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

The rates of dividend and the number of shares ranking for dividends for the year ended 31 December 2004 are not presented in this footnote for those profit distributions made prior to the incorporation of the Company as such information is not considered meaningful.

(d) The proposed final dividend of RMB0.2383 per 10 shares for the year ended 31 December 2005 is subject to the approval of the Company's shareholders at the forthcoming annual general meeting.

Cash dividends to shareholders in Hong Kong will be paid in Hong Kong dollars.

Following the incorporation of the Company, under the PRC Company Law and the Company's articles of association, net profit after tax as reported in the PRC statutory financial statements can only be distributed as dividends after allowance has been made for the following:

(i) Making up prior years' cumulative losses, if any;

(ii) Allocations to the statutory common reserve fund of at least 10% of after-tax profit, until the fund aggregates 50% of the Company's registered capital. For the purpose of calculating the transfer to reserves, the profit after tax shall be the amount determined under the PRC GAAP. The transfer to this reserve must be made before any distribution of dividends to shareholders.

The statutory common reserve fund can be used to offset previous years' losses, if any, and part of the statutory common reserve fund can be capitalised as the Company's share capital provided that the amount of such reserve remaining after the capitalisation shall not be less than 25% of the share capital of the Company;

Notes to Financial Statements

Year ended 31 December 2005

13. APPROPRIATIONS (Continued)

(iii) Allocations of 5% to 10% of after-tax profit, as determined under PRC GAAP, to the Company's statutory public welfare fund, which will be established for the purpose of providing for the Company's employees collective welfare benefits such as the construction of dormitories, canteens and other staff welfare facilities. The fund forms part of the shareholders' equity as only individual employees can use these facilities, while the title of such facilities is held by the Company. The transfer to this fund must be made before any distribution of dividends to shareholders; and

(iv) Allocations to the discretionary common reserve if approved by the shareholders.

The above reserves cannot be used for purposes other than those for which they are created and are not distributable as cash dividends.

In accordance with the articles of association of the Company, the net profit after tax of the Company for the purpose of dividends payment is based on the lesser of (i) the net profit determined in accordance with PRC GAAP; and (ii) the net profit determined in accordance with IFRSs.

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

14. EARNINGS PER SHARE ATTRIBUTABLE TO EQUITY HOLDERS OF THE PARENT

The calculation of basic earnings per share for the year ended 31 December 2005 is based on the net profit attributable to equity holders of the parent for the year ended 31 December 2005 of approximately RMB2,406,256,000, and the weighted average number of approximately 9,422,728,916 ordinary shares in issue during the year, as adjusted to reflect the new issue of 382,592,727 H shares on the exercise of the over-allotment options granted to international underwriters to subscribe for the Company's H shares during the year.

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

Diluted earnings per share for the year ended 31 December 2005 has not been disclosed because no diluting events existed during 2005.

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

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Year ended 31 December 2005

15. PROPERTY, PLANT AND EQUIPMENT

Group

	Aircraft and flight equipment RMB'000	Buildings RMB'000	Machinery RMB'000	Transportation equipment RMB'000	Office equipment RMB'000	Construction in progress RMB'000	Total RMB'000
At 1 January 2004, net of accumulated depreciation	37,789,877	2,715,540	1,051,602	293,144	90,268	483,489	42,423,920
Establishment of a joint venture *(note 45 (a))*	(267,119)	(186,169)	(86,932)	(21,673)	–	(3,947)	(565,840)
Additions	4,479,459	42,515	109,019	135,909	77,244	734,028	5,578,174
Disposals	(424,064)	(49,111)	(28,705)	(7,170)	(22,315)	–	(531,365)
Transfer from CIP	164,788	285,156	91,393	5,177	206	(546,720)	–
Depreciation charge for the year	(3,024,078)	(123,071)	(172,910)	(89,845)	(53,348)	–	(3,463,252)
At 31 December 2004 and 1 January 2005, net of accumulated depreciation	38,718,863	2,684,860	963,467	315,542	92,055	666,850	43,441,637
Additions	7,185,603	10,022	112,533	72,122	32,270	1,394,017	8,806,567
Disposals	(469,378)	(44,861)	(4,542)	(15,975)	(273)	–	(535,029)
Transfer from CIP	467,440	71,898	67,571	5,147	22,724	(634,780)	–
Exchange adjustment	(6,542)	(1,826)	–	(1,399)	–	–	(9,767)
Depreciation charge for the year	(4,128,357)	(147,542)	(156,489)	(56,501)	(23,791)	–	(4,512,680)
At 31 December 2005, net of accumulated depreciation	**41,767,629**	**2,572,551**	**982,540**	**318,936**	**122,985**	**1,426,087**	**47,190,728**
At 31 December 2004 and 1 January 2005							
Cost	63,813,626	3,674,146	2,045,002	1,068,502	223,531	666,850	71,491,657
Accumulated depreciation	(25,094,763)	(989,286)	(1,081,535)	(752,960)	(131,476)	–	(28,050,020)
Net carrying amount	38,718,863	2,684,860	963,467	315,542	92,055	666,850	43,441,637
At 31 December 2005							
Cost	**70,705,988**	**3,698,597**	**2,192,095**	**1,076,728**	**276,239**	**1,426,087**	**79,375,734**
Accumulated depreciation	**(28,938,359)**	**(1,126,046)**	**(1,209,555)**	**(757,792)**	**(153,254)**	**–**	**(32,185,006)**
Net carrying amount	**41,767,629**	**2,572,551**	**982,540**	**318,936**	**122,985**	**1,426,087**	**47,190,728**

Notes to Financial Statements

Year ended 31 December 2005

15. PROPERTY, PLANT AND EQUIPMENT (Continued)

Company

	Aircraft and flight equipment RMB'000	Buildings RMB'000	Machinery RMB'000	Transportation equipment RMB'000	Office equipment RMB'000	Construction in progress RMB'000	Total RMB'000
Transferred to the Company upon its incorporation *(note 1)*	38,595,577	1,858,577	784,743	182,711	76,724	583,635	42,081,967
Additions	372,799	–	25,547	42,916	27,182	308,493	776,937
Disposals	(9,216)	(32)	(31,158)	(1,650)	(148)	–	(42,204)
Transfer from CIP	–	219,934	17,770	176	–	(237,880)	–
Depreciation charge for the period	(804,864)	(23,307)	(29,053)	(20,021)	(31,027)	–	(908,272)
At 31 December 2004 and 1 January 2005, net of accumulated depreciation	38,154,296	2,055,172	767,849	204,132	72,731	654,248	41,908,428
Additions	6,444,967	2,209	85,229	46,376	20,404	1,347,614	7,946,799
Disposals	(460,726)	(39,100)	(1,898)	(15,096)	(197)	–	(517,017)
Transfer from CIP	467,440	63,320	57,033	5,147	22,706	(615,646)	–
Depreciation charge for the year	(3,997,538)	(130,020)	(129,145)	(36,615)	(19,429)	–	(4,312,747)
At 31 December 2005, net of accumulated depreciation	**40,608,439**	**1,951,581**	**779,068**	**203,944**	**96,215**	**1,386,216**	**45,025,463**
At 31 December 2004 and 1 January 2005							
Cost	61,842,914	2,820,374	1,520,769	830,178	131,321	654,248	67,799,804
Accumulated depreciation	(23,688,618)	(765,202)	(752,920)	(626,046)	(58,590)	–	(25,891,376)
Net carrying amount	38,154,296	2,055,172	767,849	204,132	72,731	654,248	41,908,428
At 31 December 2005							
Cost	**68,020,677**	**2,839,822**	**1,649,825**	**823,159**	**172,910**	**1,386,216**	**74,892,609**
Accumulated depreciation	**(27,412,238)**	**(888,241)**	**(870,757)**	**(619,215)**	**(76,695)**	**–**	**(29,867,146)**
Net carrying amount	**40,608,439**	**1,951,581**	**779,068**	**203,944**	**96,215**	**1,386,216**	**45,025,463**

Certain of the Group's and the Company's bank loans are secured by certain of the Group's and the Company's aircraft which had an aggregate carrying amount of approximately RMB16,471 million as at 31 December 2005 (2004: RMB16,586 million) *(note 33(a))*.

The carrying amount of aircraft held under finance leases as at 31 December 2005 is approximately RMB10,487 million (2004: RMB11,999 million) *(note 32(a))*. Leased assets are pledged as security for the related finance lease liabilities.

As at 31 December 2005, the Group is in the process of applying to obtain the title certificates of certain of its buildings with an aggregate carrying amount of approximately RMB270 million (2004: RMB2,178 million). The Directors of the Company are of the view that the Group is entitled to lawfully and validly occupy and use the above-mentioned buildings. The Directors of the Company are of the opinion that the aforesaid matter will not have any significant impact on the Group's financial position as at 31 December 2005.

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Year ended 31 December 2005

16. LEASE PREPAYMENTS

	Group		Company	
	2005	2004	**2005**	2004
	RMB'000	*RMB'000*	***RMB'000***	*RMB'000*
Cost				
At 1 January	**938,992**	30,017	**924,895**	–
Transferred to the Company upon its incorporation *(note 1)*	**–**	–	**–**	924,895
Additions	**157,723**	908,975	**151,955**	–
At 31 December	**1,096,715**	938,992	**1,076,850**	924,895
Accumulated amortisation				
At 1 January	**5,094**	210	**5,024**	–
Transferred to the Company upon its incorporation *(note 1)*	**–**	–	**–**	411
Amortisation for the year	**19,555**	4,884	**19,333**	4,613
At 31 December	**24,649**	5,094	**24,357**	5,024
Net book value				
At 31 December	**1,072,066**	933,898	**1,052,493**	919,871

17. INTERESTS IN SUBSIDIARIES

	Company	
	2005	2004
	RMB'000	*RMB'000*
Listed shares in Hong Kong, at cost	**579,472**	579,472
Unlisted investments, at cost	**137,707**	134,647
Due from subsidiaries	**11,519**	22,513
Due to subsidiaries	**(588,623)**	(559,703)
	140,075	176,929
Market value of listed shares	**2,893,811**	3,161,997

The balances with the subsidiaries are unsecured, interest-free and have no fixed terms of repayment.

As at 31 December 2005, the Group is in the process of applying to register the already transferred equity interests in certain subsidiaries with an aggregate cost of approximately RMB504,000 (2004: RMB134 million) from Air China International Corporation into the Company's name. The Directors of the Company are of the view that the Company owns the aforesaid equity interests and that the aforesaid matter will not have any significant impact on the Group's financial position as at 31 December 2005.

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17. INTERESTS IN SUBSIDIARIES (Continued)

Particulars of the principal subsidiaries at 31 December 2005 are as follows:

Company name	Place of incorporation/ establishment and operations	Legal status	Nominal value of paid-up capital (in thousands)	Percentage of equity interests attributable to the Company Direct	Indirect	Principal activities
Subsidiaries						
CNAC (中航興業有限公司)	Hong Kong	Limited liability company	HK$331,268	69	–	Investment holding
Air Macau Company Limited ("Air Macau") * (澳門航空股份有限公司)	Macau	Limited liability company	MOP400,000	–	35	Airline operator
Air China Group Import and Export Trading Co. ("AIE") (國航集團進出口貿易公司)	PRC/ Mainland China	Limited liability company	RMB90,000	100	–	Import and exportt rading
浙江航空服務有限公司 (Zhejiang Air Services Co., Ltd.) **	PRC/ Mainland China	Limited liability company	RMB20,000	100	–	Provision of airline catering and shuttle bus services
Beijing Aviation Passenger Service Corporation (北京航空旅客服務公司)	PRC/ Mainland China	Limited liability company	RMB3,000	100	–	Provision of passenger transportation services
Air China Shantou Industrial Development Company (中國民航航空汕頭實業發展公司)	PRC/ Mainland China	Limited liability company	RMB18,000	51	–	Manufacture and retail of aircraft supplies
China National Aviation Air Passenger and Cargo Services Agency Company (中國民航客貨運輸銷售代理公司)	PRC/ Mainland China	Limited liability company	RMB6,980	100	–	Provision of travel agency and freight forwarding services
Beijing Air China Engineering Technology Development Centre (北京國航工程技術發展中心)	PRC/ Mainland China	Limited liability company	RMB1,500	100	–	Provision of engineering consultancy services
Beijing Civil Aviation Blue Sky Air Travel Services Company (北京民航藍天空運服務公司)	PRC/ Mainland China	Limited liability company	RMB5,533	100	–	Provision of travel agency services
Air China Development Corporation (Hong Kong) Limited (國航香港發展有限公司)	Hong Kong	Limited liability company	HK$500	95	–	Provision of air ticketing services
上海國航基地開發中心 (Shanghai Air China Base Development Centre) **	PRC/ Mainland China	Limited liability company	RMB2,000	100	–	Provision of ground services, air passenger, cargo and consultancy services

* Air Macau is a 51%-owned subsidiary of CNAC.

** The English names are direct translations of the company's Chinese names.

The above table lists the subsidiaries of the Company which, in the opinion of the Directors, principally affected the results for the year ended 31 December 2005 or formed a substantial portion of the net assets of the Group at 31 December 2005. To give details of other subsidiaries would, in the opinion of the Directors, result in particulars of excessive length.

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18. INTERESTS IN JOINT VENTURES

	Company 2005 RMB'000	Company 2004 RMB'000
Unlisted investments, at cost	**1,398,595**	1,392,388

Particulars of the joint ventures of the Group at 31 December 2005 are as follows:

Company name	Place of incorporation/ establishment and operations	Legal status	Nominal value of paid-up capital (in thousands)	Percentage of equity interests attributable to the Group Direct	Indirect	Principal activities
Joint ventures						
Aircraft Maintenance and Engineering Corporation, Beijing (北京飛机維修工程有限公司)	PRC/ Mainland China	Limited liability company	US$112,533	60	–	Provision of aircraft overhaul and maintenance services
Air China Cargo (中國國際貨運航空有限公司)	PRC/ Mainland China	Limited liability company	RMB2,200,000	51	–	Provision of cargo carriage services
BACL (北京航空食品有限公司)	PRC/ Mainland China	Limited liability company	US$8,000	–	41	Provision of airline catering services
SWACL (西南航空食品有限公司)	PRC/ Mainland China	Limited liability company	RMB70,000	–	41	Provision of airline catering services

As at the balance sheet date and for the two years ended 31 December 2005, the Group's proportionate share of the assets, liabilities, and the Group's proportionate share of the revenue and expenses of the joint ventures are as follows:

	Group 2005 RMB'000	Group 2004 RMB'000
Current assets	**1,654,865**	1,606,903
Non-current assets	**2,147,711**	1,706,734
Total assets	**3,802,576**	3,313,637
Current liabilities	**(1,349,440)**	(1,578,665)
Non-current liabilities	**(444,475)**	(8,734)
Net assets attributable to the Group	**2,008,661**	1,726,238
Revenue	**4,248,167**	3,944,633
Operating expenses	**(3,929,313)**	(3,748,389)
Finance revenue	**10,616**	5,720
Finance costs	**(25,460)**	(21,857)
Share of profits less losses from associates	**–**	1,006
Profit before tax	**304,010**	181,113
Tax	**(35,767)**	(51,976)
Net profit attributable to the Group	**268,243**	129,137

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19. INTEREST IN ASSOCIATES

	Group		Company	
	2005	2004	**2005**	2004
	RMB'000	*RMB'000*	***RMB'000***	*RMB'000*
Listed shares in Mainland China, at cost	**–**	–	**163,477**	168,949
Unlisted investments, at cost	**–**	–	**673,879**	676,692
Share of net assets	**2,382,547**	2,587,304	**–**	–
Goodwill	**1,444,367**	1,404,966	**–**	–
Due from associates	**62,948**	90,842	**15,419**	17,305
Due to associates	**(95,905)**	(81,591)	**(129,410)**	(82,109)
	3,793,957	4,001,521	**723,365**	780,837
Market value of listed shares	**–**	–	**124,032**	288,192

The balances with the associates are unsecured, interest-free and have no fixed terms of repayment.

As at 31 December 2005, the Group is in the process of applying to register the already transferred equity interests in certain associates with an aggregate cost of approximately RMB101 million (2004: RMB846 million) from Air China International Corporation into the Company's name. The Directors of the Company are of the view that the Company owns the aforesaid equity interests and that the aforesaid matter will not have any significant impact on the Group's financial position as at 31 December 2005.

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Year ended 31 December 2005

19. INTEREST IN ASSOCIATES (Continued)

Particulars of the associates at 31 December 2005 are as follows:

Name	Place of incorporation/ establishment and operations	Registered/ issued share capital	Percentage of equity interests attributable to the Group	Principal activities
Shenzhen Airlines (深圳航空有限責任公司)	PRC/ Mainland China	RMB300,000,000	25	Airline operator
Hong Kong Dragon Airlines Limited ("Dragonair") # (港龍航空有限公司)	Hong Kong	HK$500,000,000	29.9	Airline operator
Shandong Aviation Group Corporation ("Shandong Aviation") (山東航空集團有限公司)	PRC/ Mainland China	RMB580,000,000	48	Investment holding
Shandong Airlines Co., Ltd. ("Shandong Airlines") (山東航空股份有限公司)	PRC/ Mainland China	RMB400,000,000	22.8	Airline operator
Sichuan SNECMA Aeroengine Maintenance Co., Ltd. (四川斯拉克瑪航空發動機机維修有限公司)	PRC/ Mainland China	US$21,000,0000	40.3	Provision of maintenance and repair services for aircraft engines
Chengdu Falcon Aircraft Engineering Service Co., Ltd. (成都富凱飛机工程服務有限公司)	PRC/ Mainland China	RMB16,474,293	35.6	Provision of maintenance and repair services for aircraft engines
Yunnan Airport Aircraft Maintenance Services Co., Ltd. (云南空港飛机維修服務公司)	PRC/ Mainland China	RMB10,000,000	40	Provision of maintenance and repair services
Macau Aircraft Repair and Conversion Company Limited # (澳門飛机維修工程有限公司)	Macau	MOP100,000	17.3	Provision of aircraft repair and conversion services
Jardine Airport Services Limited # (怡中航空服務有限公司)	Hong Kong	HK$10,000	34.5	Provision of airport ground handling services
Menzies Macau Airport Services Limited # (明捷澳門机場服務有限公司)	Macau	MOP10,000,000	23.2	Provision of airport ground handling services

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19. INTEREST IN ASSOCIATES (Continued)

Name	Place of incorporation/ establishment and operations	Registered/ issued share capital	Percentage of equity interests attributable to the Group	Principal activities
Guangzhou Baiyun International Airport Ground Handling Service Company Limited (廣州白云國際机場地勤服務有限公司)	PRC/ Mainland China	RMB100,000,000	21	Provision of airport ground handling services
三亞世貿發展有限公司 (Sanya World Trade Development Company Limited) *	PRC/ Mainland China	RMB5,000,000	40	Provision of airport ground handling services
CAAC Data Communications Co., Ltd. (民航數據据通信有限責任公司)'	PRC/ Mainland China	RMB10,800,000	23.2	Provision of aviation data communication services
CAAC Cares Chongqing Co., Ltd. (重慶民航凱亞信息技術有限公司)	PRC/ Mainland China	RMB9,800,000	24.5	Provision of airline-related information system services
成都民航西南凱亞有限責任公司 (Chengdu CAAC Southwest Cares Co., Ltd.) *	PRC/ Mainland China	RMB2,000,000	35	Provision of airline-related information system services
Tradeport Hong Kong Limited # (香港商貿港有限公司)	Hong Kong	HK$400	17.3	Provision of services for developing and operating logistics centre
LSG Lufthansa Service Hong Kong Limited ("LSGHK") # (德國漢莎航空膳食服務(香港)有限公司)	Hong Kong	HK$501	13.9	Provision of airline catering services
China National Aviation Finance Co., Ltd. ("CNAF") (中國航空集團財務有限責任公司) **	PRC/ Mainland China	RMB505,269,500	23.5	Provision of financial services

Shareholding interests of these associates are held indirectly through subsidiaries of the Company.

* The English names are direct translations of the company's Chinese names.

** 19.3% of the Group's equity interests in CNAF is held directly by the Company, while the remaining 4.2% is held indirectly through subsidiaries of the Company.

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Year ended 31 December 2005

19. INTEREST IN ASSOCIATES (Continued)

Summarised financial information of the Group's associates is as follows:

	Group	
	2005	2004
	RMB'000	*RMB'000*
Aggregate of associates' financial position:		
Total assets	**32,096,859**	27,767,944
Total liabilities	**(25,497,576)**	(20,747,807)
Aggregate of associates' results:		
Revenue	**21,026,538**	16,770,072
Net profit	**745,230**	1,330,066
Share of profits less losses after tax from associates:		
Dragonair	**139,824**	279,801
Others	**85,106**	184,243
	224,930	464,044

Movements of goodwill are as follows:

	Group	
	2005	2004
	RMB'000	*RMB'000*
Goodwill at beginning of the year *(note 19(a))*	**1,404,966**	1,205,390
Adjustment to opening goodwill *(note 19(b))*	**40,445**	–
Additions *(note 19(b))*	**–**	199,576
Exchange adjustment	**(1,044)**	–
Goodwill at end of the year	**1,444,367**	1,404,966
Accumulated impairment	**–**	–

Notes:

(a) The goodwill brought forward from 2003 related to the acquisition of shareholding interests of 35.86% and 7.43% in Dragonair by CNACG and its then wholly-owned subsidiary, CNAC, in June 1996 and October 1997, respectively. The aggregate goodwill arising from these two acquisitions was approximately RMB2,130 million and subsequently reduced to approximately RMB1,205 million through deemed disposal upon the initial public offering of CNAC and the accumulated amortisation on the straight-line basis over a period of 20 years until 1 January 2001 (the date of adoption of IFRS 3 by the Group).

(b) The goodwill arose in 2004 related to the acquisitions of effective shareholding interests of 48.0% in Shandong Aviation, 22.8% in Shandong Airlines and 13.9% in LSGHK by the Group, resulting in an aggregate goodwill amount of approximately RMB200 million.

During the year, Shandong Aviation and Shandong Airlines restated their retained earnings as at 31 December 2004 and as such the goodwill, being calculated as the excess of the cost of the business combination over the Group's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities of Shandong Aviation and Shandong Airlines arising on the acquisitions of shareholding interests in these two companies, were adjusted accordingly.

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Year ended 31 December 2005

19. INTEREST IN ASSOCIATES (Continued)

Impairment testing of goodwill attributable to Dragonair, Shandong Airlines and Shandong Aviation

Goodwill acquired through the business combination in relation to the acquisition of shareholding interests in Dragonair, Shandong Airlines and Shandong Aviation has been allocated to the cash-generating unit, Dragonair, Shandong Airlines and Shandong Aviation, within the airline operations segment.

The recoverable amount of Dragonair has been determined based on a value in use calculation. To calculate this, cash flow projections are based on financial budgets approved by management covering a one-year period. The discount rate applied to the cash flow projections beyond the one-year period is 5.0% (2004: 5.0%). No growth has been projected beyond the one-year period.

Key assumptions used in the value in use calculation of Dragonair, Shandong Airlines and Shandong Aviation

The following describes each key assumption on which management has based its cash flow projections when undertaking the impairment testing of goodwill attributable to Dragonair, Shandong Airlines and Shandong Aviation:

Passenger revenue – the bases used to determine the value assigned to the budgeted passenger revenue are available seat kilometers, passenger traffic, passenger load factor and passenger yield. Values assigned to the key assumptions reflect past experience and are consistent with external information sources.

Operating expenses – the bases used to determine the values assigned are staff headcount, scheduled flight hours, passenger traffic and jet fuel consumption. Values assigned to the key assumptions reflect past experience and are consistent with external information sources.

20. LONG TERM RECEIVABLE FROM CNAHC

On 30 September 2004, the Company entered into an agreement with CNAHC whereby CNAHC agreed to assume the obligation to settle an aggregate amount of approximately RMB757 million, which was recorded by the Group as government grant receivable as at 31 December 2003 of RMB842 million, consisting of long term portion and short term portion of RMB764 million and RMB78 million, respectively. This receivable from CNAHC is unsecured, interest-free and repayable over eight years commencing from 31 December 2004 by 16 semi-annual instalments to be made by 30 June and 31 December each year. Pursuant to the relevant agreement, the first instalment amount of RMB25 million was settled by 31 December 2004 and the final instalment amount of approximately RMB32 million shall be settled by 30 June 2012, with the remaining 14 semi-annual instalment amounts of RMB50 million each to be settled by 30 June and 31 December each year between 30 June 2005 and 31 December 2011.

21. AVAILABLE-FOR-SALE INVESTMENTS

Available-for-sale investments consist of unlisted equity investments.

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22. DEFERRED TAX ASSETS

	Group		Company	
	2005	2004	**2005**	2004
	RMB'000	*RMB'000*	***RMB'000***	*RMB'000*
Balance at beginning of year	**776,084**	590,153	**658,000**	–
Transferred to the Company upon its incorporation *(note 1)*	**–**	–	**–**	660,349
Charge for the year *(note 12)*	**(277,713)**	(607,824)	**(267,000)**	(2,349)
Credited to equity	**–**	793,755	**–**	–
Balance at end of year	**498,371**	776,084	**391,000**	658,000

The principal components of the Group's and the Company's deferred income tax assets are as follows:

	Group		Company	
	2005	2004	**2005**	2004
	RMB'000	*RMB'000*	***RMB'000***	*RMB'000*
Deferred income tax liabilities:				
Accelerated depreciation for tax purposes	**(447,186)**	(441,441)	**(456,000)**	(426,000)
Other deferred income tax liabilities	**(72,000)**	(47,000)	**(72,000)**	(47,000)
Gross deferred income tax liabilities	**(519,186)**	(488,441)	**(528,000)**	(473,000)
Deferred income tax assets:				
Additional tax deduction on revaluation surplus arising from the Restructuring	**528,000**	714,000	**434,000**	606,000
Provisions and accruals	**341,070**	384,000	**329,000**	381,000
Losses available for offset against future taxable income	**10,487**	20,525	**–**	–
Other deferred income tax assets	**138,000**	146,000	**156,000**	144,000
Gross deferred income tax assets	**1,017,557**	1,264,525	**919,000**	1,131,000
Net deferred income tax assets	**498,371**	776,084	**391,000**	658,000

There was no material unprovided deferred income tax during the year (2004: Nil).

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23. TRADE RECEIVABLES

The Group normally allows a credit period ranging from 30 days to 90 days to its sales agents and other customers. An aged analysis of the trade receivables, net of provision for doubtful debts, of the Group and the Company is analysed as follows:

	Group		Company	
	2005	2004	**2005**	2004
	RMB'000	*RMB'000*	***RMB'000***	*RMB'000*
Within 30 days	**1,770,628**	1,838,756	**1,511,371**	2,067,875
31 to 60 days	**458,454**	280,382	**503,590**	102,938
61 to 90 days	**177,587**	152,548	**245,168**	14,949
Over 90 days	**357,806**	93,130	**257,255**	11,531
At end of year	**2,764,475**	2,364,816	**2,517,384**	2,197,293

Included in the Group's and the Company's trade receivables was the following amount due from a joint venture:

	Group		Company	
	2005	2004	**2005**	2004
	RMB'000	*RMB'000*	***RMB'000***	*RMB'000*
Joint venture	**451,965**	412,539	**922,378**	841,916

24. INVENTORIES

Inventories primarily consist of materials and supplies.

Set out below is the breakdown of materials and supplies:

	Group		Company	
	2005	2004	**2005**	2004
	RMB'000	*RMB'000*	***RMB'000***	*RMB'000*
Flight equipment spare parts	**745,411**	680,039	**516,320**	454,220
Work in progress	**72,664**	38,061	**3,586**	1,621
Catering supplies	**33,240**	25,188	**21,547**	13,089
	851,315	743,288	**541,453**	468,930

25. PREPAYMENTS, DEPOSITS AND OTHER RECEIVABLES

Set out below is the breakdown of prepayments, deposits and other receivables:

	Group		Company	
	2005	2004	**2005**	2004
	RMB'000	*RMB'000*	***RMB'000***	*RMB'000*
Advances and others	**457,568**	324,655	**379,258**	322,047
Manufacturers' credits on aircraft acquisition receivables	**62,930**	74,518	**62,930**	74,518
Prepaid aircraft operating lease rentals	**110,472**	95,681	**91,608**	79,260
Receivables from the sale of staff quarters	**4,333**	24,681	**4,333**	24,681
Miscellaneous deposits	**127,132**	395,595	**113,649**	388,531
	762,435	915,130	**651,778**	889,037

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26. DEPOSITS AND CASH AND CASH EQUIVALENTS

	Group		Company	
	2005	2004	**2005**	2004
	RMB'000	*RMB'000*	***RMB'000***	*RMB'000*
Cash and bank balances	**1,092,900**	8,635,653	**439,803**	7,888,436
Cash placed with CNAF	**67,567**	261,904	**37,570**	219,655
	1,160,467	8,897,557	**477,373**	8,108,091
Time deposits placed with banks	**958,573**	648,667	**141,677**	94,287
Time deposits placed with CNAF	**403,296**	305,081	**377,796**	300,000
	1,361,869	953,748	**519,473**	394,287
Less: Pledged deposits against:				
Bank loans *(note 33)*	**81,598**	64,242	**81,598**	64,242
Finance leases *(note 32)*	**–**	16,277	**–**	16,277
Others *	**94,977**	36,712	**2,450**	–
Pledged deposits	**176,575**	117,231	**84,048**	80,519
Less: Non-pledged deposits with maturity of more than three months when acquired	**97,375**	320,850	**20,875**	313,768
Cash and cash equivalents	**2,248,386**	9,413,224	**891,923**	8,108,091

* Including deposits pledged against the Group's aircraft operating leases and financial derivatives.

At the balance sheet date, the cash and cash equivalents balances of the Group denominated in RMB amounted to RMB992,468,000 (2004: RMB8,549,508,000). The RMB is not freely convertible into other currencies, however, under Mainland China's Foreign Exchange Control Regulations and Administration of Settlement, Sale and Payment of Foreign Exchange Regulations, the Group is permitted to exchange RMB for other currencies through banks authorised to conduct foreign exchange business.

Cash at banks earns interest at floating rates based on daily bank deposit rates. Time deposits are made for terms of between three days and one year depending on the immediate cash requirements of the Group and the Company, and earn interest at the respective time deposit rates.

27. BALANCES WITH OTHER CNAHC GROUP COMPANIES

The balances with other CNAHC group companies are unsecured, interest-free and have no fixed terms of repayment.

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28. TRADE PAYABLES

An aged analysis of the trade payables is as follows:

	Group		Company	
	2005	2004	**2005**	2004
	RMB'000	*RMB'000*	***RMB'000***	*RMB'000*
Within 30 days	**3,247,501**	3,108,028	**2,549,447**	2,740,974
31 to 60 days	**603,010**	805,858	**468,948**	673,690
61 to 90 days	**293,407**	304,943	**253,482**	243,448
Over 90 days	**457,446**	224,779	**394,251**	161,241
At end of year	**4,601,364**	4,443,608	**3,666,128**	3,819,353

Included in the Group's and the Company's trade payables was the following amount due to a joint venture:

	Group		Company	
	2005	2004	**2005**	2004
	RMB'000	*RMB'000*	***RMB'000***	*RMB'000*
Joint venture	**115,435**	179,934	**288,588**	449,835

29. BILLS PAYABLE

An aged analysis of the bills payable is as follows:

	Group and Company	
	2005	2004
	RMB'000	*RMB'000*
Over 90 days	**327,937**	362,033
At end of year	**327,937**	362,033

Included in the Group's and the Company's bills payable was the following amount due to CNAF:

	Group and Company	
	2005	2004
	RMB'000	*RMB'000*
CNAF	**103,426**	–

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30. OTHER PAYABLES AND ACCRUALS

Set out below is a breakdown of other payables and accruals:

	Group		Company	
	2005	2004	**2005**	2004
	RMB'000	*RMB'000*	***RMB'000***	*RMB'000*
Provision for staff housing benefits	**135,381**	469,617	**112,372**	448,694
Accrued salaries, wages and benefits	**894,052**	692,510	**732,240**	562,493
Interest expense payable	**308,152**	269,928	**298,330**	255,977
Accruals for share issue expenses	**–**	208,644	**–**	208,644
Custom duties and levies payable	**982,819**	742,201	**900,544**	665,986
Current portion of long term payables *(note 35)*	**100,218**	101,802	**100,218**	101,802
Current portion of deferred income *(note 36)*	**76,943**	76,943	**76,943**	76,943
Advances from customers	**259,965**	294,798	**163,608**	224,321
Accrued operating expenses	**1,038,995**	716,548	**909,260**	611,257
Others	**371,910**	347,296	**275,381**	231,753
	4,168,435	3,920,287	**3,568,896**	3,387,870

31. PROVISION FOR MAJOR OVERHAULS

Set out below is the movement of provision for major overhauls in respect of aircraft and engines under operating leases for each of the two years ended 31 December 2005 and 2004.

	Group		Company	
	2005	2004	**2005**	2004
	RMB'000	*RMB'000*	***RMB'000***	*RMB'000*
At beginning of year	**498,828**	404,939	**401,372**	–
Transferred to the Company upon its incorporation *(note 1)*	**–**	–	**–**	363,842
Provision for the year	**415,513**	221,543	**271,550**	61,341
Utilised during the year	**(259,902)**	(127,654)	**(179,630)**	(23,811)
At end of year	**654,439**	498,828	**493,292**	401,372
Less: Portion classified as current liabilities	**(18,721)**	(28,130)	**(18,721)**	(28,130)
Long term portion	**635,718**	470,698	**474,571**	373,242

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32. OBLIGATIONS UNDER FINANCE LEASES

The Group and the Company have obligations under finance lease agreements expiring during the years from 2006 to 2011 (2004: 2005 to 2011) in respect of aircraft and related equipment. As at the balance sheet date, future minimum lease payments under these finance leases, together with the present value of the net minimum lease payments, which are principally denominated in foreign currencies, are as follows:

	Group and Company		Group and Company	
	Minimum lease payments 2005	**Present value of Minimum lease payments 2005**	Minimum lease payments 2004	Present value of Minimum lease payments 2004
	RMB'000	***RMB'000***	*RMB'000*	*RMB'000*
Amounts repayable:				
Within one year	**2,306,587**	**1,954,873**	2,313,871	1,705,146
In the second year	**2,330,192**	**1,949,802**	2,408,481	1,943,630
In the third to fifth years, inclusive	**6,850,768**	**6,071,492**	7,784,209	6,722,448
Over five years	**79,157**	**57,377**	2,049,406	1,910,163
Total minimum finance lease payments	**11,566,704**	**10,033,544**	14,555,967	12,281,387
Less: Amounts representing finance charges	**(1,533,160)**		(2,274,580)	
Present value of minimum lease payments	**10,033,544**		12,281,387	
Less: Portion classified as current liabilities	**(1,954,873)**		(1,705,146)	
Long term portion	**8,078,671**		10,576,241	

Certain lease financing arrangements comprised finance leases between the Company and certain of its subsidiaries, and the corresponding borrowings between such subsidiaries and banks. The Company has guaranteed the subsidiaries' obligations under the bank borrowings and, accordingly, the aforesaid assets and obligations are recorded in the balance sheets to reflect the substance of the transactions. The future payments under these leases have therefore been presented by the Company and the Group in the amounts that reflect the payments under the bank borrowings between the subsidiaries and the banks.

At 31 December 2005, there were 21 (2004: 23) aircraft under finance lease agreements. Under the terms of the leases, the Company has the option to purchase, at the end of or during the lease terms, certain aircraft at fair market value and others at either fair market value or at the price as stipulated in the finance lease agreements. For the current year, the effective borrowing rate ranged from 1.64% to 9.84% (2004: 1.64% to 9.13%).

The Group's and the Company's finance leases were secured by:

(a) mortgages over certain of the Group's and the Company's aircraft, which had an aggregate carrying value of approximately RMB10,487 million as at 31 December 2005 (2004: RMB11,999 million) *(note 15)*;

(b) the pledge of certain of the Group's and the Company's bank deposits amounting to approximately RMB16 million as at 31 December 2004 *(note 26)*; and

(c) guarantees by certain commercial banks in an aggregate amount of approximately RMB12,044 million (2004: RMB14,785 million).

Notes to Financial Statements

Year ended 31 December 2005

32. OBLIGATIONS UNDER FINANCE LEASES (Continued)

As at 31 December 2005, certain PRC state-owned banks have provided counter-guarantees in an aggregate amount of RMB2,521 million (2004: RMB3,074 million) in respect of the commercial bank guarantee arrangements set out in note 32 (c) above. At 31 December 2004, CNAHC and CNAF, in turn, provided counter-guarantees to certain of these PRC state-owned banks in the amounts of RMB921 million and RMB3,976 million *(note 46)*, respectively. These counter-guarantees provided by CNAHC and CNAF were released during the year.

33. BANK AND OTHER LOANS

	Group		Company	
	2005	2004	**2005**	2004
	RMB'000	*RMB'000*	***RMB'000***	*RMB'000*
Bank loans:				
Secured	**11,667,241**	13,685,002	**11,258,268**	13,643,002
Unsecured	**8,336,734**	7,519,047	**8,126,735**	7,144,917
	20,003,975	21,204,049	**19,385,003**	20,787,919
Other loans:				
Secured	**50,560**	66,667	**50,560**	66,667
Unsecured	**169,514**	431,957	**140,351**	297,731
	220,074	498,624	**190,911**	364,398
Corporate bonds:				
Unsecured	**3,000,000**	–	**3,000,000**	–
	23,224,049	21,702,673	**22,575,914**	21,152,317
Bank loans repayable:				
Within one year	**10,217,210**	8,359,280	**9,973,050**	7,943,149
In the second year	**2,732,712**	3,049,084	**2,698,551**	3,049,084
In the third to fifth years, inclusive	**4,677,985**	6,178,222	**4,575,502**	6,178,222
Over five years	**2,376,067**	3,617,464	**2,137,900**	3,617,464
Other loans repayable:				
Within one year	**183,960**	446,771	**154,797**	312,546
In the second year	**14,446**	14,815	**14,446**	14,815
In the third to fifth years, inclusive	**21,669**	37,037	**21,668**	37,037
Corporate bonds:				
Over five years	**3,000,000**	–	**3,000,000**	–
Total bank and other loans	**23,224,049**	21,702,673	**22,575,914**	21,152,317
Less: Portion classified as current liabilities	**(10,401,170)**	(8,806,051)	**(10,127,847)**	(8,255,695)
Long term portion	**12,822,879**	12,896,622	**12,448,067**	12,896,622

Notes to Financial Statements

Year ended 31 December 2005

33. BANK AND OTHER LOANS (Continued)

Further details of bank and other loans at the balance sheet date are as follows:

Nature	Interest rate and final maturity	Group 2005 RMB'000	Group 2004 RMB'000	Company 2005 RMB'000	Company 2004 RMB'000
RMB denominated loans:					
Loans for purchases of aircraft and related equipment	Floating interest rates ranging from 5.18% to 5.51% and 4.94% to 5.76% per annum at 31 December 2005 and 2004, respectively, with maturities through 2014	**4,452,262**	5,382,986	**4,452,262**	5,382,986
Loans for working capital	Fixed interest rates ranging from 2.92% to 5.02% and 4.54% to 4.94% per annum at 31 December 2005 and 2004, respectively, with maturities through 2007	**4,196,394**	2,528,869	**4,140,000**	2,171,800
United States dollars denominated loans:					
Loans for purchases of aircraft and related equipment	Fixed interest rates ranging from 5.40% to 8.33% and 5.40% to 10.17% per annum at 31 December 2005 and 2004, respectively, with maturities through 2012	**5,837,073**	7,155,311	**5,837,073**	7,155,311
Loans for purchases of aircraft and related equipment	Floating interest rate at six months LIBOR + 0.4% to 0.7% per annum at 31 December 2005 and 2004 with maturities through 2014	**1,514,147**	1,270,236	**1,105,174**	1,270,236
Loans for working capital	Floating interest rates at six months LIBOR + 0.5% to 0.7% and six months LIBOR + 0.6% to 0.8% per annum at 31 December 2005 and 2004, respectively, with maturities through 2007	**4,000,508**	5,365,271	**3,833,345**	5,171,984
Hong Kong dollars denominated loans:					
Loans for working capital	Fixed interest rate at 4.60% per annum at 31 December 2005 with maturities through 2006	**15,605**	–	**–**	–
Loans for working capital	Floating interest rate at six months LIBOR +1% per annum at 31 December 2005 with maturities through 2006	**208,060**	–	**208,060**	–
Corporate bonds					
Corporate bonds for purchases of aircraft and related equipment	Fixed interest rate at 4.50% per annum at 31 December 2005 with maturity in September 2015	**3,000,000**	–	**3,000,000**	–
		23,224,049	21,702,673	**22,575,914**	21,152,317
Less: Loans due within one year classified as current liabilities		**(10,401,170)**	(8,806,051)	**(10,127,847)**	(8,255,695)
Loans due after one year classified as long term portion		**12,822,879**	12,896,622	**12,448,067**	12,896,622

Notes to Financial Statements

Year ended 31 December 2005

33. BANK AND OTHER LOANS (Continued)

The interest rates of RMB denominated loans are set and subject to change by the People's Bank of China.

The Group's and the Company's bank and other loans of approximately RMB14,718 million as at 31 December 2005 (2004: RMB13,710 million) were secured by:

(a) mortgages over certain of the Group's and the Company's aircraft and related equipment, which had an aggregate carrying value of approximately RMB16,471 million as at 31 December 2005 (2004: RMB16,586 million) *(note 15)*;

(b) the pledge of certain of the Group's and the Company's bank deposits amounting to RMB82 million as at 31 December 2005 (2004: RMB64 million) *(note 26)*; and

(c) guarantees by certain commercial banks amounting to RMB9,780 million (2004: RMB8,294 million).

As at 31 December 2005, certain PRC state-owned banks provided counter-guarantees in an aggregate amount of RMB4,891 million (2004: RMB5,943 million) to one of these commercial banks as mentioned in note 33 (c) above. At 31 December 2004, CNAHC and CNAF, in turn, provided counter-guarantees to certain of these PRC state-owned banks in the amounts of RMB1,455 million and RMB761 million *(note 46)*, respectively. These counter-guarantees provided by CNAHC and CNAF were released during the year.

34. DUE FROM/(TO) SHAREHOLDERS

Set out below is the breakdown of the amounts due from/(to) shareholders:

	Group		Company	
	2005	2004	**2005**	2004
	RMB'000	*RMB'000*	***RMB'000***	*RMB'000*
Due from CNAHC	**474,216**	–	**474,216**	–
Due to CNAHC	**–**	(2,137,437)	**–**	(2,121,533)
Due to CNACG	**(133,680)**	(118,680)	**(118,680)**	(118,680)
	(133,680)	(2,256,117)	**(118,680)**	(2,240,213)

The amount due from CNAHC mainly arose from transactions as set out in notes 20 and 46(A) to the financial statements. The amount is unsecured, interest-free and repayable within one year.

The amounts due to shareholders are unsecured, interest-free and repayable within one year.

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35. LONG-TERM PAYABLES

Long term payables mainly represent customs duties and value-added tax payable after one year to the PRC government in respect of the acquisition of aircraft and related equipment under finance leases. The customs duties and value-added tax are payable upon repayment of the corresponding finance lease installments. Set out below are details of the customs duties and value-added tax payable further analysed into non-current and current portions:

	Group		Company	
	2005	2004	**2005**	2004
	RMB'000	*RMB'000*	***RMB'000***	*RMB'000*
Customs duties and value-added tax payable	**417,339**	539,121	**417,339**	539,121
Others	**35,759**	8,992	**258**	258
	453,098	548,113	**417,597**	539,379
Less: Portion classified as current liabilities *(note 30)*	**(100,218)**	(101,802)	**(100,218)**	(101,802)
Long term portion	**352,880**	446,311	**317,379**	437,577

36. DEFERRED INCOME

In 2000, the Group acquired an aircraft which was funded by the PRC government, and a further aircraft was injected into the Group by the PRC government during 2004. In accordance with IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*, the Group recorded these aircraft purchased in 2000 and received in 2004 as property, plant and equipment with the corresponding amounts of government grant recorded as deferred income at the respective dates of the delivery of the aircraft. As such, the government subsidies in relation to the aforesaid aircraft purchased in 2000 and the aircraft received in 2004 are recorded in deferred income of the Group in 2000 and 2004, respectively. The deferred income is recognised as income over the expected useful lives of the relevant aircraft on the straight-line basis.

Notes to Financial Statements

Year ended 31 December 2005

36. DEFERRED INCOME (Continued)

The movements of deferred income as stated under current and non-current liabilities are as follows:

	Group		Company	
	2005	2004	**2005**	2004
	RMB'000	*RMB'000*	***RMB'000***	*RMB'000*
Deferred income:				
At beginning of the year	**1,462,667**	1,157,880	**1,462,667**	–
Transferred to the Company upon its incorporation *(note 1)*	**–**	–	**–**	1,462,667
Additions during the year	**–**	304,787	**–**	–
At end of year	**1,462,667**	1,462,667	**1,462,667**	1,462,667
Accumulated income recognised as other operating revenue:				
At beginning of year	**282,871**	212,278	**282,871**	–
Transferred to the Company upon its incorporation *(note 1)*	**–**	–	**–**	263,636
Credit during the year *(note 5)*	**76,943**	70,593	**76,943**	19,235
At end of the year	**359,814**	282,871	**359,814**	282,871
Net amount	**1,102,853**	1,179,796	**1,102,853**	1,179,796
Less: Portion classified as current liabilities *(note 30)*	**(76,943)**	(76,943)	**(76,943)**	(76,943)
Long term portion	**1,025,910**	1,102,853	**1,025,910**	1,102,853

37. SHARE CAPITAL

	Number of shares 2005	**Nominal value 2005**	Number of shares 2004	Nominal value 2004
		RMB'000		*RMB'000*
Company and Group				
Registered, issued and fully paid:				
– State legal person shares of RMB1.00 each	**4,826,195,989**	**4,826,196**	4,855,945,675	4,855,946
– Non-H foreign shares of RMB1.00 each	**1,380,482,920**	**1,380,483**	1,388,992,507	1,388,992
– H shares of RMB1.00 each	**3,226,532,000**	**3,226,532**	2,805,680,000	2,805,680
	9,433,210,909	**9,433,211**	9,050,618,182	9,050,618

Notes to Financial Statements

Year ended 31 December 2005

37. SHARE CAPITAL (Continued)

A summary of the movements in the Company's issued share capital for the year ended 31 December 2005 is as follows:

	Number of shares 2005	Nominal value 2005 RMB'000
At beginning of year	**9,050,618,182**	**9,050,618**
State legal person shares converted into H shares *(note 37(a))*	**(29,749,686)**	**(29,750)**
Non-H foreign shares converted into H shares *(note 37(a))*	**(8,509,587)**	**(8,509)**
Share placement and public offer *(note 37(b))*	**420,852,000**	**420,852**
	9,433,210,909	**9,433,211**

A summary of the movements in the Company's issued share capital for the period from 30 September 2004 (date of incorporation of the Company) to 31 December 2004 is as follows:

	Number of shares 2004	Nominal value 2004 RMB'000
Restructuring *(note 37(c))*	6,500,000,000	6,500,000
State legal person shares converted into H shares *(note 37(d))*	(198,331,240)	(198,331)
Non-H foreign shares converted into H shares *(note 37(d))*	(56,730,578)	(56,731)
Share placement and public offer *(note 37(e))*	2,805,680,000	2,805,680
	9,050,618,182	9,050,618

Notes:

(a) In January 2005, upon the exercise of the over-allotment options granted to international underwriters, the Company issued 420,852,000 H shares, consisting of 382,592,727 new shares, 29,749,686 H shares converted from state legal person shares and 8,509,587 H shares converted from non-H foreign shares, with a par value of RMB1.00 each at HK$2.98 (equivalent to RMB3.17072) per share. The proceeds from the sale of the state legal person shares and non-H foreign shares totalling approximately RMB117 million, after deducting share issue expenses of approximately RMB4 million which were borne by the Social Security Fund in connection with the sale of the state legal person shares and non-H foreign shares, were remitted to the Social Security Fund.

(b) As referred to in note 37 (a) above, the Company issued 420,852,000 H shares upon the exercise of the over-allotment options granted to international underwriters. After deducting aggregate net proceeds of approximately RMB117 million from the sale of 29,749,686 H shares converted from state legal person shares and 8,509,587 H shares converted from non-H foreign shares, which were remitted to the Social Security Fund and share issue expenses of approximately RMB45 million (before deducting share issue expenses of approximately RMB4 million borne by the Social Security Fund), the Company raised net proceeds of approximately RMB1,172 million, of which paid-up share capital amounted to approximately RMB383 million and capital reserve amounted to approximately RMB789 million.

(c) Pursuant to the Restructuring, and the basis of presentation thereof, as discussed in note 1 to these financial statements, the owners' equity of the Company in the consolidated balance sheet as at 30 September 2004, the date of incorporation of the Company, was converted into the Company's share capital of RMB6,500 million of RMB1.00 each with the rest as capital reserve.

Notes to Financial Statements

Year ended 31 December 2005

37. SHARE CAPITAL (Continued)

Notes: (Continued)

(d) The Company's H shares were listed on the Hong Kong Stock Exchange and the London Stock Exchange on 15 December 2004 and 2,805,680,000 H shares, consisting of 2,550,618,182 new shares, 198,331,240 shares converted from state legal person shares and 56,730,578 shares converted from non-H foreign shares, with a par value of RMB1.00 each were issued to the public by way of placement and offer at HK$2.98 (equivalent to approximately RMB3.17072) each. The proceeds from the sale of the 198,331,240 state legal person shares and 56,730,578 non-H foreign shares totalling approximately RMB759 million, after deducting the portion of share issuing expenses of approximately RMB50 million which were borne by the Social Security Fund in connection with these sales of State legal person shares and non-H foreign shares, were remitted to the Social Security Fund.

(e) As referred to in note 37 (d) above, the Company issued 2,805,680,000 H shares to the public by way of placement and offer. After deducting aggregate net proceeds of approximately RMB759 million from the sale of 198,331,240 H shares converted from state legal person shares and 56,730,578 H shares converted from non-H foreign shares which were remitted to the Social Security Fund as referred to in note 37 (d) above and share issue expenses of approximately RMB536 million (before deducting share issue expenses of approximately RMB50 million borne by the Social Security Fund as referred to in note 37 (d) above), the Company raised net proceeds of approximately RMB7,601 million, of which paid-up share capital amounted to approximately RMB2,551 million and capital reserve amounted to approximately RMB5,050 million.

The H shares rank pari passu, in all material respects, with the state legal person shares and non-H foreign shares of the Company.

38. RESERVES

Group

The amounts of the Group's reserves and the movements therein for each of the two years ended 31 December 2005 are presented in the consolidated statement of changes in equity on page 58 of these financial statements.

Company

	Capital reserve RMB'000	Reserve funds RMB'000	Retained earnings RMB'000	Proposed final dividend RMB'000	Total RMB'000
Upon incorporation of the Company *(note 38(a))*	(627,464)	–	34,813	–	(592,651)
Profit for the period from 1 October to 31 December 2004	–	–	1,229,603	–	1,229,603
Distributions *(note 38(b))*	–	–	(377,550)	–	(377,550)
Transfer to reserve funds *(note 13)*	–	51,908	(51,908)	–	–
Issue of new shares upon listing *(note 37(e))*	5,536,678	–	–	–	5,536,678
Share issue expenses *(note 37(e))*	(486,457)	–	–	–	(486,457)
At 31 December 2004 and I January 2005	4,422,757	51,908	834,958	–	5,309,623
Profit for the year	–	–	2,113,350	–	2,113,350
Transfer to statutory reserve funds *(note 13)*	–	252,908	(252,908)	–	–
Proposed final 2005 dividend *(note 13(d))*	–	–	(224,793)	224,793	–
Issue of new shares upon exercise of over-allotment options *(note 37(b))*	830,414	–	–	–	830,414
Share issue expenses *(note 37(b))*	(40,910)	–	–	–	(40,910)
At 31 December 2005	**5,212,261**	**304,816**	**2,470,607**	**224,793**	**8,212,477**

Notes to Financial Statements

Year ended 31 December 2005

38. RESERVES (Continued)

Notes:

(a) As described in note 1 to these financial statements, the financial statements of the Group for the year ended 31 December 2004 have been prepared as if the Group had been in existence throughout the year and as if the Relevant Businesses and the interests in the Relevant Companies were transferred to the Company prior to 1 January 2004. Upon incorporation of the Company on 30 September 2004, the historical net asset value of the Relevant Businesses and the interests in the Relevant Companies transferred to the Company were converted into the Company's registered capital as described in note 37 (c) to these financial statements with all the then existing reserves eliminated and the resulting difference dealt with in the capital reserve and retained earnings. Accordingly, the aggregate of the capital reserve and retained earnings amounts, being the difference between the amount of share capital issued and the historical net asset value of the Relevant Businesses and the interests in the Relevant Companies transferred to the Company as at 30 September 2004, were presented in the reserves of both the Group and the Company.

Retained earnings of the Company and the Group upon incorporation of the Company represent the amounts set aside for distributions, details of which are set out in note 13 to these financial statements. Therefore, these amounts were not capitalised by the Company and the Group upon the Company's incorporation.

(b) Details of the distributions are set out in note 13 to these financial statements.

39. LONG TERM COMPENSATION PLAN

The Company has adopted a long term compensation plan (the "Plan") which was approved by the shareholders on 18 October 2004 for the purpose of motivating its employees. The Plan provides for the grant of share appreciation rights ("SARs") to eligible participants, including the Company's Directors (excluding independent non-executive Directors), supervisors (excluding independent supervisors), president, vice presidents, heads of key departments in the Company's headquarters, general managers and general deputy managers of principal branches and subsidiaries as well as selected senior professionals and key specialists. In any event, SARs will be granted to no more than 200 individuals. The Plan will remain in force unless otherwise cancelled or amended.

Under the Plan, the holders of SARs are entitled the rights to receive an amount in respect of the appreciation in market value of the Company's H shares from the date of grant of SARs and the date of exercise. No shares will be issued under the Plan and therefore the Company's equity interests will not be diluted as a result of the issuance of SARs. The maximum number of unexercised SARs permitted to be granted under the Plan is, upon their exercise, limited to 2% of the Company's H shares in issue at any time during each year. The maximum number of SARs granted to eligible participants under the Plan within any 12-month period is, upon their exercise, limited to 0.4% of the Company's H shares in issue at any time during each year. The maximum number of SARs granted to any eligible participant is limited to 10% of the total number of unexercised SARs in issue at any time during each year. Any further grant of SARs in excess of the above limits is subject to shareholders' approval in general meetings.

The exercise period of all SARs commences after a vesting period and ends on a date which is not later than five years from the date of grant of the SARs. As at each of the last day of the second, third and fourth anniversary of the date of grant, the total number of SARs exercisable will not exceed 30%, 70% and 100%, respectively, of the total SARs granted to the respective eligible participants.

The exercise price of SARs will be equal to the average closing price of the Company's H shares on the Hong Kong Stock Exchange for the five consecutive trading days immediately preceding the date of the grant.

As at 31 December 2005 and 31 December 2004, no SARs had been issued under the Plan.

Notes to Financial Statements

Year ended 31 December 2005

40. DISTRIBUTABLE RESERVES

As at 31 December 2005, in accordance with the PRC Company Law, an amount of approximately RMB8,505 million (2004: RMB7,704 million) standing to the credit of the Company's capital reserve account, and an amount of approximately RMB305 million (2004: RMB52 million) standing to the credit of the Company's reserve funds, as determined in accordance with PRC GAAP, were available for distribution by way of future capitalisation issue. In addition, the Company had retained earnings of approximately RMB1,641 million (2004: RMB208 million), as determined in accordance with PRC GAAP and being the lesser amount of the retained earnings determined in accordance with PRC GAAP and IFRSs, available for distribution as dividend.

41. CONTINGENT LIABILITIES

Pursuant to the Restructuring, the following legal matters set out in items (a) and (b) below were transferred to or assumed by the Company upon its incorporation. As at 31 December 2005, the Group had the following contingent liabilities:

(a) Pursuant to the Restructuring of CNAHC, in preparation for the listing of the Company's H shares on Hong Kong Stock Exchange and the London Stock Exchange, the Company entered into a restructuring agreement with CNAHC and CNACG on 20 November 2004 ("Restructuring Agreement"), except for liabilities constituting or arising out of or relating to business undertaken by the Company after the Restructuring, no other liabilities were assumed by the Company and the Company is not liable, whether severally, or jointly and severally, for debts and obligations incurred prior to the Restructuring by CNAHC and CNACG. The Company has also undertaken to indemnify CNAHC and CNACG in respect of any damage suffered or incurred by CNAHC and CNACG as a result of any breach by the Company of any provision of the Restructuring Agreement.

(b) On 15 April 2002, Flight CA129 crashed on approach to Gimhae International Airport, South Korea. There were 129 fatalities including 121 passengers and 8 crew members aboard the crashed aircraft. An investigation was conducted by the Chinese and the Korean civil aviation authorities, but the cause of the accident has yet to be released at the date of these financial statements. Certain injured passengers and families of the deceased passengers have commenced proceedings in Korean courts seeking damages against Air China International Corporation, the predecessor of the Company. The Group cannot predict the timing of the courts' judgements or the possible outcome of the lawsuits nor any possible appeal actions. Up to 31 December 2005, the Company, Air China International Corporation and the Company's insurer had paid an aggregate amount of approximately RMB197 million in respect of passenger liability and other auxiliary costs. Included in the RMB197 million is an amount of approximately RMB179 million borne by the Company's insurer. As part of the Restructuring, CNAHC has agreed to indemnify the Group for any liabilities relating to the crash of Flight CA129, excluding the compensation already paid up to 30 September 2004 (being the date of incorporation of the Company). The Directors of the Company believe that there will not be any material adverse impact on the Group's financial position.

Notes to Financial Statements

Year ended 31 December 2005

41. CONTINGENT LIABILITIES (Continued)

(c) The Group and the Company have issued guarantees to banks in respect of the bank loans granted to the following parties:

	Group		Company	
	2005	2004	**2005**	2004
	RMB'000	*RMB'000*	***RMB'000***	*RMB'000*
Joint ventures	**91,000**	–	**–**	–
Associates	**149,109**	214,002	**128,303**	198,102
	240,109	214,002	**128,303**	198,102

42. COMMITMENTS

(a) Capital commitments

The Group and the Company have the following amounts of contractual commitments for the acquisition and construction of plant, property and equipment:

	Group		Company	
	2005	2004	**2005**	2004
	RMB'000	*RMB'000*	***RMB'000***	*RMB'000*
Contracted, but not provided for:				
Aircraft and flight equipment	**31,696,796**	8,750,195	**31,403,107**	7,272,969
Buildings	**835,902**	544,855	**664,614**	211,607
Others	**22,339**	8,426	**22,339**	8,426
	32,555,037	9,303,476	**32,090,060**	7,493,002
Authorised, but not contracted for:				
Aircraft and flight equipment	**3,973,095**	–	**3,564,126**	–
Buildings	**1,920,079**	2,528,544	**1,920,079**	2,528,544
Others	**65,608**	–	**–**	–
Total capital commitments	**38,513,819**	11,832,020	**37,574,265**	10,021,546

(b) Investment commitments

As at 31 December 2005, the Company is committed to make capital contributions of RMB358 million (equivalent to approximately US$45 million) (2004: RMB422 million) and RMB103 million (2004: Nil) to a joint venture and an associate, respectively.

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42. COMMITMENTS (Continued)

(c) Operating lease commitments

The Group and the Company lease certain of its office premises, aircraft and related equipment under operating lease arrangements. Leases for these assets are negotiated for terms ranging from 1 to 20 years.

At the balance sheet date, the Group and the Company have the following future minimum lease payments under non-cancellable operating leases:

	Group		Company	
	2005	2004	**2005**	2004
	RMB'000	*RMB'000*	***RMB'000***	*RMB'000*
Within one year	**1,507,057**	1,140,228	**760,230**	748,202
In the second to fifth years, inclusive	**2,862,349**	3,215,879	**1,657,353**	2,111,282
Over five years	**1,066,083**	1,000,319	**644,741**	566,585
	5,435,489	5,356,426	**3,062,324**	3,426,069

43. FINANCIAL INSTRUMENTS

(a) Fair value

Financial assets of the Group and the Company mainly include cash and cash equivalents, pledged deposits, trade receivables, available-for-sale investments, deposits and other receivables. Financial liabilities of the Group and the Company mainly include bank and other loans, obligations under finance leases, trade payables, other payables, bills payable and air traffic liabilities.

The carrying amounts of the Group's and the Company's financial instruments approximated their fair value as at the balance sheet date. Fair value estimates are made at a specific point in time and based on relevant market information about the financial instruments. These estimates are subjective in nature and involve uncertainties and matters of significant judgement and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

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Year ended 31 December 2005

43. FINANCIAL INSTRUMENTS (Continued)

(b) Interest rate risk

The following table sets out the carrying amount, by maturity, of the Group's financial instruments that are exposed to interest rate risk:

For the year ended 31 December 2005

Fixed rate

	Within one year *RMB'000*	**In the second year** *RMB'000*	**In the third to fifth years, inclusive** *RMB'000*	**Over five years** *RMB'000*	**Total** *RMB'000*
Obligations under finance leases	**1,625,907**	**1,949,802**	**6,071,492**	**57,377**	**9,704,578**
Bank and other loans	**4,877,843**	**1,502,072**	**2,856,723**	**812,434**	**10,049,072**
4.5% corporate bonds	**–**	**–**	**–**	**3,000,000**	**3,000,000**
Bills payable	**327,937**	**–**	**–**	**–**	**327,937**
Cash assets	**2,522,336**	**–**	**–**	**–**	**2,522,336**

Floating rate

	Within one year *RMB'000*	**In the second year** *RMB'000*	**In the third to fifth years, inclusive** *RMB'000*	**Over five years** *RMB'000*	**Total** *RMB'000*
Obligations under finance leases	**328,966**	**–**	**–**	**–**	**328,966**
Bank and other loans	**5,523,327**	**1,245,086**	**1,842,931**	**1,563,633**	**10,174,977**

For the year ended 31 December 2004

Fixed rate

	Within one year *RMB'000*	In the second year *RMB'000*	In the third to fifth years, inclusive *RMB'000*	Over five years *RMB'000*	Total *RMB'000*
Obligations under finance leases	1,629,551	1,606,254	6,722,448	1,910,163	11,868,416
Bank and other loans	3,197,913	1,195,648	3,694,366	1,596,253	9,684,180
Bills payable	362,033	–	–	–	362,033
Cash assets	9,851,305	–	–	–	9,851,305

Floating rate

	Within one year *RMB'000*	In the second year *RMB'000*	In the third to fifth years, inclusive *RMB'000*	Over five years *RMB'000*	Total *RMB'000*
Obligations under finance leases	75,595	337,376	–	–	412,971
Bank and other loans	5,608,138	1,868,251	2,520,893	2,021,211	12,018,493

Interest on financial instruments classified as floating rate is repriced at intervals of less than one year. Interest on financial instruments classified as fixed rate is fixed until the maturity of the instrument. The other financial instruments of the Group that are not included in the above tables are non-interest-bearing and are therefore not subject to interest rate risk.

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Year ended 31 December 2005

44. FINANCIAL RISK MANAGEMENT OBJECTIVES AND POLICIES

The Group's principal financial instruments, other than derivatives, comprise bank and other loans, obligations under finance leases, cash and cash equivalents and pledged deposits. The main purpose of these financial instruments is to raise finance for the Group's operations. The Group has various other financial assets and liabilities such as trade receivables and trade payables, which arise directly from its operations.

The Group also enters into derivative transactions, including principally swaps and collars contracts. The purpose is to manage the jet fuel price risk arising from the Group's operations.

It is, and has been throughout the year under review, the Group's policy that no trading in financial instruments shall be undertaken.

The Group operates globally and generates revenue in various currencies. The Group's airline operations are exposed to business risk, liquidity risk, jet fuel price risk, foreign currency risk, interest rate risk and credit risk. The Group's overall risk management approach is to moderate the effects of such volatility on its financial performance.

Financial risk management policies are periodically reviewed and approved by the Board of Directors and they are summarised below.

(a) Business risk

The operations of the air transportation industry are substantially influenced by global political and economic development. Factors such as accidents and wars may have a material impact on the Group's operations or the industry as a whole. In addition, the Group primarily conducts its principal operations in Mainland China and accordingly is subject to special consideration and significant risks not typically associated with companies in the United States of America and Western Europe. These include risks associated with, among other things, the political, economic and legal environment, competition and influence of the CAAC in the Chinese civil aviation industry.

(b) Liquidity risk

The Group's net current liabilities amounted to approximately RMB16,006 million at 31 December 2005 (2004: RMB9,053 million). The Group recorded a net cash inflow from operating activities of approximately RMB6,048 million for the year ended 31 December 2005 (2004: RMB6,151 million). For the same period, the Group had a net cash outflow from investing activities of approximately RMB12,500 million (2004: RMB4,979 million). The Group also recorded a net cash outflow from financing activities of approximately RMB766 million and an inflow from financing activities of approximately RMB5,620 million for the years ended 31 December 2005 and 2004, respectively. The Group has recorded a decrease in cash and cash equivalents of approximately RMB7,165 million and an increase in cash and cash equivalents of approximately RMB6,824 million for the years ended 31 December 2005 and 2004, respectively.

With regards to 2006 and thereafter, the liquidity of the Group is primarily dependent on its ability to maintain adequate cash inflow from operations to meet its debt obligations as they fall due, and on its ability to obtain external financing to meet its committed future capital expenditure. With regards to its future capital commitments and other financing requirements, the Company has already obtained several banking facilities with several PRC banks of up to an amount of RMB78,570 million as at 31 December 2005, of which an amount of approximately RMB33,476 million was utilised.

Notes to Financial Statements

Year ended 31 December 2005

44. FINANCIAL RISK MANAGEMENT OBJECTIVES AND POLICIES (Continued)

(b) Liquidity risk (Continued)

The Directors of the Company have carried out a detailed review of the cash flow forecast of the Group for the year ending 31 December 2006. Based on such forecast, the Directors have determined that adequate liquidity exists to finance the working capital and capital expenditure requirements of the Group during 2006. In preparing the cash flow forecast, the Directors have considered historical cash requirements of the Group as well as other key factors, including the availability of the above-mentioned loans financing which may impact the operations of the Group prior to the end of 2006. The Directors are of the opinion that the assumptions and sensitivities which are included in the cash flow forecast are reasonable. However, as with all assumptions in regard to future events, these are subject to inherent limitations and uncertainties and some or all of these assumptions may not be realised.

(c) Jet fuel price risk

The Group's strategy for managing the risk on jet fuel price aims to provide the Group with protection against sudden and significant increases in prices. In meeting these objectives, the Group allows for the judicious use of approved derivative instruments such as swaps and collars with approved counter-parties and within approved limits.

Moreover, counter-party credit risk is generally restricted to any gains on changes in fair value at any time, and not the principal amount of the instrument. Therefore, the possibility of material loss arising in the event of non-performance by a counter-party is considered to be unlikely.

The fair values of derivative instruments of the Group and the Company at the balance sheet date are as follows:

	Group		Group	
	2005	**2005**	2004	2004
	Assets	**Liabilities**	Assets	Liabilities
	RMB'000	***RMB'000***	*RMB'000*	*RMB'000*
Swaps and collars expiring:				
Within 6 months	**–**	**–**	–	–
Over 6 months to 21 months	**127,659**	**(1,791)**	–	–
	127,659	**(1,791)**	–	–

	Company		Company	
	2005	**2005**	2004	2004
	Assets	**Liabilities**	Assets	Liabilities
	RMB'000	***RMB'000***	*RMB'000*	*RMB'000*
Swaps and collars expiring:				
Within 6 months	**–**	**–**	–	–
Over 6 months to 21 months	**115,220**	**(1,791)**	–	–
	115,220	**(1,791)**	–	–

Fair values of derivative instruments, denominated in United States dollars, are obtained from quoted market prices, dealer price quotations, discounted cash flow models and option pricing models, which consider current market and contractual prices for the underlying instruments, as well as time value of money, yield curve and volatility of the underlying instruments.

Notes to Financial Statements

Year ended 31 December 2005

44. FINANCIAL RISK MANAGEMENT OBJECTIVES AND POLICIES (Continued)

(d) Foreign currency risk

The Group's finance lease obligations as well as certain bank and other loans are denominated in United States dollars and Japanese yen, and certain expenses of the Group are denominated in currencies other than RMB. The Group generates foreign currency revenue from ticket sales made in overseas offices and would normally generate sufficient foreign currencies after payment of foreign currency expenses, to meet its foreign currency liabilities repayable within one year. RMB against United States dollars and Hong Kong dollars have been comparatively stable in the past. However, RMB against Japanese yen had experienced a significant level of fluctuation during the year which is the major reason for the significant exchange difference recognised by the Group for the year.

(e) Interest rate risk

The Group's earnings are also affected by changes in interest rates due to the impact of such changes on interest income and expense from short-term deposits and other interest-bearing financial assets and liabilities. A significant portion of the Group's interest-bearing financial liabilities with maturities over one year have predominately fixed rates of interest and are denominated in United States dollars and Japanese yen.

The Group's short-term deposits and other interest-bearing financial assets and liabilities are predominately denominated in RMB, United States dollars and Hong Kong dollars.

(f) Credit risk

The Group's cash and cash equivalents are deposited with banks in Mainland China, overseas banks and an associate. The Group has policies in place to limit the exposure to any one financial institution.

A significant portion of the Group's air tickets are sold by agents participating in the Billing and Settlements Plan ("BSP"), a clearing system between airlines and sales agents organised by the International Air Transportation Association. The balance due from BSP agents amounted to approximately RMB529 million as at 31 December 2005 (2004: RMB531 million).

Except for the above, the Group has no significant concentration of credit risk, with exposure spread over a number of counter-parties.

Notes to Financial Statements

Year ended 31 December 2005

45. CONSOLIDATED CASH FLOW STATEMENT

(a) Establishment of a joint venture

For the year ended 31 December 2004, the establishment of a joint venture has been shown in the consolidated cash flow statement as a single item. The cash flow effect can be analysed as follows:

	2004 *RMB'000*
Cash and bank balances	561,509
Trade receivables	16,844
Other receivables	2,778
Property, plant and equipment *(note 15)*	565,840
Inventories	352
Trade payables	(40,018)
Other payables and accruals	(357,517)
Air traffic liabilities	(2,010)
Net assets attributable to the joint venture partners	747,778
Dilution gain on an investment *(note 9)*	330,222
Cash contribution from the joint venture partners	1,078,000
Less: Cash attributable to the joint venture partners	(561,509)
Cash flow on establishment of a joint venture, net of cash attributable to the joint venture partners	516,491

(b) Major non-cash transactions

Major non-cash transactions in 2004 were as follows:

(i) In 2004, the Group received an aircraft injected by the PRC government amounting to RMB304,787,000 *(note 36)*. This amount has been recorded in property, plant and equipment.

(ii) Upon incorporation of the Company on 30 September 2004, CNAHC effected the transfer of certain land use rights in an aggregate amount of approximately RMB885,626,000 to the Company.

Notes to Financial Statements

Year ended 31 December 2005

46. RELATED PARTY TRANSACTIONS

The Group is part of a larger group of companies under CNAHC and has extensive transactions and relationships with members of CNAHC. As such, it is possible that the terms of these transactions are not the same as those that would result from transactions among wholly-unrelated parties. Related parties refer to corporations in which CNAHC is a shareholder and is able to exercise control or joint control. The transactions were made at prices and terms mutually agreed between the parties. The Directors of the Company are of the opinion that the transactions with related parties (see below) were conducted in the usual course of business.

The Group had the following significant transactions between the Group and (i) CNAHC, its subsidiaries (other than the Group) and joint ventures (collectively known as the "CNAHC Group"); (ii) its joint ventures; and (iii) its associates:

	Group	
	2005	2004
	RMB'000	*RMB'000*
A. Included in air traffic revenue		
Sale of air tickets		
CNAHC Group	**9,836**	17,227
Associates	**1,463**	2,154
	11,299	19,381
Sale of cargo space		
CNAHC Group	**200,273**	213,836
Government charted flights		
CNAHC	**407,048**	–
B. Included in other operating revenue		
Aircraft and related equipment lease income		
CNAHC Group	**–**	1,912
Aircraft engineering income		
Associates	**11,563**	9,876
Ground services income		
CNAHC Group	**1,061**	–
Joint ventures	**23,417**	942
Associates	**34,401**	19,849
	58,879	20,791
Bellyhold income		
Joint venture	**1,496,302**	1,384,457
Others		
CNAHC Group	**22,432**	5,734
Joint ventures	**33,406**	14,424
Associates	**35,568**	11,484
	91,406	31,642

Notes to Financial Statements

Year ended 31 December 2005

46. RELATED PARTY TRANSACTIONS (Continued)

		Group	
		2005	2004
		RMB'000	*RMB'000*
C.	Included in finance revenue and finance costs		
	Interest income		
	Associate	**2,363**	3,409
	Interest expense		
	Associate	**14,532**	21,843
D.	Included in operating expenses		
	Airport ground services, take-off, landing and depot expenses		
	CNAHC Group	**92,836**	97,183
	Associates	**248,128**	210,103
		340,964	307,286
	Air catering charges		
	CNAHC Group	**49,695**	43,241
	Joint ventures	**115,116**	85,874
	Associates	**7,496**	5,123
		172,307	134,238
	Repair and maintenance costs		
	Joint ventures	**363,181**	472,378
	Associates	**125,717**	107,508
		488,898	579,886
	Sale commission expenses		
	CNAHC Group	**7,571**	25,913
	Associates	**6,119**	–
		13,690	25,913
	Management fees		
	CNAHC Group	**10,096**	44,080
	Aircraft leasing fees		
	Associate	**201,388**	–
	Others		
	CNAHC Group	**79,197**	71,729
	Associates	**7,517**	9,050
		86,714	80,779

Notes to Financial Statements

Year ended 31 December 2005

46. RELATED PARTY TRANSACTIONS (Continued)

	Group 2005 RMB'000	Group 2004 RMB'000	Company 2005 RMB'000	Company 2004 RMB'000
E. Deposits, loans and bills payable				
Deposits placed with an associate	**470,863**	566,985	**415,366**	519,655
Loans from an associate	**203,016**	481,132	**190,910**	364,400
Bills payable to an associate	**103,426**	–	**103,426**	–
F. Outstanding balance with related parties				
Due from CNAHC (long term)	**531,813**	631,813	**531,813**	631,813
Due from other CNAHC group companies	**38,039**	44,916	**12,993**	8,801
Due from associates	**62,948**	90,842	**15,419**	17,305
Due to associates	**(95,905)**	(81,591)	**(129,410)**	(82,109)
Due from a joint venture	**451,965**	412,539	**922,378**	841,916
Due to CNAHC and CNACG	**(133,680)**	(2,256,117)	**(118,680)**	(2,240,213)
Due to other CNAHC group companies	**(40,471)**	(49,617)	**(22,413)**	(12,163)
Due to a joint venture	**(115,435)**	(179,934)	**(288,588)**	(449,835)
Due from CNAHC	**474,216**	–	**474,216**	–
Due from subsidiaries	**–**	–	**11,519**	22,513
Due to subsidiaries	**–**	–	**(588,623)**	(559,703)

The long term amount due from CNAHC is unsecured, interest-free and is not repayable within one year from the balance sheet date. Except for the long term amount due from CNAHC, the outstanding balances with related parties are unsecured, interest-free and repayable within one year.

	Group 2005 RMB'000	Group 2004 RMB'000
G. Compensation of key management personnel of the Group		
Short term employee benefits	**5,501**	5,002
Post-employment benefits	**142**	93
Total compensation paid to key management personnel	**5,643**	5,095

Further details of directors' emoluments are included in note 10 to the financial statements.

	Group 2005 RMB'000	Group 2004 RMB'000
H. Disposal of a long term investment to CNAHC Group	**20,737**	–

On 30 September 2005, Beijing Catering Co. Ltd., a 60% joint venture of the Group, sold its shares in CNAF to CNAHC for a total consideration of approximately RMB34 million.

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Year ended 31 December 2005

46. RELATED PARTY TRANSACTIONS (Continued)

(a) In addition to the above, on 18 October 1997, CNAC entered into a licence agreement with China National Aviation Corporation ("CNAC (PRC)") pursuant to which CNAC (PRC) had agreed to grant a licence to CNAC, free of royalty, for the right to use certain trademarks in Hong Kong, the Taiwan region and Macau so long as CNAC is a subsidiary of CNACG.

On 25 August 2004, CNAC (PRC) entered into two assignment agreements with CNACG pursuant to which CNAC (PRC) has agreed to assign, free of royalty, the above-mentioned trademarks to CNACG for use in Hong Kong and Macau, respectively. On 25 August 2004, CNACG entered into two licence agreements with CNAC pursuant to which CNACG has agreed to grant licences to CNAC, free of royalty, for the rights to use those trademarks in Hong Kong and Macau, respectively, so long as CNAC is a direct or indirect subsidiary of CNAHC. These licence agreements supersede the licence agreement entered into between CNAC (PRC) and CNAC on 18 October 1997.

No royalty charge was levied in respect for the use of these trademarks during each of the two years ended 31 December 2005.

(b) Pursuant to certain of the Company's aircraft leasing arrangements and bank loans arrangements, the overseas lessors and lenders require guarantees to be given by some major PRC state-owned banks. In giving such guarantees, the PRC state-owned banks in turn require CNAHC and CNAF to provide counter-guarantees in favour of the banks. As at the balance sheet date, the amounts of such counter-guarantees provided by CNAHC and CNAF are as follows:

	Group	
	2005	2004
	RMB'000	*RMB'000*
CNAHC :		
Finance leases *(note 32)*	–	921,000
Bank loans *(note 33)*	–	1,455,000
	–	2,376,000
CNAF :		
Finance leases *(note 32)*	–	3,976,000
Bank loans *(note 33)*	–	761,000
	–	4,737,000
	–	7,113,000

(c) The Company entered into several agreements with CNAHC which govern the use of trademarks granted by the Company to CNAHC; the provision of financial services by CNAF; the provision of construction project management services by China National Aviation Construction and Development Company; the subcontracting of charter-flight services to CNAHC; the leasing of properties from and to CNAHC; the provision of air ticketing and cargo services; media and advertising services arrangement to China National Aviation Media and Advertising Co., Ltd.; the tourism services co-operation agreement with CNAHC; the comprehensive services agreement with CNAHC; and the provision of maintenance and other ground services by China Aircraft Services Limited.

(d) There were no pension payments relating to the Supplementary Pension Benefits of the Group for the year ended 31 December 2005. All pension payments relating to the Supplementary Pension Benefits of RMB39 million for the year ended 31 December 2004 were borne by CNAHC *(note 11)*.

Notes to Financial Statements

Year ended 31 December 2005

46. RELATED PARTY TRANSACTIONS (Continued)

(e) On 19 August 2004, Fly Top Limited, a wholly-owned subsidiary of CNAC, entered into the following acquisition agreements:

(a) a sale and purchase agreement with CNACG in relation to the acquisition of approximately 16% of the issued share capital of LSGHK, a company incorporated in Hong Kong with limited liability (the "CNACG Agreement"); and

(b) a sale and purchase agreement with Hong Kong International Air Catering Limited ("HKIAC"), a company incorporated in Hong Kong with limited liability and in which Air China International Corporation has a 25% equity interest, in relation to the acquisition of approximately 4.2% of the issued share capital of LSGHK (the "HKIAC Agreement").

The total consideration of the above acquisitions is approximately RMB122 million. Immediately after the completion of the CNACG Agreement and the HKIAC Agreement, the Group's effective shareholding interests in LSGHK is approximately 14%.

The Group operates in an economic environment predominated by enterprises directly or indirectly owned or controlled by the PRC government through its numerous authorities, affiliates or other organisations (collectively "State-owned Enterprises"). During the year, the Group had transactions with State-owned Enterprises including, but not limited to, the provision of air passenger and air cargo services and purchases of services. The Directors consider that transactions with other State-owned Enterprises are activities in the ordinary course of the Group's business and that the dealings of the Group have not been significantly or unduly affected by the fact that the Group and the other State-owned Enterprises are ultimately controlled or owned by the PRC government. The Group has also established pricing policies for products and services, and such pricing policies do not depend on whether or not the customers are State-owned Enterprises. Having due regard to the substance of the relationships, the Directors are of the opinion that none of these transactions are material related party transactions that require separate disclosure.

47. NET PROFIT ATTRIBUTABLE TO EQUITY HOLDERS OF THE PARENT

The net profit attributable to equity holders of the parent for the year ended 31 December 2005 and for the period from 1 October 2004 to 31 December 2004 dealt with in the financial statements of the Company was approximately RMB2,113 million and RMB1,230 million *(note 38)*, respectively.

48. COMPARATIVE FIGURES

The following comparative figures have been reclassified to conform to the current year's presentation:

(a) Reclassification of profit and loss items:

Nature of item	2004 Classification	**2005 Classification**	**Group** *RMB'000*
Share of tax attributable to associates	Tax	**Share of profits less losses from associates**	**96,974**
Finance revenue (which includes interest income, net gains on fuel derivatives, net and dividend income from available-for-sale investments)	Finance costs	**Finance revenue**	**79,361**

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Year ended 31 December 2005

48. COMPARATIVE FIGURES (Continued)

(b) Reclassification of balance sheet items:

Nature of item	2004 Classification	**2005 Classification**	**Group** *RMB'000*	**Company** *RMB'000*
Non-pledged deposits with maturity of more than three months when acquired	Cash and cash equivalents	**Non-pledged deposits with maturity of more than three months when acquired**	320,850	313,768
Advance payments for aircraft and related equipment	Prepayments, deposits and other receivables	**Advance payments for aircraft and related equipment**	2,193,458	1,958,515

The Directors are of the view that the above changes would result in a more appropriate presentation of the Group's financial statements and better reflect the Group's financial performance and financial position.

49. EVENTS AFTER THE BALANCE SHEET DATE

(a) On 17 January 2006, the Company and AIE, a wholly-owned subsidiary of the Company, entered into an aircraft purchase agreement with Boeing Company ("Boeing") pursuant to which the Company has agreed to purchase 10 Boeing 737-800 aircraft (the "Boeing Aircraft") from Boeing for an aggregate consideration of US$655.2 million (equivalent to approximately RMB5,288 million). The aggregate consideration for the acquisition of the Boeing Aircraft is payable in cash by installments and the Boeing Aircraft are scheduled to be delivered in stages from 2007 to 2008.

(b) On 24 January 2006, the Group, through a subsidiary and an associate of CNAC, entered into several agreements with Shun Tak Air Transport Limited and its subsidiaries (the "Macau Asia Express Agreements") to establish Macau Asia Express Limited ("Macau Asia Express") to engage in the business of operating low cost model air transport services based in Macau. Pursuant to the Macau Asia Express Agreements, the Group will hold an indirect effective interest of 30% in Macau Asia Express. The aggregate initial investment to Macau Asia Express is up to approximately HK$234 million (equivalent to approximately RMB243 million) and in which the share of investment cost attributable to the Group, in an aggregate amount of approximately HK$161 million (equivalent to approximately RMB167 million), will be funded by internal resources. The completion of the establishment of Macau Asia Express is subject to certain conditions to be fulfilled.

Macau Asia Express is a subsidiary of CNAC, as defined by the laws of Macau, but CNAC does not have unilateral control over the entity. Accordingly, it will be accounted for as a jointly controlled entity in the Group's financial statements accordance with IAS *31 Interests in Joint Ventures.*

50. APPROVAL OF THE FINANCIAL STATEMENTS

The financial statements were approved and authorised for issue by the Board of Directors on 18 April 2006.