NOTES TO FINANCIAL STATEMENTS

1. Corporate Information

The Company was incorporated in the Cayman Islands on 16 February 2004 as an exempted company with limited liability. The Company is an investment holding company and its subsidiaries are engaged in the manufacture and distribution of dairy products in the People's Republic of China (the "PRC").

2.1 Basis of Preparation

These financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRSs"). They are prepared on a historical cost basis, except for available-for-sale investments that have been measured at fair value. They are presented in Renminbi ("RMB") and all values are rounded to the nearest thousand (RMB'000) except when otherwise indicated.

Basis of consolidation

The consolidated financial statements comprise the financial statements of the Company and its subsidiaries (the "Group") for the year ended 31 December 2005. The financial statements of the subsidiaries are prepared for the same reporting year as the Company, using consistent accounting policies. All intra-group balances, transactions, income and expenses and profits and losses resulting from intra-group transactions that are recognised in assets, are eliminated in full. Subsidiaries are fully consolidated from the date of acquisition, being the date on which the Group obtains control, and continue to be consolidated until the day that such control ceases.

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

2.2 Impact of New and Revised IFRSs

(a) Effect of adopting new and revised IFRSs

In 2005, the Group adopted the following new and revised IFRSs which are relevant to its operations and comparative amounts have been amended as required.

IAS 1	Presentation of Financial Statements
IAS 2	Inventories
IAS 8	Accounting Policies, Changes in Accounting Estimates and Errors
IAS 10	Events after the Balance Sheet Date
IAS 16	Property, Plant and Equipment
IAS 17	Leases
IAS 21	The Effects of Changes in Foreign Exchange Rates
IAS 24	Related Party Disclosures
IAS 27	Consolidated and Separate Financial Statements
IAS 28	Investments in Associates
IAS 32	Financial Instruments: Disclosure and Presentation
IAS 33	Earnings per Share
IAS 39	Financial Instruments: Recognition and Measurement
IFRS 2	Share-based Payment
IFRS 5	Non-current Assets Held for Sale and Discontinued Operations

2.2 Impact of New and Revised IFRSs *(Continued)*

(a) Effect of adopting new and revised IFRSs *(Continued)*

The adoption of the above new and revised IFRSs did not result in substantial changes to the Group's accounting policies nor any significant financial impact on the Group. In summary:

– IAS 1 has affected the presentation of minority interests on the face of the consolidated balance sheet, consolidated income statement, consolidated statement of changes in equity and other disclosures. In addition, in prior periods, the Group's share of tax attributable to associates was presented as a component of the Group's total tax charge in the consolidated income statement. Upon the adoption of IAS 1, the Group's share of the post-acquisition results of associates is presented net of the Group's share of tax attributable to associates.

– The adoption of IASs 2, 8, 10, 16, 17, 24, 27, 28, 32, 33 and 39 has had no material effect on the Group's accounting policies.

– IAS 21 requires goodwill to be allocated to foreign operations and carried at that foreign operation's functional currency. Goodwill and fair value adjustments are translated at the closing rate. Such change has had no material effect on the Group but the wording of the accounting policy on foreign currency translation has been amended to align with the new wording adopted in the revised IAS 21.

– IFRS 2 requires the cost of share options and other share-based incentives to be expensed in the income statement when the Group receives goods or services as consideration. Although the Company's share option scheme was approved on 28 June 2005, no share options or other share-based incentives have been granted during the year. Therefore, the adoption of IFRS 2 has had no material effect on the Group.

– IFRS 5 requires those non-current assets held for sale to be presented separately in the balance sheet. Such assets are measured at the lower of carrying amount and fair value less costs to sell and are not depreciated. The adoption of IFRS 5 has had no material effect on the Group.

(b) Impact of issued but not yet effective standards

The Group has not early adopted any of the following new or revised standards or interpretations that have been issued but are not yet effective. Unless otherwise stated, these IFRSs are effective for annual periods beginning on or after 1 January 2006. The Group is in the process of determining whether these new and revised standards and interpretations will have any material impact on the financial statements of the Group.

IAS 1 Amendment	Capital Disclosures
IAS 19 Amendment	Employee Benefits – Actuarial Gains and Losses, Group Plans and Disclosures
IAS 21 Amendment	The Effects of Changes in Foreign Exchange Rate – Net Investment in a Foreign Operation
IAS 39 Amendment	Cash Flow Hedge Accounting of Forecast Intragroup Transactions
IAS 39 Amendment	The Fair Value Option

2.2 Impact of New and Revised IFRSs *(Continued)*

(b) Impact of issued but not yet effective standards *(Continued)*

IAS 39 and IFRS 4 Amendments	Financial Instruments: Recognition and Measurement and Insurance Contract – Financial Guarantee Contracts
IFRS 6	Exploration for and Evaluation of Mineral Resources
IFRS 7	Financial Instruments: Disclosures
IFRIC Interpretation 4	Determining whether an Arrangement contains a Lease
IFRIC Interpretation 5	Rights to Interests Arising from Decommissioning, Restoration and Environmental Rehabilitation Funds
IFRIC Interpretation 6	Liabilities arising from Participating in a Specific Market – Waste Electrical and Electronic Equipment
IFRIC Interpretation 7	Applying the Restatement Approach under IAS 29 Financial Reporting in Hyperinflationary Economies
IFRIC Interpretation 8	Scope of IFRS 2
IFRIC Interpretation 9	Reassessment of Embedded Derivatives

IAS 1 Amendment and IFRS 7 shall be applied for annual periods beginning on or after 1 January 2007.

2.3 Summary of Significant Accounting Policies

Subsidiaries

A subsidiary is an entity, whose financial and operating policies the Company controls, directly or indirectly, so as to obtain benefits from its activities. The results of subsidiaries are included in the Company's income statement to the extent of dividends received and receivable. The Company's interests in subsidiaries are stated at cost less any impairment losses.

Associates

The Group's investments in its associates are 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. Under the equity method, the investments in associates are carried in the balance sheet at cost plus post-acquisition changes in the Group's share of net assets of the associates. 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 Group's share of the results of the operations of the associates. When there has been a change recognised directly in the equity of the associates, the Group recognises its share of any changes and discloses this, when applicable, in the 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.

2.3 Summary of Significant Accounting Policies *(Continued)*

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 investments, 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 transaction 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.

Available-for-sale investments

The Group only holds available-for-sale investments which are non-trading investments in unlisted equity securities intended to be held on a long term basis. After initial recognition, available-for-sale investments 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 consolidated income statement.

The fair value of investment 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; and a discounted cash flow analysis.

If an available-for-sale investment 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 in respect of equity instruments classified as available-for-sale are not recognised in profit.

Property, plant and equipment and depreciation

Items of property, plant and equipment are stated at cost less accumulated depreciation (see below) and impairment losses. The cost of self-constructed assets includes the cost of materials, direct labour and an appropriate proportion of production overheads.

Where an item of property, plant and equipment comprises major components having different useful lives, they are accounted for as separate items of property, plant and equipment.

Expenditure incurred to replace a component of an item of property, plant and equipment that is accounted for separately, including major inspection and overhaul expenditure, is capitalised. Other subsequent expenditure is capitalised only when it increases the future economic benefits embodied in the item of property, plant and equipment. All other expenditure is recognised in the consolidated income statement as an expense when incurred.

2.3 Summary of Significant Accounting Policies *(Continued)*

Property, plant and equipment and depreciation *(Continued)*

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.

Depreciation is charged to the consolidated income statement on a straight-line basis over the estimated useful lives of items of property, plant and equipment and major components that are accounted for separately.

The estimated useful lives of property, plant and equipment are as follows:

Buildings and structures	20 years
Plant and machinery	5 to 10 years
Office equipment	5 years
Motor vehicles	5 years

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

The assets' residual values, useful lives and depreciation methods are reviewed, and adjusted if appropriate, at each financial year end.

Construction in progress

Construction in progress represents plant and property under construction, which is stated at cost less any impairment losses, and is not depreciated. Cost comprises the direct costs of construction and capitalised borrowing costs on related borrowed funds during the period of construction. Construction in progress is reclassified to the appropriate category of property, plant and equipment when completed and ready for use.

Land use rights

Land use rights are initially stated at cost and subsequently recognised as an expense in the consolidated income statement on a straight-line basis over the lease terms.

Goodwill

Goodwill on acquisition is initially measured at cost being the excess of the cost of the business combination over the acquirer'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.

2.3 Summary of Significant Accounting Policies *(Continued)*

Goodwill *(Continued)*

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 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 on the basis of the relative values of the operation disposed of and the portion of the cash-generating unit retained.

Borrowing costs

Borrowing costs directly attributable to the acquisition, construction or production of qualifying assets, i.e., assets that necessarily take a substantial period of time to prepare for their intended use, are capitalised as a part of the cost of those assets. The capitalisation of such borrowing costs ceases when the assets are substantially ready for their intended use.

All other borrowing costs are recognised as expenses in the period in which they are incurred.

Inventories

Inventories are valued at the lower of cost and net realisable value.

Costs incurred in bringing each product to its present location and condition are accounted for as follows:

Raw materials	–	cost on a weighted average basis;
Finished goods	–	cost of direct materials and labour and a proportion of manufacturing overheads based on normal operating capacity but excluding borrowing costs on a weighted average basis.

Net realisable value is the estimated selling price in the ordinary course of business, less any estimated costs of completion and the estimated costs necessary to make the sale.

2.3 Summary of Significant Accounting Policies *(Continued)*

Revenue recognition

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

Sale of goods

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

Interest income

Revenue is recognised as interest accrues (taking into account the effective yield on the relevant asset).

Dividends

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

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 consolidated income statement over the expected useful life of the relevant asset by equal annual instalments.

Operating leases

Leases where the lessor retains substantially all the risks and benefits of ownership of the asset are classified as operating leases. Operating lease payments are recognised as an expense in the consolidated income statement on a straight-line basis over the lease term.

Research and development costs

Research costs are expensed as incurred. An intangible asset arising from development expenditure on an individual project is recognised only when the Group can demonstrate the technical feasibility of completing the intangible asset so that it will be available for use or sale, its intention to complete and its ability to use or sell the asset, how the asset will generate future economic benefits, the availability of resources to complete and the ability to measure reliably the expenditure during the development. Following the initial recognition of the development expenditure, the cost model is applied requiring the asset to be carried at cost less any accumulated amortisation and accumulated impairment losses. Any expenditure capitalised is amortised over the period of expected future sales from the related project.

The carrying value of development costs is reviewed for impairment annually when the asset is not yet in use or more frequently when an indication of impairment arises during the reporting year.

2.3 Summary of Significant Accounting Policies *(Continued)*

Foreign currency translation

Each of the Company and its subsidiaries determines its functional currency based on the assessment of each company's specific facts and circumstances. The Company chooses Renminbi ("RMB") as the presentation currency for the financial statements of the Group and the Company. Transactions in foreign currencies are initially recorded at 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 consolidated income statement. Non-monetary items that are measured in terms of historical cost in a foreign currency are translated using the exchange rate as at the date of initial transaction. 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 companies whose functional currency differs from the presentation currency are translated into the presentation currency of the Group 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 reporting period. The exchange differences arising on the retranslation are taken directly to a separate component of equity. On disposal of a foreign entity, the deferred cumulative amount recognised in equity relating to that particular foreign operation is recognised in the income statement.

Income tax

Income tax comprises current and deferred tax. Income tax is recognised in the income statement, or in equity if it relates to items that are recognised in the same or a different period directly in equity.

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 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 taxable temporary differences associated with investments in subsidiaries, associates and interests in joint ventures, except 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.

2.3 Summary of Significant Accounting Policies *(Continued)*

Income tax *(Continued)*

Deferred tax (Continued)

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

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 tax asset to be recovered.

Deferred income tax assets and liabilities are measured at the tax rates that are expected to apply to the year 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.

Deferred tax assets and deferred 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.

Cash and cash equivalents

Cash and cash equivalents comprise cash at banks and in hand and term deposits with an original maturity of three months or less. For the purpose of the consolidated statement of cash flows, cash and cash equivalents consist of cash and cash equivalents as defined above, net of outstanding bank overdrafts, if any.

Trade receivables, other receivables and amounts due from related parties

Trade receivables are recognised and carried at original invoice amount less an allowance for any uncollectible amounts. Other receivables and amounts due from related parties are recognised and carried at cost less provision for any doubtful amount. 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.

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 method.

Gains and losses are recognised in net profit or loss when the liabilities are derecognised as well as through the amortisation process.

2.3 Summary of Significant Accounting Policies *(Continued)*

Provisions

Provisions are recognised when the Group has a present obligation (legal or constructive) as a result of a past event, 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.

Where the Group expects some or all of a provision to be reimbursed, the reimbursement is recognised as a separate asset but only when the reimbursement is virtually certain. The expense relating to any provision is presented in the income statement net of any reimbursement. 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.

Retirement benefits

The Group's subsidiaries operating in the PRC (except for Hong Kong) participate in a central defined contribution retirement benefits plan managed by the local municipal government in the locations in which they operate. Contributions are made based on a percentage of the companies' payroll costs and are charged to the consolidated income statement as they become payable in accordance with the rules of the central pension scheme.

The Company also participates in the defined contribution Mandatory Provident Fund retirement benefits scheme (the "MPF Scheme") in Hong Kong. Contributions are made to a separately administered fund based on a percentage of the employees' basic salaries and are charged to the income statement as they become payable in accordance with the rules of the MPF Scheme.

Derecognition of financial assets and liabilities

Financial assets

A financial asset is derecognised where the rights to receive cash flows from the asset have expired or when the Group has transferred its rights to receive cash flows from the asset as well as substantially all the risks and rewards or control of the asset.

Where the Group has transferred its rights to receive cash flows from the asset but not substantially all the risks and rewards or 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 pay.

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.

2.3 Summary of Significant Accounting Policies *(Continued)*

Impairment of assets

The Group assesses at each reporting date whether there is any 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.

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' 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.

Dividends

Final dividends proposed by the directors are classified as a separate allocation of retained earnings within the equity section of the balance sheet, until they have been approved by the shareholders in a general meeting. When these dividends are approved by the shareholders and declared, they are recognised as a liability.

Interim dividends are simultaneously proposed and declared, because the Company's memorandum and articles grant the directors the authority to declare interim dividends. Consequently, interim dividends are recognised directly as a liability when they are proposed and declared.

2.4 Significant Accounting Estimate

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 financial year, are discussed below.

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 RMB115,549,000 (2004: RMB 115,549,000). More details are given in note 17 to the consolidated financial statements.

3. Segment Information

The Group's operating businesses are organised and managed separately according to the nature of the products, with each segment representing a strategic business segment that offers different products in the PRC market. The liquid milk products segment carries out the business of the manufacture and distribution of processed UHT milk, milk beverages and yogurt. The ice cream products segment carries out the business of the manufacture and distribution of ice cream products. The other dairy products segment carries out the business of the manufacture and distribution of processed milk powder and milk tablets products.

During the year, the Group's revenue, results, assets and liabilities and capital expenditure were principally generated in the PRC. Accordingly, an analysis of the Group's revenue, results, assets and liabilities and capital expenditure by geographical segment is not presented.

The following tables present revenue, results and certain asset and liability information for the Group's business segments for the year ended 31 December 2005.

	2005	2004
	RMB'000	*RMB'000*
Segment revenue		
Liquid milk	**9,314,688**	6,097,187
Ice cream	**1,295,861**	805,208
Other dairy products	**214,401**	311,432
	10,824,950	7,213,827
Segment results		
Liquid milk	**637,292**	414,265
Ice cream	**80,492**	53,821
Other dairy products	**(623)**	24,142
	717,161	492,228
Unallocated corporate expenses	**(65,673)**	(52,610)
Profit from operating activities	**651,488**	439,618
Interest income	**12,898**	10,346
Finance costs	**(43,956)**	(39,432)
Share of (losses)/profits of associates	**(3,295)**	21
Profit before tax	**617,135**	410,553
Income tax expense	**(61,612)**	(18,454)
Net profit for the year	**555,523**	392,099

3. Segment Information *(Continued)*

	2005	2004
	RMB'000	*RMB'000*
Segment assets		
Liquid milk	**4,274,241**	3,566,647
Ice cream	**886,902**	585,881
Other dairy products	**169,559**	285,661
Unallocated corporate assets	**1,226,247**	808,970
Eliminations	**(469,844)**	(410,775)
Total assets	**6,087,105**	4,836,384
Segment liabilities		
Liquid milk	**2,547,286**	2,303,830
Ice cream	**386,960**	170,511
Other dairy products	**67,239**	161,876
Unallocated corporate liabilities	**788,385**	307,814
Eliminations	**(469,844)**	(410,775)
Total liabilities	**3,320,026**	2,533,256
Capital expenditure		
Liquid milk	**739,821**	764,715
Ice cream	**246,915**	252,653
Other dairy products	**20,823**	81,732
Others	**38,294**	65,341
	1,045,853	1,164,441
Depreciation		
Liquid milk	**208,987**	125,092
Ice cream	**51,972**	35,692
Other dairy products	**5,713**	1,628
Others	**10,292**	7,064
	276,964	169,476
Other non-cash expenses/(income)		
Liquid milk	**(764)**	3,040
Ice cream	**219**	910
Other dairy products	**2,795**	6,058
Others	**(95)**	377
	2,155	10,385

4. Revenue and Other Income

Revenue, being the turnover of the Group, represents the net invoiced value of goods sold, after allowances for goods returns and trade discounts, and after eliminations of all significant intra-group transactions.

An analysis of the Group's revenue and other income is as follows:

	Notes	**2005**	2004
		RMB'000	*RMB'000*
Revenue		**10,824,950**	7,213,827
Other income			
Government grants	*(a)*	**10,426**	7,865
Trademark fees		**1,896**	1,000
Amortisation of deferred income	*(b)*	**4,145**	3,860
Foreign exchange gains, net		**5,733**	–
Others		**2,767**	413
		24,967	13,138
		10,849,917	7,226,965

Notes:

(a) The government grants have been received for the Group's contribution to the local economy with respect to the establishment of infrastructure relating to the dairy products industry. There are no unfulfilled conditions or contingences attaching to these grants.

(b) The Group has received certain government grants in the form of property, plant and equipment donations or cash donations to purchase property, plant and equipment. The grants are initially recorded as deferred income and amortised to match the depreciation charge of the underlying property, plant and equipment in accordance with the assets' estimated useful lives.

5. Profit from Operating Activities

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

	2005 *RMB'000*	2004 *RMB'000*
Cost of inventories sold	**8,411,745**	5,607,363
Employee benefits expenses (excluding directors' remuneration as disclosed in note 6)		
– Wages, salaries and bonuses	**380,277**	248,809
– Retirement benefit contributions	**10,050**	3,459
	390,327	252,268
Depreciation on property, plant and equipment	**276,964**	169,476
Amortisation of land use rights	**1,309**	906
Research and development costs	**6,291**	7,428
(Write-back of provision for)/provision for doubtful debts	**(194)**	4,113
Write-down of inventories to net realisable value	**2,349**	6,212
Minimum lease payments under operating leases on land and buildings	**8,788**	3,073
Display space leasing fees	**60,886**	38,597
Losses on disposal of items of property, plant and equipment	**3,243**	60
Auditors' remuneration	**2,270**	1,500
Foreign exchange differences, net	**(5,733)**	1,969

6. Directors' and Senior Executives' Emoluments

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

	2005 *RMB'000*	2004 *RMB'000*
Fees	**165**	60
Other emoluments		
– basic salaries, housing benefits, other allowances and benefits in kind	**3,503**	2,028
– retirement benefits contributions	**20**	14
	3,688	2,102

6. Directors' and Senior Executives' Emoluments *(Continued)*

	Fees *RMB'000*	Basic salaries, housing benefits, other allowances and benefits in kind *RMB'000*	Retirement benefits contributions *RMB'000*	Total remuneration *RMB'000*
2005				
Executive Directors				
– Mr Niu Gensheng	**18**	**858**	**5**	**881**
– Ms Lu Jun	**18**	**685**	**5**	**708**
– Mr Yang Wenjun	**18**	**1,050**	**5**	**1,073**
– Mr Sun Yubin	**18**	**910**	**5**	**933**
Non-Executive Directors				
– Mr Jiao Shuge	**–**	**–**	**–**	**–**
– Mr Liu Haifeng, David	**–**	**–**	**–**	**–**
– Ms Jin Yujuan, Lily	**–**	**–**	**–**	**–**
Independent Non-Executive Directors				
– Mr Wang Huaibao	**31**	**–**	**–**	**31**
– Mr Zhang Julin	**31**	**–**	**–**	**31**
– Mr Li Jianxin	**31**	**–**	**–**	**31**
	165	**3,503**	**20**	**3,688**
2004				
Executive Directors				
– Mr Niu Gensheng	6	780	4	790
– Ms Lu Jun	6	399	4	409
– Mr Yang Wenjun	6	433	3	442
– Mr Sun Yubin	6	416	3	425
Non-Executive Directors				
– Mr Jiao Shuge	–	–	–	–
– Mr Liu Haifeng, David	–	–	–	–
– Ms Jin Yujuan, Lily	–	–	–	–
Independent Non-Executive Directors				
– Mr Wang Huaibao	12	–	–	12
– Mr Zhang Julin	12	–	–	12
– Mr Li Jianxin	12	–	–	12
	60	2,028	14	2,102

6. Directors' and Senior Executives' Emoluments *(Continued)*

Three non-executive directors agreed to waive their entitlements to directors' fees totalling RMB54,000 (2004: RMB18,000) for the year. Other than this, there was no arrangement under which a director waived or agreed to waive any remuneration during the year.

Three (2004: Three) of the five highest paid individuals were directors whose emoluments have been shown above. Details of emoluments paid to the remaining two (2004: two) non-director, highest paid senior executives for the year were as follows:

	2005 *RMB'000*	2004 *RMB'000*
Basic salaries, housing benefits, other allowances and benefits in kind	**1,604**	1,100
Discretionary bonus	**208**	–
Retirement benefits scheme contributions	**25**	4
	1,837	1,104

The remuneration of the remaining two (2004: two) highest paid senior executives for the year ended 31 December 2005 fell within the band of nil to HK$1,000,000. Out of the above amount, approximately RMB889,000 (2004: RMB454,000) was paid or payable to Mr Yao Tongshan.

7. Finance Costs

	2005 *RMB'000*	2004 *RMB'000*
Interest on bank loans wholly repayable within five years	**46,241**	46,294
Less: Amounts capitalised	**(2,285)**	(6,862)
	43,956	39,432

The amounts capitalised are borrowing costs related to funds borrowed specifically for the purpose of obtaining qualifying assets. The interest rates on such capitalised borrowings during the year varied from 2.88% to 5.76% (2004: 2.88% to 5.76%) per annum.

8. Income Tax Expense

Hong Kong profits tax has not been provided as the Group had no assessable profits arising in Hong Kong during the year. The tax charge represents the provision for PRC corporate income tax ("CIT") for the year.

Under PRC income tax law, except for certain preferential treatment available to fourteen (2004: six) of the Group's subsidiaries, the entities within the Group are subject to CIT at a rate of 33% on the taxable income as reported in their statutory accounts which are prepared in accordance with PRC accounting standards and financial regulations.

A reconciliation of the income tax expense applicable to profit before tax at the statutory income tax rate to income tax expense at the Group's effective income tax rate for the year is as follows:

	Note	**2005** **_RMB'000_**	2004 *RMB'000*
Profit before tax		**617,135**	410,553
At PRC CIT rate of 33%		**203,655**	135,482
Non-deductible/(taxable) items and others, net		**22,685**	(188)
Effect on tax exemption	*(a)*	**(164,728)**	(116,840)
At effective income tax rates of 10.0% (2004: 4.5%)		**61,612**	18,454

Notes:

(a) Fourteen (2004: six) subsidiaries were subject to tax exemption in 2005. The profit subject to tax exemption in respect of these subsidiaries amounted to approximately RMB499,176,000 (2004: RMB354,060,000) in aggregate. Out of the fourteen subsidiaries, seven (2004: five) subsidiaries were granted tax exemption by the state tax bureau in accordance with the "Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises" under which these subsidiaries would be exempted from CIT for the first two profitable years and subject to 50% of the applicable tax rate for the following three profitable years. The remaining seven (2004: one) subsidiaries were granted tax exemption by the local tax bureau in accordance with the policy of "The Notice of Income Tax Exemption for the Country's Key Enterprises in Agricultural Industries" of the tax authorities.

(b) The share of tax attributable to associates amounting to approximately RMB1,687,000 (2004: RMB11,000) is included in the share of (losses)/profits of associates on the face of the consolidated income statement.

9. Dividends

	Note	**2005** **RMB'000**	2004 RMB'000
Declared and paid during the year			
Equity dividends on ordinary shares		**80,053**	61,860
Proposed for approval at AGM			
Equity dividends on ordinary shares			
Proposed final – RMB0.0686 (2004: RMB0.0585) per ordinary share	*(a)*	**93,873**	64,966
Interest on convertible instrument		**–**	15,087
		93,873	80,053

Note:

(a) The proposed final dividend for the year is subject to the approval of the Company's shareholders at the forthcoming Annual General Meeting ("AGM"). Such dividend is not recognised as a liability in the consolidated financial statements as at 31 December 2005 but will be reflected as an appropriation of retained earnings for the year ending 31 December 2006.

10. Earnings Per Share

The calculation of basic earnings per share for the year is based on the net profit for the year attributable to ordinary equity holders of the Company of RMB456,847,000 (2004: RMB319,393,000) and the weighted average number of 1,251,129,000 (2004: 893,965,000) ordinary shares in issue during the year.

The weighted average number of shares used to calculate the basic earnings per share for the year ended 31 December 2005 includes approximately 257,891,000 ordinary shares issued upon conversion of the convertible instrument on 16 June 2005. The weighted average number of shares used to calculate the basic earnings per share for the year ended 31 December 2004 included 250,000,000 ordinary shares issued upon the listing of the Company's shares on The Stock Exchange of Hong Kong Limited ("Hong Kong Stock Exchange") on 10 June 2004 and approximately 110,525,000 ordinary shares issued upon conversion of the convertible instrument on 20 December 2004.

The calculation of diluted earnings per share is based on the net profit for the year attributable to ordinary equity holders of the Company of RMB456,847,000 (2004: RMB319,393,000) and the weighted average number of approximately 1,368,416,000 (2004: 1,118,851,000) ordinary shares in issue during the year, being the weighted average number of ordinary shares outstanding during the year, adjusted for the effects of dilutive potential ordinary shares outstanding during the year.

A reconciliation of the weighted average number of shares used in calculating the basic and diluted earnings per share amounts is as follows:

	2005 **Number of** ***shares'000***	2004 Number of *shares'000*
Weighted average number of ordinary shares for the purpose of the basic earnings per share calculation	**1,251,129**	893,965
Weighted average number of ordinary shares, assumed to be issued at the conversion of convertible instrument at the beginning of the year	**117,287**	224,886
Weighted average number of ordinary shares for the purpose of the diluted earnings per share calculation	**1,368,416**	1,118,851

11. Property, Plant and Equipment

Movements of the Group's property, plant and equipment during the year are as follows:

	Buildings and structures *RMB'000*	Plant and machinery *RMB'000*	Office equipment *RMB'000*	Motor vehicles *RMB'000*	Total *RMB'000*
At 1 January 2005, net of accumulated depreciation	775,481	1,351,753	62,374	37,920	2,227,528
Additions	–	340,988	6,062	3,287	350,337
Transfers from construction in progress	286,735	557,206	3,434	–	847,375
Disposals	(5,104)	(2,449)	(83)	(207)	(7,843)
Depreciation charged for the year	(44,396)	(206,609)	(16,106)	(9,853)	(276,964)
At 31 December 2005, net of accumulated depreciation	1,012,716	2,040,889	55,681	31,147	3,140,433
At 1 January 2005					
Cost	810,337	1,563,042	78,432	49,174	2,500,985
Accumulated depreciation	(34,856)	(211,289)	(16,058)	(11,254)	(273,457)
Net carrying amount	775,481	1,351,753	62,374	37,920	2,227,528
At 31 December 2005					
Cost	1,091,858	2,457,703	84,409	51,955	3,685,925
Accumulated depreciation	(79,142)	(416,813)	(28,729)	(20,808)	(545,492)
Net carrying amount	1,012,716	2,040,890	55,680	31,147	3,140,433

11. Property, Plant and Equipment *(Continued)*

	Buildings and structures *RMB'000*	Plant and machinery *RMB'000*	Office equipment *RMB'000*	Motor vehicles *RMB'000*	Total *RMB'000*
At 1 January 2004, net of accumulated depreciation	294,804	823,682	42,033	30,959	1,191,478
Additions	–	76,584	16,146	10,921	103,651
Transfers from construction in progress	504,761	579,251	15,254	2,923	1,102,189
Disposals	–	(156)	(149)	(9)	(314)
Depreciation charged for the year	(24,084)	(127,608)	(10,910)	(6,874)	(169,476)
At 31 December 2004, net of accumulated depreciation	775,481	1,351,753	62,374	37,920	2,227,528
At 1 January 2004					
Cost	305,576	907,363	47,181	35,339	1,295,459
Accumulated depreciation	(10,772)	(83,681)	(5,148)	(4,380)	(103,981)
Net carrying amount	294,804	823,682	42,033	30,959	1,191,478
At 31 December 2004					
Cost	810,337	1,563,042	78,432	49,174	2,500,985
Accumulated depreciation	(34,856)	(211,289)	(16,058)	(11,254)	(273,457)
Net carrying amount	775,481	1,351,753	62,374	37,920	2,227,528

All of the Group's buildings are located in Mainland China.

Certain property, plant and equipment of the Group with a net book value of approximately RMB467,667,000 (2004: RMB363,727,000) have been pledged to secure the long term payables of the Group, details of which are set out in note 27 to the consolidated financial statements.

11. Property, Plant and Equipment *(Continued)*

Movements of the Company's property, plant and equipment during the year, which comprise entirely office equipment, are as follows:

	2005	2004
	RMB'000	*RMB'000*
At 1 January, net of accumulated depreciation	**105**	–
Additions	**6**	115
Depreciation charged for the year	**(23)**	(10)
At 31 December, net of accumulated depreciation	**88**	105
At 1 January		
Cost	**115**	–
Accumulated depreciation	**(10)**	–
Net carrying amount	**105**	–
At 31 December		
Cost	**121**	115
Accumulated depreciation	**(33)**	(10)
Net carrying amount	**88**	105

12. Construction in Progress

Movements of the Group's construction in progress, all of which is located in the PRC, are as follows:

	2005	2004
	RMB'000	*RMB'000*
Carrying amount at beginning of the year	**292,013**	146,016
Additions during the year	**790,735**	1,248,186
Transferred to property, plant and equipment	**(847,375)**	(1,102,189)
Carrying amount at end of the year	**235,373**	292,013

13. Land Use Rights

	Group	
	2005	2004
	RMB'000	*RMB'000*
Carrying amount at beginning of the year	**34,062**	34,293
Recognised during the year	**35,118**	675
Amortised during the year	**(1,309)**	(906)
Carrying amount at end of the year	**67,871**	34,062
Current portion included in prepayments, deposits and other receivables under current assets (note 21)	**1,948**	1,047
Non-current portion	**65,923**	33,015
	67,871	34,062

14. Interests in Subsidiaries

	Company	
	2005	2004
	RMB'000	*RMB'000*
Unlisted shares, at cost	**689,210**	689,210
Due from a subsidiary	**972,419**	972,419
	1,661,629	1,661,629

The amount due from a subsidiary is unsecured, interest-free and has no fixed terms of repayment. The carrying amount of the amount due from a subsidiary approximates to its fair value.

14. Interests in Subsidiaries *(Continued)*

Details of the Company's subsidiaries at 31 December 2005 are set out below:

Name	Date of incorporation /establishment *	Paid-up share/ registered capital	Percentage of equity interests attributable to the Company		Principal activities
			Direct	Indirect	
China Dairy Holdings (i)	5 June 2002	US$214	100%	–	Investment holding
China Dairy (Mauritius) Limited (i)	15 June 2002	US$100	–	100%	Investment holding
Inner Mongolia Mengniu Dairy (Group) Company Limited (iii) (內蒙古蒙牛乳業(集團)股份有限公司)	18 August 1999	RMB267,429,488	–	84.32%	Manufacture and sale of dairy products
Beijing Mengniu Dairy Co., Ltd. (i)(ii) (北京蒙牛乳制品有限責任公司)	4 July 2000	RMB500,000	–	43.85%	Package and sale of dairy products
Inner Mongolia Mengniu Founding Industry Management Co., Ltd. (i) (ii) (內蒙古蒙牛方鼎產業管理有限責任公司)	9 February 2002	RMB30,000,000	–	83.34%	Investment holding
Mengniu Dairy (Wulanhaote) Co., Ltd. (i) (iii) (蒙牛乳業(烏蘭浩特)有限責任公司)	18 June 2002	RMB30,000,000	–	84.31%	Manufacture and sale of dairy products
Inner Mongolia Mengniu Dairy Keerqin Co., Ltd. (i) (iii) (內蒙古蒙牛乳業科爾沁有限責任公司)	19 June 2002	RMB20,000,000	–	84.32%	Manufacture and sale of dairy products
Mengniu Dairy (Dangyang) Co., Ltd. (i) (iii) (蒙牛乳業(當陽)有限責任公司)	7 November 2002	RMB42,000,000	–	84.32%	Manufacture and sale of dairy products
Mengniu Dairy (Beijing) Co., Ltd. (i) (ii) (蒙牛乳業(北京)有限責任公司)	11 November 2002	RMB60,000,000	–	84.31%	Manufacture and sale of dairy products

14. Interests in Subsidiaries *(Continued)*

Name	Date of incorporation /establishment *	Paid-up share/ registered capital	Percentage of equity interests attributable to the Company Direct	Indirect	Principal activities
Jinhua Mengniu Dairy Co., Ltd. (i)(ii) (金華蒙牛乳業有限公司)	19 February 2003	RMB500,000	–	43.00%	Manufacture and sale of dairy products
Mengniu Dairy (Shenyang) Co., Ltd. (i) (ii) (蒙牛乳業（沈陽）有限責任公司)	4 December 2003	RMB100,000,000	–	84.32%	Manufacture and sale of dairy products
Beijing Mengniu Hongda Dairy Co., Ltd. (i) (ii) (北京蒙牛宏達乳制品有限責任公司)	12 September 2002	RMB10,000,000	–	43.85%	Package and sale of dairy products
Inner Mongolia Mengniu Dairy Baotou Co., Ltd. (i) (ii) (內蒙古蒙牛乳業包頭有限責任公司)	9 January 2003	RMB30,000,000	–	84.32%	Manufacture and sale of dairy products
Mengniu Dairy (Dengkou Bayan Gaole) Co., Ltd. (i) (iii) (蒙牛乳業（磴口巴彥高勒）有限責任公司)	13 July 2003	RMB40,000,000	–	84.31%	Manufacture and sale of dairy products
Inner Mongolia Mengniu Dairy (Group) Shanxi Dairy Co., Ltd. (i) (ii) (內蒙古蒙牛乳業（集團）山西乳業有限公司)	14 July 2003	RMB10,000,000	–	75.89%	Manufacture and sale of dairy products
Mengniu Dairy (Jiaozuo) Co., Ltd. (i) (iii) (蒙牛乳業（焦作）有限公司)	6 November 2003	RMB110,000,000	–	84.32%	Manufacture and sale of dairy products
Mengniu Dairy Taian Co., Ltd. (i) (ii) (蒙牛乳業泰安有限責任公司)	18 November 2003	RMB110,000,000	–	84.32%	Manufacture and sale of dairy products
Mengniu Dairy (Luannan) Co., Ltd. (i) (ii) (蒙牛乳業（灤南）有限責任公司)	31 March 2004	RMB56,000,000	–	84.32%	Manufacture and sale of dairy products

14. Interests in Subsidiaries *(Continued)*

Name	Date of incorporation /establishment *	Paid-up share/ registered capital	Percentage of equity interests attributable to the Company Direct	Indirect	Principal activities
Mengniu Dairy (Tangshan) Co., Ltd. (i) (ii) (蒙牛乳業(唐山)有限責任公司)	31 March 2004	RMB70,000,000	–	84.32%	Manufacture and sale of dairy products
Mengniu Dairy (Maanshan) Co., Ltd. (i) (iii) (蒙牛乳業(馬鞍山)有限公司)	4 February 2005	RMB110,000,000	–	84.32%	Manufacture and sale of dairy products
Mengniu Dairy (Shangzhi) Co., Ltd. (i) (ii) (蒙牛乳業(尚志)有限責任公司)	10 June 2005	RMB4,500,000	–	84.31%	Manufacture and sale of dairy products
Mengniu Dairy (Chabei) Co., Ltd. (i) (ii) (蒙牛乳業(察北)有限公司)	15 June 2005	RMB12,000,000	–	54.81%	Manufacture and sale of dairy products
Mengniu Dairy (Baoji) Co., Ltd. (i) (iii) (蒙牛乳業(寶鷄)有限公司)	1 November 2005	RMB5,000,000	–	84.31%	Manufacture and sale of dairy products

* *Except for China Dairy Holdings and China Dairy (Mauritius) Limited, which were incorporated in the Cayman Islands and Mauritius, respectively, all subsidiaries were incorporated in the PRC.*

(i) Not audited by Ernst & Young Hong Kong or other Ernst & Young International member firms.

(ii) The subsidiaries are registered as companies with limited liability under the PRC law.

(iii) The subsidiaries are registered as sino-foreign equity joint ventures under the PRC law.

15. Interests in Associates

	Group	
	2005	2004
	RMB'000	*RMB'000*
Share of net assets	**18,700**	20,578

Details of the Group's associates at 31 December 2005 are set out below:

Name	Business structure	Place of incorporation/ registration and operations	Percentage of equity interests attributable to the Group (indirect)		Principal activities
			2005	2004	
Xinjiang Tianxue Food Co., Ltd. (i) (新疆天雪食品有限公司)	Corporate	The PRC	**21%**	21%	Trading of dairy products
Inner Mongolia Meng Niu AustAsia Model Dairy Farm Company Limited (i) (內蒙古蒙牛澳亞示範牧場有限責任公司)	Corporate	The PRC	**25%**	25%	Production of raw milk, planting of pastures and processing of milk
Shandong Mengniu International Trading Co., Ltd. (i) (山東蒙牛國際貿易有限責任公司)	Corporate	The PRC	**21%**	21%	Import and export of equipment
Fuzhou Mengxin Trading Co., Ltd. (i) (福州蒙鑫貿易有限公司)	Corporate	The PRC	**38%**	38%	Trading of dairy products
Shijiazhuang Mengniu Ice Cream Sales Co., Ltd. (i) (石家庄蒙牛冰淇淋銷售有限公司)	Corporate	The PRC	**33%**	33%	Trading of dairy products
Tianjin Mengniu Ice Cream Sales Co., Ltd. (i) (天津蒙牛冰淇淋銷售有限責任公司)	Corporate	The PRC	**33%**	33%	Trading of dairy products
Guangzhou Mengniu Dairy Trading Co., Ltd. (i) (廣州市蒙牛乳業貿易有限公司)	Corporate	The PRC	**33%**	33%	Trading of dairy products

15. Interests in Associates *(Continued)*

Name	Business structure	Place of incorporation/ registration and operations	Percentage of equity interests attributable to the Group (indirect) 2005	2004	Principal activities
Wuhan Mengniu Dairy Co., Ltd. (i) (武漢蒙牛乳業有限公司)	Corporate	The PRC	**31%**	31%	Trading of dairy products
Guilin Mengniu Dairy Sales Co., Ltd (i) (桂林蒙牛乳業銷售有限公司)	Corporate	The PRC	**33%**	33%	Trading of dairy products
Tianjin Mengniu Dairy Sales Co., Ltd (i) (天津市蒙牛乳業銷售有限公司)	Corporate	The PRC	**33%**	33%	Trading of dairy products
Wenzhou Mengniu Dairy Co., Ltd (i) (溫州蒙牛乳業有限公司)	Corporate	The PRC	**33%**	33%	Trading of dairy products
Harbin Mengniu Dairy Co., Ltd (i) (哈爾濱蒙牛乳業有限公司)	Corporate	The PRC	**38%**	38%	Trading of dairy products
Chengdu Mengniu Dairy Sales Co., Ltd (i) (成都蒙牛乳業銷售有限責任公司)	Corporate	The PRC	**33%**	33%	Trading of dairy products
Nanjing Mengniu Dairy Sales Co., Ltd. (i) (南京蒙牛乳業銷售有限公司)	Corporate	The PRC	**38%**	–	Trading of dairy products
Shenyang Mengniu Dairy Co., Ltd. (i) (沈陽蒙牛乳業有限公司)	Corporate	The PRC	**17%**	–	Trading of dairy products
Jinan Mengniu Dairy Co., Ltd. (i) (濟南蒙牛乳業有限公司)	Corporate	The PRC	**38%**	–	Trading of dairy products
Taiyuan Mengniu Dairy Co., Ltd. (i) (太原市蒙牛乳業有限公司)	Corporate	The PRC	**33%**	–	Trading of dairy products
Nanchang Mengniu Dairy Sales Co., Ltd. (i) (南昌蒙牛乳業銷售有限責任公司)	Corporate	The PRC	**38%**	–	Trading of dairy products
Chongqing Mengniu Dairy Sales Co., Ltd. (i) (重慶市蒙牛乳業銷售有限公司)	Corporate	The PRC	**38%**	–	Trading of dairy products

15. Interests in Associates *(Continued)*

Name	Business structure	Place of incorporation/ registration and operations	Percentage of equity interests attributable to the Group (indirect) 2005	2004	Principal activities
Hefei Mengniu Dairy Sales Co., Ltd. (i) (合肥市蒙牛乳業銷售有限公司)	Corporate	The PRC	**38%**	–	Trading of dairy products
Shijiazhuang Jinmengyuan Trading Co., Ltd. (i) (石家庄金蒙源貿易有限責任公司)	Corporate	The PRC	**38%**	–	Trading of dairy products
Beijing Mengniu Technical Development Co., Ltd. (i) (北京蒙牛科技發展有限公司)	Corporate	The PRC	**17%**	–	Technical development
Shanghai Mengniu Food Sales Co., Ltd. (i) (上海蒙牛食品銷售有限公司)	Corporate	The PRC	**38%**	–	Trading of dairy products

(i) Not audited by Ernst & Young Hong Kong or other Ernst & Young International member firms.

16. Available-for-sale Investments

	Group 2005 RMB'000	2004 RMB'000
Unlisted equity investments, at fair value	**8,029**	3,409

17. Goodwill

Goodwill acquired through business combinations has been allocated to the following cash-generating units ("CGUs"), which are reportable segments, for impairment testing:

– liquid milk products CGU;

– ice cream products CGU; and

– other dairy products CGU.

17. Goodwill *(Continued)*

The recoverable amount of each CGU has been determined based on a value in use calculation using cash flow projections based on financial budgets or forecasts approved by senior management covering a five-year period. The growth rates used to extrapolate the cash flows beyond the five-year period are based on the estimated growth rate of each unit taking into account of the industry growth rate, past experience and the medium or long-term growth target of each CGU. The growth rates for these CGUs are higher than the respective average industry growth rates. Senior management believes such growth rates are justified because:

– the growth rates of these CGUs have significantly exceeded those in the market in the past six years;

– the success rate for new product launch and new market expansion in the past was very high;

– strong brand equity and marketing capability contributing to the continuous growth in market share in past years;

– expertise on product innovation, portfolio enhancement and marketing will be further leveraged.

The discount rate applied to cash flow projections and the growth rate used to extrapolate cash flows beyond the five-year period are as follows:

	Discount rate	**Growth rate**
Liquid milk products CGU	12.2%	8.3%
Ice cream products CGU	12.2%	8.3%
Other dairy products CGU	12.2%	8.3%

The carrying amounts of goodwill of RMB 115,549,000 as of 31 December 2005 and 31 December 2004 allocated to the liquid milk products CGU, ice cream products CGU and other dairy products CGU were approximately RMB83,839,000, RMB23,865,000 and RMB 7,845,000, respectively.

Key assumptions were used in the value in use calculation of each CGU for 31 December 2005. The following describes each key assumption on which management has based its cash flow projections to undertake impairment testing of goodwill:

(a) Budgeted gross margins – the basis used to determine the value assigned to the budgeted gross margins is the average gross margins achieved in the year immediately before the budgeted year, adjusted for expected efficiency improvements and expected increase in production costs.

(b) Discount rates – The discount rates used are before tax and reflect specific risks relating to the relevant CGUs.

(c) Raw materials price increase – reference is made to actual past year data of countries from where raw materials are sourced. The values assigned to key assumptions are consistent with external information sources.

18. Inventories

	Group	
	2005	2004
	RMB'000	*RMB'000*
Raw materials	**488,937**	465,976
Finished goods	**292,064**	248,823
	781,001	714,799

19. Bills Receivable

	Group	
	2005	2004
	RMB'000	*RMB'000*
Within 3 months	**81,167**	77,952
4 to 6 months	**361**	2,454
	81,528	80,406

As at 31 December 2005, bills receivable amounting to approximately RMB80,590,000 (2004: RMB74,270,000) were factored with recourse to financial institutions. The corresponding amounts were recorded as short term bank loans (note 25). Subsequent to the balance sheet date, the bills receivable have been fully settled.

20. Trade Receivables

The Group normally allows a credit period of not more than 30 days to its customers. The Group closely monitors overdue balances. In view of the aforementioned and that the Group's trade receivables relate to a large number of diversified customers, there is no significant concentration of credit risk. Trade receivables are non-interest-bearing.

An ageing analysis of the trade receivables of the Group is as follows:

	Group	
	2005	2004
	RMB'000	*RMB'000*
Within 3 months	**168,626**	162,465
4 to 6 months	**7,965**	21,904
7 to 12 months	**6,926**	3,513
Over 1 year	**–**	64
	183,517	187,946
Less: Provision for doubtful debts	**(8,860)**	(8,783)
	174,657	179,163

Amounts due from associates of approximately RMB30,748,000 (2004: RMB21,582,000) are included in the above balance. These balances are unsecured, non-interest-bearing and are repayable on credit terms similar to those offered to other major customers of the Group.

21. Prepayments, Deposits and Other Receivables

	Group	
	2005	2004
	RMB'000	*RMB'000*
Deposits	**3,047**	306
Prepayments	**144,076**	110,258
Land use rights – current portion (note 13)	**1,948**	1,047
Other receivables	**15,404**	18,622
	164,475	130,233

22. Cash and Cash Equivalents and Pledged Deposits

	Group	
	2005	2004
	RMB'000	*RMB'000*
Bank balances	**1,301,437**	841,322
Time deposits	**–**	198,369
	1,301,437	1,039,691
Less: Deposits pledged for banking facilities (note 23)	**(53,673)**	(20,763)
Cash and cash equivalents	**1,247,764**	1,018,928

	Company	
	2005	2004
	RMB'000	RMB'000
Bank balances	**2,624**	8,736
Time deposits	**–**	2,262
	2,624	10,998

The Group's cash and cash equivalents comprise cash at banks and in hand. Cash at banks earns interest at floating rates based on daily bank deposit rates. Cash and bank balances aggregating RMB1,285,418,000 (2004: RMB844,974,000) were denominated in Renminbi, which is not freely convertible in the international foreign exchange market and its exchange rate is determined by the People's Bank of China.

23. Trade and Bills Payables

An ageing analysis of the trade and bills payables of the Group, based on the invoice date, is as follows:

	Group	
	2005	2004
	RMB'000	*RMB'000*
Within 3 months	**896,018**	585,208
4 to 6 months	**198,911**	81,172
7 to 12 months	**15,438**	26,100
Over 1 year	**6,638**	2,117
	1,117,005	694,597

An amount due to an associate of approximately RMB3,224,000 (2004: RMB669,000) is included in the above balance. The balance is unsecured, non-interest-bearing and is repayable on demand.

The Group's bills payable are secured by the pledge of certain of the Group's deposits amounting to RMB 36,475,000 (2004: RMB 20,763,000) (note 22).

The Group's trade payables are unsecured, non-interest-bearing and are repayable on demand.

24. Accruals and Other Payables

	Group	
	2005	2004
	RMB'000	*RMB'000*
Advances from customers	**227,484**	136,870
Salary and welfare payables	**79,699**	40,220
Current portion of long term payables *(note 27)*	**146,766**	102,334
Other payables	**498,195**	454,270
Other accruals	**24,430**	24,466
	976,574	758,160

24. Accruals and Other Payables *(Continued)*

The amounts due to related parties included in the above can be analysed as follows:

	Group	
	2005	2004
	RMB'000	*RMB'000*
Associates	**32,374**	17,825
A related party *(note)*	**–**	1,039
	32,374	18,864

Note:

The related party is an entity controlled and beneficially owned by a director of a major subsidiary of the Group.

The balances are unsecured, non-interest-bearing and are repayable on demand.

25. Interest-Bearing Bank Loans

		Group	
		2005	2004
	Maturity	***RMB'000***	*RMB'000*
Short term bank loans, secured	2006	**80,590**	74,270
Short term bank loans, unsecured	2006	**285,000**	470,542
Long term bank loans, unsecured	2007-2008	**445,702**	239,500
		811,292	784,312

At 31 December 2005, short term bank loans of approximately RMB80,590,000 (2004: RMB74,270,000) were secured by certain bills receivable of the Group.

During the year, the annual interest rates of the short term bank loans and the long term bank loans varied from 3.00% to 5.58% and from 2.88% to 5.76% (2004: varied from 3.65% to 5.31% and from 2.88% to 5.76%), respectively. As at 31 December 2005, except for a long term bank loan of US$10,000,000 (equivalent to approximately RMB80,702,000) (2004: US$20,000,000) denominating in United States dollars, all the Group's interest-bearing bank loans were denominated in RMB.

25. Interest-Bearing Bank Loans *(Continued)*

The repayment schedule of the bank loans is as follows:

	Group	
	2005	2004
	RMB'000	*RMB'000*
Within 1 year	**365,590**	544,812
1 – 2 years	**190,000**	76,500
2 – 5 years	**255,702**	163,000
Total interest-bearing bank loans	**811,292**	784,312
Less: Amount due within 1 year included in current liabilities	**(365,590)**	(544,812)
	445,702	239,500

26. Other Loans

	Group	
	2005	2004
	RMB'000	*RMB'000*
Short term	**23,600**	22,600
Long term	**11,481**	18,000
	35,081	40,600

The repayment schedule of the other loans is as follows:

	2005	2004
	RMB'000	*RMB'000*
Within 1 year	**23,600**	22,600
1 – 2 years	**11,481**	18,000
	35,081	40,600

The other loans represented unsecured, interest-free loans from various local government authorities to support the Group's establishment of production plants in various locations in the PRC.

27. Long Term Payables

The Group's long term payables represent outstanding instalments payable for the purchase of plant, machinery and equipment. The balances are interest-free and are repayable as follows:

	Group	
	2005	2004
	RMB'000	*RMB'000*
Within 1 year	**146,766**	102,334
1 – 2 years	**165,881**	86,939
2 – 5 years	**145,640**	102,986
Total long term payables	**458,287**	292,259
Less: Amount due within 1 year included in current liabilities *(note 24)*	**(146,766)**	(102,334)
	311,521	189,925

Certain long term payables are secured by the Group's property, plant and equipment (note 11).

28. Deferred Tax

Deferred tax assets have not been recognised in respect of the following items:

	Group	
	2005	2004
	RMB'000	*RMB'000*
Tax losses arising in the PRC	**14,377**	10,491
Provision for doubtful debts	**8,241**	9,155
Write-down of inventories to net realisable value	**454**	7,146
Accrued expenses	**24,430**	16,169
Accumulated depreciation of property, plant and equipment	**30,821**	16,250
Unrealised profit on inventories	**2,122**	3,041
	80,445	62,252

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

29. Deferred Income

Various local government authorities have granted certain property, plant and equipment to the Group for nil consideration and provided finance to the Group to purchase certain property, plant and equipment by way of a cash donation. Both the property, plant and equipment and grants are recorded at fair value. The grants received are regarded as deferred income, which is amortised to match the depreciation charge of such property, plant and equipment granted/purchased in accordance with their estimated useful lives. Movements of the balance during the year are as follows:

	Group	
	2005	2004
	RMB'000	*RMB'000*
At beginning of the year	**64,226**	57,706
Received during the year	**–**	10,380
Amortisation during the year	**(4,145)**	(3,860)
At end of the year	**60,081**	64,226
Current portion	**4,145**	4,145
Non-current portion	**55,936**	60,081
	60,081	64,226

30. Share Capital

	Notes	**2005**	2004
		RMB'000	*RMB'000*
Authorised:			
3,000,000,000 ordinary shares of HK$0.10 each		**319,235**	319,235

		Number of ordinary shares *'000*	*RMB'000*
Issued and fully paid:			
At incorporation on 16 February 2004	*(a)*	–	–
Shares issued for the Reorganisation	*(b)*	144	15
Additional shares issued for the Reorganisation	*(c)*	749,856	79,770
New issue on public listing	*(d)*	250,000	26,595
Shares issued upon conversion of convertible instrument	*(e)*	110,525	11,758
At 31 December 2004		1,110,525	118,138
Shares issued upon conversion of convertible instrument	*(f)*	257,891	27,435
At 31 December 2005		1,368,416	145,573

30. Share Capital *(Continued)*

Notes:

(a) On 16 February 2004 (date of incorporation), the authorised share capital of the Company was HK$100,000 divided into 1,000,000 ordinary shares of HK$0.10 each. One share was allotted and issued at par.

(b) On 14 May 2004, pursuant to a group reorganisation scheme to rationalise the structure of the Group in preparation for the public listing of the Company's shares on the Hong Kong Stock Exchange (the "Reorganisation"), the Company issued approximately 144,000 ordinary shares of HK$0.10 each to the then shareholders of China Dairy Holdings in exchange for the entire issued share capital in China Dairy Holdings.

(c) Upon the approval of the Company's listing on the Hong Kong Stock Exchange and pursuant to the resolution passed on 18 May 2004, the Company issued approximately 749,856,000 ordinary shares of HK$0.10 each to the then existing shareholders in proportion to their respective shareholdings. The issued share capital of RMB79,770,000 was offset with the share premium arising from the public listing.

(d) On 10 June 2004, 250,000,000 ordinary shares of HK$0.10 each were issued to the public at a price of HK$3.925 per share for a total cash consideration, before the related issue expenses, of HK$981,250,000 (equivalent to RMB1,043,854,000) giving rise to a share premium of RMB1,017,259,000.

(e) On 20 December 2004, convertible instrument of US$10,570,000 (equivalent to approximately RMB86,985,000) were converted into approximately 110,525,000 ordinary shares of HK$0.10 each (note 32), giving rise to a share premium of RMB75,227,000, being the excess of the value of the convertible instrument of RMB86,985,000 over the par value of the new shares issued of RMB11,758,000.

(f) On 16 June 2005, convertible instrument of approximately US$24,664,000 (equivalent to approximately RMB204,636,000) were converted into approximately 257,891,000 ordinary shares of HK$0.10 each (note 32), giving rise to a share premium of approximately RMB177,201,000, being the excess of the value of the convertible instrument of RMB204,636,000 over the par value of the new shares issued of RMB27,435,000.

31. Reserves

(A) Group

Movements in other reserves of the Group during the year are as follows:

	Share premium	**Contributed surplus**	**Statutory reserves**	**Currency translation differences**	**Total**
		Note (a)	*Note (b)*		
	RMB'000	*RMB'000*	*RMB'000*	*RMB'000*	*RMB'000*
At 1 January 2004	–	–	60,005	–	60,005
Issuance of convertible instrument and shares for the Reorganisation	–	214,677	–	–	214,677
Issuance of shares upon public listing	1,017,259	–	–	–	1,017,259
Share premium transfer to issued capital	(79,770)	–	–	–	(79,770)
Share issue costs	(62,336)	–	–	–	(62,336)
Shares issued upon conversion of convertible instrument *(Note 30(e))*	75,227	–	–	–	75,227
Transfer to statutory reserves	–	–	89,957	–	89,957
Currency translation differences and net losses not recognised in the consolidated income statement	–	–	–	(1,969)	(1,969)
At 31 December 2004	950,380	214,677	149,962	(1,969)	1,313,050
Shares issued upon conversion of convertible instrument *(Note 30(f))*	177,201	–	–	–	177,201
Transfer to statutory reserves	–	–	136,137	–	136,137
Dividends paid to equity holders of the Company	–	(10,000)	–	–	(10,000)
Currency translation differences and net losses not recognised in the consolidated income statement	–	–	–	(647)	(647)
At 31 December 2005	1,127,581	204,677	286,099	(2,616)	1,615,741

31. Reserves *(Continued)*

(B) Company

Movements in reserves of the Company during the year are as follows:

	Notes	Share premium RMB'000	Contributed surplus RMB'000 Note (a)	Currency translation differences RMB'000	Retained earnings RMB'000	Total RMB'000
Net profit for the year	Note (d)	–	–	–	1,263	1,263
Issuance of shares for the Reorganisation	30(b)/32	–	397,574	–	–	397,574
Issuance of shares upon public listing	30(d)	1,017,259	–	–	–	1,017,259
Share premium transfer to issued capital	30(c)	(79,770)	–	–	–	(79,770)
Share issue costs		(62,336)	–	–	–	(62,336)
Shares issued upon conversion of convertible instrument	30(e)	75,227	–	–	–	75,227
At 31 December 2004		950,380	397,574	–	1,263	1,349,217
Net profit for the year	Note (d)	–	–	–	69,880	69,880
Dividends paid		–	(10,000)	–	(70,053)	(80,053)
Shares issued upon conversion of convertible instrument	30(f)	177,201	–	–	–	177,201
Currency translation differences and net losses not recognised in the income statement		–	–	(199)	–	(199)
At 31 December 2005		1,127,581	387,574	(199)	1,090	1,516,046

31. Reserves *(Continued)*

Notes:

(a) **Contributed surplus**

The contributed surplus of the Group represents the difference between the nominal value of the share capital of the subsidiaries acquired pursuant to the Reorganisation over the nominal value of the shares of the Company issued in exchange therefor.

The contributed surplus of the Company represents the difference between the then combined net asset value of the subsidiaries acquired pursuant to the Reorganisation over the nominal value of the shares of the Company issued in exchange therefor.

(b) **Statutory reserves**

In accordance with the relevant PRC laws and regulations, PRC domestic companies are required to transfer 10% of profit after income tax, as determined under PRC accounting standards and financial regulations, to the statutory common reserve, until the balance of the fund reaches 50% of the registered capital of that company. Subject to certain restrictions as set out in the relevant PRC laws and regulations, the statutory common reserve may be used to offset against accumulated losses, if any.

Pursuant to the relevant PRC laws and regulations, certain subsidiaries within the Group are also required to transfer 5% to 10% of their net profits, as determined under PRC accounting standards and financial regulations, to the statutory common welfare reserve. This reserve can only be used to provide staff welfare facilities and other collective benefits to the employees of that company. This reserve is non-distributable other than in the event of liquidation.

(c) **Distributable reserves**

Under the Companies Law (2001 Second Revision) of the Cayman Islands, the share premium and contributed surplus of the Company are distributable to shareholders, provided that immediately following the distribution of the dividend, the Company is able to pay off its debts as and when they fall due in the ordinary course of business. As at 31 December 2005, the Company's reserves available for distribution to shareholders amounted to RMB1,516,046,000 (2004: RMB1,349,217,000).

(d) The net profit attributable to equity holders of the Company for the year ended 31 December 2005 dealt with in the financial statements of the Company was RMB69,880,000 (2004: RMB1,263,000) , including dividend income from a subsidiary amounting to RMB80,053,000 (2004: nil).

32. Non-voting Convertible Redeemable Preferred Shares/Convertible Instrument

On 17 October 2003, China Dairy Holdings issued 49,379 non-voting convertible redeemable preferred shares (the "Preferred Shares") to MS Dairy Holdings, CDH China Fund, L.P. and Actis China Investment Company Limited (collectively the "Financial Investors"). Upon the approval of the Company's listing on the Hong Kong Stock Exchange, the Company issued units of convertible instrument (the "Convertible Instrument") in exchange for all Preferred Shares held by the Financial Investors.

32. Non-voting Convertible Redeemable Preferred Shares/Convertible Instrument *(Continued)*

The principal amount of the Convertible Instrument amounted to US$35,233,827 (equivalent to approximately RMB291,621,000) and the holders of the Convertible Instrument are entitled to interest payable simultaneously with any payment of dividends to the holders of the Company's ordinary shares, in an aggregate amount equal to the aggregate amount of the dividends declared on the ordinary shares multiplied by a pre-determined formula. The proposed interest regarded as an equity transaction is calculated based on the proposed final dividend for the ordinary shares as set out in note 9 to the consolidated financial statements. The outstanding principal amount of the Convertible Instrument shall convert into such number of ordinary shares of the Company at a conversion price equal to approximately US$0.096 per share (the "Conversion Price"). The Group has pledged its interest in the entire share capital of China Dairy (Mauritius) Limited, a wholly-owned subsidiary of the Group, to the Financial Investors to secure this Convertible Instrument.

30% and 70% of the Convertible Instrument were converted into ordinary shares of the Company at the Conversion Price on 20 December 2004 and 16 June 2005, respectively (note 30(e) and (f)).

33. Operating Lease Commitments

At the balance sheet date, the Group had total future minimum lease payments under non-cancellable operating leases in respect of buildings as follows:

	Group	
	2005	2004
	RMB'000	*RMB'000*
Within one year	**4,841**	1,530
In the second to fifth years, inclusive	**17,165**	38
	22,006	1,568

The Company did not have any significant commitments as at the balance sheet date.

34. Contingent Liabilities

The Group is contingently liable in respect of loan guarantees granted to certain banks in favour of certain suppliers of raw milk (the "Suppliers"). The amount of guarantees granted as at 31 December 2005 amounted to RMB140,976,000 (2004: RMB83,000,000). The guarantees are solely given by the Group, but the guarantees are counter-guaranteed by these Suppliers who are independent third parties. Security under these counter-guarantees included property, dairy cattle and other assets owned by these Suppliers.

The Company did not have any significant contingent liabilities as at the balance sheet date.

35. Commitments

The Group had the following outstanding capital commitments in respect of the purchase and construction of property, plant and equipment as at the balance sheet date:

	Group	
	2005	2004
	RMB'000	*RMB'000*
Contracted, but not provided for	**343,232**	419,076

Subsequent to the balance sheet date, the board of directors approved capital expenditure (not contracted for) amounting to approximately RMB 1,226,768,000 (2004: RMB449,000,000).

36. Fair Values of Financial Instruments

The carrying amounts of the Group's financial assets and liabilities (which are classified as current assets and liabilities) approximated to their fair values as at 31 December 2005 because of the short maturity of these instruments.

The carrying amounts of the Group's long term interest-bearing loans approximated to their fair values based on borrowing rates currently charged for loans with similar terms and maturities.

The carrying amounts of the Group's long term payables approximated to their fair values based on the implicit interest rate currently used to arrive at the cash price for purchase on normal credit terms.

37. Related Party Transactions

In addition to the transactions and balances which are disclosed elsewhere in these financial statements, the Group had the following significant transactions with its associates and related parties:

			Group	
		Notes	**2005** *RMB'000*	2004 *RMB'000*
(a)	Sales of liquid milk to associates	*(i)/(iii)*	**1,234,058**	668,009
(b)	Sales of ice cream and other dairy products to associates	*(i)/(iii)*	**97,704**	26,914
(c)	Purchase of raw materials from an associate	*(i)/(iii)*	**(17,475)**	–
(d)	Purchase of packaging materials from a related party	*(i)/(ii)*	**–**	(14,450)

Notes:

(i) The prices were determined with reference to the then prevailing market prices/rates and the prices charged to third parties.

(ii) The related party is a company controlled and beneficially owned by a minority shareholder of the Company.

(iii) Such transactions did not constitute connected transactions as defined in the Listing Rules.

(iv) Key management compensation is detailed in note 6 to the consolidated financial statements.

38. Financial Risk Management Objectives and Policies

The Group's principal financial instruments comprise cash and cash equivalents, trade receivables and payables, other receivables and payables, balances with related parties, bank loans, other loans and long term payables.

The main risks arising from the Group's financial instruments are interest rate risk, foreign currency risk, credit risk, commodity price risk and liquidity risk. The Group does not have any written risk management policies and guidelines. However, the board of directors and senior management meet periodically to analyse and formulate measures to manage the Group's exposure to those risks. Generally, the Group adopts reasonably prudent strategies on its risk management. As the Group's exposure to these risks is kept to a minimum, the Group has not used any derivatives and other instruments for hedging purposes. The Group does not hold or issue derivative financial instruments for trading purposes. The board of directors reviews and agrees policies for managing each of these risks and they are summarised below:

(i) Interest rate risk

The Group's income and operating cash flows are substantially independent of changes in market interest rates and the Group has no significant interest-bearing assets, other than cash at banks. The Group's exposure to risks of changes in market interest rates relates primarily to the Group's borrowings with floating interest rates. The Group closely monitors its interest rate risk by performing periodic review and evaluation of its debt portfolio and gearing ratio. The interest rates and terms of repayment of the bank loans of the Group are disclosed in note 25 to the consolidated financial statements. In the opinion of the directors, the Group has no significant interest rate risk and has not used any interest rate swaps to hedge its exposure to interest rate risk.

38. Financial Risk Management Objectives and Policies *(Continued)*

(ii) Foreign currency risk

The Group's businesses are principally located in the PRC and substantially all transactions are conducted in RMB, except for the purchases of machinery and equipment and sales of dairy products to Hong Kong and Macau. As at 31 December 2005, substantially all of the Group's assets and liabilities were denominated in RMB except that cash and cash equivalents of approximately RMB3,894,000 (2004: RMB182,179,000) and RMB12,125,000 (2004: RMB12,539,000) were denominated in United States dollars and Hong Kong dollars, respectively, and that interest-bearing bank loans of approximately RMB80,702,000 (2004: RMB 165,542,000) and long term payables of approximately RMB139,059,000 (2004: RMB94,841,000) were denominated in United States dollars. The fluctuation of the exchange rates of RMB against foreign currencies could affect the Group's results of operations. However, in the opinion of the directors, the foreign currency risk exposure is under management's control.

(iii) Credit risk

The carrying amounts of trade receivables and cash included in the consolidated financial statements represent the Group's maximum exposure to credit risk in relation to its financial assets. The Group's cash and cash equivalents are mainly deposited with state-owned commercial banks in the PRC. The majority of the Group's sales are conducted on a cash basis. The Group has implemented policies to ensure that sales of products are made to distributors, who wish to trade on credit terms, with an appropriate credit history which is subject to periodic review. Receivable balances are monitored on an ongoing basis and the Group's exposure to bad debts is not significant.

In addition, the Group's guarantees of the bank loans borrowed by certain suppliers of raw milk amounting to RMB140,976,000 (2004: RMB83,000,000) (note 34) represent the Group's other exposure to credit risk. These guarantees are cross-guaranteed and secured by assets owned by these suppliers.

(iv) Commodity price risk

The Group's exposure to price risk is insignificant.

(v) Liquidity risk

The Group closely monitors its liquidity risk by performing periodic review and evaluation of its liquidity with regards to the industry characteristics, market conditions, business strategies and changes in the Group's state of affairs and adjusting the current and non-current portion of the Group's debt portfolio on a proper and timely basis. In addition, the Group aims to ensure a continuity of fund and flexibility through the use of various means of financing and by keeping committed credit lines available.

39. Subsequent Event

On 8 January 2006, Inner Mongolia Mengniu Dairy (Group) Company Limited ("Mengniu"), a subsidiary of the Company, entered into an investment agreement (the "Agreement") with an independent third party to set up an equity joint venture, Mengniu (Wuhan) Frealthy Dairy Co., Ltd. ("Mengniu Wuhan") in Wuhan, the PRC. The registered capital of Mengniu Wuhan is RMB60,000,000, of which Mengniu is to invest 52% in the form of cash whilst the joint venture partner is to invest 48% by way of injection of its entire existing dairy business, production equipment and trademark. Mengniu Wuhan was established in January 2006.

Apart from the above, no significant events took place subsequent to 31 December 2005.

40. Comparative Amounts

Due to the adoption of certain new and revised IFRSs during the year, certain comparative amounts have been reclassified to conform with current year's presentation and accounting treatment.

41. Approval of the Financial Statements

The financial statements were approved and authorised for issue by the board of directors on 10 April 2006.