

## Report of the Directors

The Directors present their annual report and the audited financial statements for the year ended 31 December 2005 ("Reporting Period").

### IMPORTANT NOTICE

Save for independent non-executive Directors Mr. Zhang Sheng Ping, Mr. Lu Qing and Mr. Cheung Yui Kai, Warren and supervisors Mr. Zeng Jun Hong and Mr. Bai Yun Feng, the members of the sixth Board and the current supervisors and senior management of the Company warrant that the content of this report does not contain any false statement, misleading representation and material omission and are collectively and individually responsible for the truthfulness, accuracy and completeness of such contents.

Among which:

- 1) Independent non-executive Directors Mr. Zhang Sheng Ping, Mr. Lu Qing and Mr. Cheung Yui Kai, Warren are of the opinion that:

We have conducted a thorough exploration and study into the issues in relation to the report, nevertheless: (i) as stated in the auditor's report, the auditors have not been able to obtain adequate information on the issues for which they hold qualified opinions; (ii) with the impact of a number of factors such as the notes financing without any transaction actually conducted during the period under the operation of the former management, unreconciled inter-company transactions and balances, and the Company having to adopt an accounting treatment of backtracking operating cost of the principal operations in 2005, there may be inaccuracy in the separation of cash flow statement and profit and loss for the year 2005 from previous years. As a result, we are unable to guarantee the accuracy, truthfulness and completeness of the income statement and cash flow statement for 2005. Investors should take extra precaution.

We agree on the qualified opinions set forth in the auditor's report and the Board's explanation for such qualified opinions. Save for the aforesaid cash flow statement and income statement, we guarantee the accuracy, truthfulness and completeness of the balance sheet and the other information set out in the Company's annual report for the current year.

Our opinions on the significant issues in relation to this report:

1. Our opinions on the execution of the Sales Agency Agreement, the Supplemental Agreement to the Sales Agency Agreement as well as the Second Supplemental Agreement to the Sales Agency Agreement ("the Sales Agency Agreement and its supplemental agreements") entered into between the Company and Qingdao Hisense Marketing Company Limited:

We have carefully reviewed the Sales Agency Agreement and its supplemental agreements between the Company and Qingdao Hisense Marketing Company Limited ("Hisense Agent"), the independent financial advisers' reports prepared respectively by AMS Corporate Finance Limited on 27 April 2006 and GF Securities Co., Ltd. on 8 May 2006 as well as the self-inspection report on the Sales Agency Agreement and its supplemental agreements disclosed by the Company on 15 June 2006, and are of the opinion that, based on the preliminary self-inspection report, the execution of the Sales Agency Agreement and its supplemental agreements were not seen to have done any harm to the interests of the Company. Based on the self-inspection report, we would like to draw the attention of the investors to the following issues:

- (1) The self-inspection report was prepared by the Company internally, and it has not been audited by any intermediate organisation. The Board has engaged Shenzhen Nan-fang Minhe Certified Public Accountants to audit the progress of the Sales Agency Agreement and its supplemental agreements. As the sales agency arrangement involves over 30 branches of the Company and covers a broad scope of matters, it will take a certain period of time for the audit to be completed, and it is estimated that the job could be done by the end of August. We will ensure that the Company make timely disclosure based on the audit results.

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- (2) In the course of execution of the Sales Agency Agreement, Hisense Agent has failed to settle RMB300,000,000 within ten business days of signing the agreement, and the last payment was made on 15 December. Save for the prepayment terms of the Sales Agency Agreement and its supplemental agreements, Hisense Agent has complied with the terms of the Sales Agency Agreement and its supplemental agreements.
- (3) Meanwhile, we are of the view that the execution of the Sales Agency Agreement has enabled the Company to obtain the funds necessary for the production and the marketing activities of the Company. It has also improved the image and the confidence of distributors towards the Company, enhanced the collection of trade receivables and capital utilisation, thus enabling a smooth supply and sales process. The Sales Agency Agreement is essential for the continuation of the Company's operations during the transitional period and also safeguards the interests of the Company.
2. Our opinions on misappropriation of the Company's capital by Mr. Gu Chu Jun, former chairman of the Company, and his related parties and the relevant debt clearing measures:

We have reviewed the special investigation report by KPMG about the abnormal material cash flow incurred between Gu Chu Jun and the Greencool Companies (which means Greencool Enterprise Development Company Limited ("Guangdong Greencool") and its related companies) and, through the management, finance and legal departments of the Company, understood the details about the misappropriation of funds by and litigation against Gu Chu Jun, the Greencool Companies and third parties as well as the "Special Explanation of misappropriation of funds of controlling shareholders and related parties of Guangdong Kelon Electrical Holdings Company Limited" provided by the auditors. The amounts due from the Greencool Companies and the amounts misappropriated by the third parties are 680 million, the payables are 131 million, The Company has made provision for bad debts of 374 million. We believe that the basis of the report about misappropriation of funds by Mr. Gu Chu Jun, the Greencool Companies and the third parties is reasonable. Under the special situation that the case of economic crime related to Mr. Gu Chu Jun and the Greencool Companies has not been judged and concluded, the Company has brought litigation, safeguarded assets to settle the debts and ensure the assets allocation involved with the Greencool Companies. We believe that these measures are reasonable. We suggest that the Company put more efforts in repayment and get support from governments and regulatory authorities, recover the misappropriated funds at the utmost so as to reduce loss.

3. Opinions on accounting treatments of the Company's impairment provisions:

We are aware that, in complying with the Accounting Regulation for Business Enterprises, the Company has employed independent third parties to perform the assessment on the impairment of respective assets, and based on the conclusion of which, adjusted the financial accounts. After reviewing the assessment report in a stringent manner, and also according to some new or further evidence obtained after the balance sheet date, we consider the Company's estimation and assumption of the impairment of respective assets are reasonable.

Special attention should be drawn to investors on the above opinions.

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- 2) As at the date of this announcement, the Company could not contact Mr. Zeng Jun Hong, a supervisor of the Company. Supervisors Mr. Bai Yung Feng and Mr. Liu Zhan Cheng attended the supervisory committee meeting and considered this announcement, but no supervisory resolution thereof was passed. Mr. Liu Zhan Cheng, a supervisor of the Company, agreed with the opinions expressed in the audit report issued by auditors and the Board's explanations on matters involved with such audit opinions.

Opinions of supervisor Mr. Bai Yung Feng on relevant matters were as follows: After understanding the relevant matters relating to this announcement, I noticed that: (i) the auditors issued a qualified audit report with emphasised matters as there were insufficient audit information on such matters available; (ii) the causes of the decrease in the Company's profits, including impairment provided for fixed assets, construction in progress, finished products and raw materials. I was unable to express any opinion in this announcement due to such uncertainties, so I abstain from voting.

Opinions on material matters relating to this announcement:

1. Opinion on the execution of the Sales Agency Agreement, Supplemental Agreement to the Sales Agency Agreement and the Second Supplemental Agreement to the Sales Agency Agreement entered into between the Company and Qingdao Hisense Marketing Company Limited:

I do not have a thorough understanding of the above agreements, but in my view, it is necessary for accounting firms to be engaged by the Board to carry out an audit on the execution of the Sales Agency Agreement, and the audit work should be completed as soon as possible.

2. Opinion on the misappropriation of the Company's funds by former chairman Mr. Gu Chu Jun and his related parties and settlement methods:

I agree on any claim by any legal means for the recovery of the Company's funds which were appropriated by Mr. Gu Chu Jun, the Greencool Companies and third parties, in order to maximise the protection of the Company's interests.

3. Opinion on the accounting treatments of the Company's impairment provisions:

I reserve my opinion regarding the impairments provided for fixed assets, construction in progress, inventory and raw materials, etc, by the Company.

Investors should draw special attention to the above opinions.

As I cannot make any comment in respect of the report with emphasised matters incorporated with qualified opinions, I am not able to make any comment to the Board's specific explanation, so I abstain from voting.

Nine out of the nine of the Directors attended the Board Meeting, while executive Directors Ms. Yu Shu Min and Mr. Lin Lan, independent non-executive Directors Mr. Lu Qing and Mr. Cheung Yui Kai, Warren attended the meeting and voted by way of telephone conference.

An auditor's report with qualified opinion and emphasised matters was submitted by the auditors employed by the Company for the financial year 2005; detailed explanations of relevant issues were also made by the Board and the supervisory committees of the Company. Investors are advised to take note in reading them.

Mr. Tang Ye Guo, the chairman of the Board, Mr. Xiao Jian Lin, the Vice president of finance, and Ms. Dai Hui Jiao, the person in charge of the accounting department, have declared that they confirm the truthfulness and completeness of the financial statements in the annual report for the year.

## Report of the Directors

### PRINCIPAL ACTIVITIES

The Group is principally engaged in the manufacture and sale of refrigerators and air-conditioners.

### RESULTS AND APPROPRIATIONS

Details of the results of the Group for the year are set out in the consolidated income statement on page 87.

The Directors do not recommend the payment of a final dividend for the year 2005.

### LIQUIDITY AND SOURCES OF FUNDS

Net cash used in operating activities was approximately RMB518,443,000 for the year ended 31 December 2005 (2004: net cash inflow of approximately RMB584,054,000).

As at 31 December 2005, the Company had bank deposits and cash (including pledged bank balances) amounting to approximately RMB287,098,000 (2004: RMB2,320,121,000), and bank loans amounting to approximately RMB2,160,523,000 (2004: RMB3,368,168,000).

Total capital expenditures for the year 2005 amounted to approximately RMB336,836,000 (2004: RMB540,535,000).

### HUMAN RESOURCE AND EMPLOYEES' REMUNERATION

As at 31 December 2005, the Group had approximately 20,458 employees, mainly comprising 1,448 technical staff, 5,292 sales representatives, 474 financial staff, 954 administrative staff and 12,290 production staff. Seven of the Company's employees hold a doctorate degree while 259 hold a master degree and 2,573 hold a bachelor degree. There were 597 employees with an official title of middle rank or above. In addition, the Company currently has 67 resigned or retired staff. Staff cost for the year ended 31 December 2005 amounted to approximately RMB562,167,000 (2004: RMB497,174,000).

### CHARGES ON THE GROUP'S ASSETS

As at 31 December 2005, the Group's property, plant and equipment amounting to approximately RMB931,283,009 (2004: RMB726,597,000) were pledged as security for the Group's bank borrowings.

### EXPOSURE TO EXCHANGE RATE FLUCTUATION

Since substantially all of the Group's sales and purchases in the Reporting Period were denominated in Renminbi, the Group had some exposure to exchange rate fluctuation and financial instruments such as discounted export bills, import/export bills, and hedging were used to hedge exchange rate risk.

### PUBLIC FLOAT

As at the date of this annual report, the Directors acknowledged that based on publicly available information and within the knowledge of the Directors, 25% or above of the total issued share capital of the Company are held by the public. Therefore, the public float of the Company satisfies the requirements stipulated under the Listing Rules.

## Report of the Directors

### CONTINGENT LIABILITIES

During the reporting period, the Group was involved in a number of material litigations with estimated contingent liabilities of RMB595,923,307.

### MATERIAL LITIGATION

At 23 June 2006, the Company and its subsidiaries were involved in 15 litigations in which each case involved an amount over RMB10 million, the litigations involved a total amount of RMB967,300,739.

### AUDIT COMMITTEE

The sixth Audit Committee of the Company has reviewed the final result announcement and report for the year ended 31 December 2005.

### CAPITAL EXPENDITURE

The Group expects that the capital expenditure for 2006 to be approximately RMB51,505,000.

### TRUST DEPOSITS

As at 31 December 2005, the Company did not own any trust deposit in any financial institution in the PRC. All of the Company's deposits are placed with the commercial banks in the PRC and Hong Kong.

### LIQUIDITY, FINANCIAL RESOURCES AND CAPITAL STRUCTURE

As at 31 December 2005, the Group had long-term bank borrowings of RMB nil (2004: RMB16,723,000) and cash and cash equivalents of RMB184,284,000 (2004: RMB1,017,534,000), of which over 78% are denominated in Renminbi.

### GEARING RATIO

As at 31 December 2005, the gearing ratio of the Group was 41.41%.

### PROPERTY, PLANT AND EQUIPMENT

During the year, the Group spent approximately RMB330 million on acquisition of property, plant and equipment. The details of the movements in property, plant and equipment of the Group during the year are set out in note 15 to the financial statements.

### PENSION SCHEMES

Details of the Group's pension schemes for the year ended 31 December 2005 are set out in note 29 to the financial statements.

## Report of the Directors

### RESERVES

Details of movements in reserves of the Group and the Company during the year 2005 are set out in statement of changes in equity on page 90 of the financial statements.

### DISTRIBUTABLE RESERVES

There was no distributable reserves of the Company as at 31 December 2005.

### INDEPENDENCE OF THE INDEPENDENT NON-EXECUTIVE DIRECTORS

The fifth Board have received written confirmations from all of the independent non-executive Directors in respect of their independence in accordance with the requirements provided under Rule 3.13 of the Listing Rules, and consider that all the independent non-executive Directors of the fifth Board are in compliance with the relevant guidelines under Rule 3.13 of the Listing Rules and are still independent persons.

### SERVICE CONTRACTS OF DIRECTORS AND SUPERVISORS

The Company convened the first 2006 extraordinary general meeting on 26 June 2006, during which the sixth Board was elected. The Company has not entered into any service contracts with the Directors of the sixth Board.

As at the date of this annual report, certain executive Directors of the fifth Board, namely Mr. Gu Chu Jun, Mr. Yan You Song and Mr. Zhang Hong, were detained by the PRC police department for alleged economic crimes, and none of them could be contacted. In addition, the Company was also unable to contact Mr. Zeng Jun Hong. Save as disclosed above, as at 31 December 2005 or during the year 2005, no Director of the fifth Board or supervisor was materially interested, either directly or indirectly, in any contract of significance.

## Report of the Directors

### INDEPENDENT NON-EXECUTIVE DIRECTORS' REVIEWS OF CONTINUING CONNECTED TRANSACTIONS

The independent non-executive Directors of the fifth Board have reviewed the continuing connected transactions of the Company for the year 2005, and confirmed that these transactions were conducted in the ordinary course of business of the Company on normal commercial terms which were fair and reasonable and in the interest of the shareholders of the Company as a whole. These connected transactions were as follows:

#### 1. Connected transactions between the Company (Party A) and Hisense Agent (Party B)

##### (1) The contents of the connected transactions between Hisense and the Company

Connected:	Hisense Agent
Subject matter:	the Company's domestically sold products
Transaction period:	16 September 2005 to 10 May 2006
Pricing policy:	The pricing of the connected transactions are mainly based on the market prices at which the Company usually sells its products to its distributors. The settlement prices obtained by Hisense Agent from the Company are equal to those at which Hisense Agent sells the commissioned products to its distributors. The settlement prices are fixed between the Company and its distributors.
Transaction prices:	The settlement prices obtained by Hisense Agent from the Company are equal to those at which Hisense Agent sells the commissioned products to its distributors. The settlement prices are fixed between the Company and its distributors. The Company is responsible for the approval and payment of all selling expenses, which include but is not limited to the discounts given to distributors, price differences, joining expense, marketing expense, display platform expense, products storage expense, cargo handling expense, logistics expense (including trunk lines and branch lines) and labour expense.
Transaction amount:	In consideration of the fact that the Company is in the early stage of its recovery within the domestic market, both parties have mutually agreed that the total amount for the products commissioned by the Company to Hisense Agent will not exceed RMB2.8 billion, and in particular will not exceed RMB0.8 billion by the end of 2005.
Percentage of amount of similar transactions:	100%.
Settlement method:	Upon receipt of prepayment, the Company will begin to provide Hisense Agent with its products and deliver the products to the warehouses designated by Hisense Agent. After delivery of the products to the warehouses designated by Hisense Agent, the ownership of such products is transferred to Hisense Agent. When the prepayment from Hisense Agent is exceeded, both parties will carry out procedures to purchase the finished goods on credit terms. The effective credit period for the proceeds of products sold by the Company to Hisense Agent was 60 days.
Prepayment:	The aggregate amount of prepayments made by Hisense Agent for the purchase of products from the Company shall not exceed RMB0.6 billion, amongst which an amount of RMB0.3 billion shall be paid within ten business days after the execution of the agreement. Within one month after initial injection of capital, Hisense Agent may make another prepayment of not more than RMB0.3 billion, based on the Company's actual capital needs for production and sales to the market. Within the effective period of the agreement, Hisense Agent will not demand the Company to repay the prepayment that it made to the Company in the amount of not more than RMB0.6 billion.

## Report of the Directors

Sales method: The Company's existing sales network remains intact, and the promotion of products to the end dealers still functions smoothly. All sales activities are still performed through the Company's existing sales network. Agency fees: (1) Hisense Agent will charge the Company agency fees of 1% of its sales amount on quarterly basis. Hisense Agent will not charge any other expenses nor assume any distribution costs. Any distribution costs incurred (including costs such as the salaries of the persons sent by Hisense Agent) will be borne by the Company. (2) Within the effective period of the agreement, the Company will assess the operational targets realized by Hisense Agent at the end of 2005 and at the expiry of the agreement respectively. Settlement of the agency fees will be effected after assessing the operational targets, which will be finally determined by the Company following assessment methods and the Company will give written notice to Hisense Agent. (3) The agency fees will be transferred by the Company into the account designated by Hisense Agent within seven working days after mutual confirmation of such settlement.

If Hisense Agent fails to realise the aforementioned operational targets, the Company will deduct the agency fees based on the following standards:

- (1) If 90% to 100% of the operational targets is achieved, 5% of the agency fees payable to Hisense Agent will be deducted.
- (2) If 80% to 90% of the operational targets is achieved, 10% of the agency fees payable to Hisense Agent will be deducted.
- (3) If 70% to 80% of the operational targets is achieved, 15% of the agency fees payable to Hisense Agent will be deducted.
- (4) If 60% to 70% of the operational targets is achieved, 20% of the agency fees payable to Hisense Agent will be deducted.
- (5) If less than 60% of the operational targets is achieved, all the agency fees payable to Hisense Agent will be deducted.

During the effective period of the agreement, Hisense Agent will charge the Company a utilisation fee in respect of the prepayments on a quarterly basis based on the following: Capital utilisation fee = the amount of prepayment x actual days of capital utilisation x annual interest rate for working capital loans announced by the People's Bank of China ÷ 360.

- (2) During the Reporting Period, the progress and status of the connected transaction between the Company and Hisense Agent

The fifth Board of the Company received an internal inspection report on the progress and status of the Sales Agency Agreement, the supplemental agreement of Sales Agency and the second supplemental agreement of Sales Agency ("Internal Inspection Report") from the management of the Company on 26 May 2006. In accordance with the Internal Inspection Report, the Company disclosed the initial progress and status of the Sales Agency Agreement as follows:

### 1) TERMS RELATING TO PREPAYMENTS UNDER THE SALES AGENCY AGREEMENT AND THE PROGRESS THEREOF

#### (1) Terms relating to Prepayments under the Sales Agency Agreement

Terms of the Sales Agency Agreement:	Party A shall make prepayments to Party B in respect of the purchase of products in an amount not exceeding RMB600,000,000, of which RMB300,000,000 shall be paid within ten business days of the execution of the agreement. An amount not exceeding RMB300,000,000 shall be paid by Party B within one month of the first capital contribution, in accordance with the actual capital requirements of Party B after it commences operation, marketing and sales. Under the terms of this agreement, Party B is not required to repay the prepayment made by Party A in an amount not exceeding RMB600,000,000.
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### (2) Progress and status of the Terms of Prepayments

As shown in the Internal Inspection Report, the details of the prepayments under the Sales Agency Agreement are as follows:

Date of receipt	Cash	<i>In RMB</i>	
		Acceptance Bank Notes	Total
2005-9-23		4,000,000.00	4,000,000.00
2005-9-23		13,904,000.00	13,904,000.00
2005-10-12	30,000,000.00		30,000,000.00
2005-10-13	100,000,000.00		100,000,000.00
2005-10-13	50,000,000.00		50,000,000.00
2005-10-24	72,000,000.00		72,000,000.00
2005-12-15	31,100,000.00		31,100,000.00
Total	283,100,000.00	17,904,000.00	301,004,000.00

### 2) Terms relating to Sale Price under the Sales Agency Agreement and its progress and status

#### ① Terms relating to sale price under the Sales Agency Agreement

Terms of the Sales Agency Agreement:	The settlement price of goods sold by the Party B to Party A shall be equivalent to the settlement price of goods sold by Party A to the distributors, and such price shall be determined by Party B and the distributors.
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#### ② Execution Progress of the Terms relating to the Sales Prices under the Sales Agency Agreement

According to the Internal Inspection Report:	Hisense Agent and the Company also entered into Policies in Relation to the Settlement Price between the Company and Hisense Agent on 27 September 2005, pursuant to which the parties agreed that the accounting department of the Company shall issue an invoice to Hisense Agent on a monthly basis, based on the quantity of goods ordered by Hisense Agent and in accordance with the wholesale prices offered by respective production divisions, with no gross profit made by Hisense Agent and its subsidiaries in respect of the goods. If gross profit is generated by Hisense Agent, the parties shall analyse the cause and make adjustments to the invoice in the following month. At the beginning of every month, the marketing branch office of the Company and the branch office of Hisense Agent in the corresponding regions shall review the prices of the goods sold in the previous month and confirm by way of signing and sealing.
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The Company and the branch office of Hisense Agent fully settled the gross profit of the year during the period commencing from October to November, 2005. The price differences and policies of Hisense Agent during the period from 1 December to 15 December 2005 were reviewed and confirmed, and made an advance settlement of a portion of the gross profits incurred in December in the amount of RMB-8,188,813.52.

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(3) Terms relating to the Delivery of Goods and Payments under the Sales Agency Agreement

1. Terms relating to the Delivery of Goods and Payments:

**Restriction of the Agreement:** Upon receipt of the prepayment by Party B, Party B will begin to supply goods to Party A and deliver such products to the warehouses designated by Party A. Upon delivery of products to the warehouses designated by Party A, the ownership of such products will be transferred to Party A. If the value of the sale of goods made by Party B exceeds the prepayment actually received by Party B, the Party A shall enter into a deed of buying or borrowing on credit of goods and Party A must pay Party B the value of the sale of goods which is in excess of the prepayments within 60 days.

2. Details on the Execution of Terms relating to the Delivery of Goods and Payments under the Sales Agency Agreement

i. As shown in the Internal Inspection Report, the details of sales of goods by the Company to Hisense Agent are as follows:

<b>Item</b>	<i>Unit: RMB</i> <b>Sales to Hisense Agent, net of tax</b>
October 2005	183,392,995.64
November 2005	270,132,525.40
December 2005	423,747,614.00
<b>Total (Note 1):</b>	<b>877,273,135.04</b>

*Note 1:* The above table summarises the data in respect of the revenue of goods delivered but not yet invoiced, and the revenue in respect of goods ordered by the branches of Hisense Agent from the subsidiaries of the Company was not included as the goods are still being processed.

ii. Details of sales revenue received by the Company from Hisense Agent as shown in the Internal Inspection Report are as follows:

As at 31 December 2005, sales revenue received by the Company from Hisense Agent amounted to an aggregate of RMB812,724,143.04.

## Report of the Directors

4. Terms relating to agency fees and fees in relation to the working capital loan and the progress thereof.

① Terms of the Sales Agency Agreement:

**Restriction of the Agreement:** During the effective period of this agreement, Party A will receive quarterly prepayments from Party B for fees in relation to the working capital loan, which will be calculated according to the following formula: Fees in Relation to the Working Capital Loan = Amounts of Prepayments x Actual Days of Working Capital Loan x Annual Interest Rates on Working Capital Loans Announced by the People's Bank of China ÷ 360; Party A will receive 1% of the sales revenue as agency fees every quarter, and Party A shall neither charge any other fees nor undertake any marketing fees.

② Progress of Terms relating to the Agency Fees and Fees in relation to the Working Capital Loan

Details of agency fees and fees in relation to working capital loan as shown in the Internal Inspection Report are as follows:

Item	Refunds	Income (Sales to Hisense Agent, with tax)	Unit: RMB	
			Agency Fee from (Sales to Hisense Agent, with tax *1%)	Amount of Fees in Relation to the Working Capital Loan
As at 31 December 2005	812,724,143.04	877,273,135.04	8,772,731.35	3,409,550.50

Among the above calculations, actual days of Working Capital Loans starts from the day that the Company received prepayment and up to 31 December 2005.

As at the end of this Reporting Period, Hisense Agent has not yet asked the Company to pay the Agency Fees and the Fees in relation to the Working Capital Loan in accordance with the Sales Agency Agreement. The Company has not paid any Agency Fees and Fees in relation to the Working Capital Loan.

For the progress and status of the Sales Agency Agreement after this Reporting Period, please refer to the Company's announcement dated 15 June 2006 titled "Announcement relating to the status and progress of the Sales Agency Agreement, the First Supplemental Agency Agreement and the Second Supplemental Agency Agreement entered into between Guangdong Kelon Electrical Holdings Company Limited and Qingdao Hisense Marketing Company Limited", which was set out in the "Securities Times" and "China Securities Journal" in the PRC and "China Daily" and "Hong Kong Commercial Daily" in Hong Kong on 16 June 2006. The Board of Directors of the Company has appointed Shenzhen Nanfang Minhe Certified Public Accountants Ltd. to audit the progress of the Sales Agency Agreement.

As the Company has to proceed with the settlement of the Sales Agency Agreement and its supplemental agreements, up till now, the Sales Agency Agreement and its supplemental agreements are still under the process of auditing. The Board of the Company will disclose the audit results and information in due course.

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2. Connected transactions between Guangdong Kelon Mould Co., Ltd (“Kelon Mould”) (a subsidiary of the Company) and Hisense Electric Co., Ltd (“Hisense Electrical Appliances”)

Connected party:	Hisense Electrical Appliances
Subject matter:	Moulds produced as required by Hisense Electrical Appliances
Transaction period:	22 December 2005 to 31 December 2006
Pricing policy:	Kelon Mould will consider whether it will conduct business with Hisense Electrical Appliances for the manufacture of moulds and will fix the prices for the moulds to be manufactured by reference to the following conditions: (1) the minimum profits which may be obtained by Kelon Mould from similar transactions; (2) the bidding prices which may be offered by the competitors in the tenders for the manufacture of moulds organised by Hisense Electrical Appliances; (3) the costs which must be paid by Kelon Mould for the performance of its obligations under the moulds purchase contract.
Contract amount:	RMB20,000,000, among which the aggregate cap up to the end of each year (including 2005 and 2006) will not exceed RMB10,000,000
Percentage of amount of similar contracts:	6%

### Transaction purpose and its impact on the Company

- ① Kelon Mould is specialised in development, design and manufacturing of all sorts of precise and sophisticated metal moulds, plastic injection moulds, blistering moulds, foaming moulds and die-casting moulds of large and medium dimension, and is one of the largest and most advanced mould manufacturers in the PRC in terms of technology and productivity. Kelon Mould focuses on export business, with customers all over Europe, America and Asia, and Hisense Electrical Appliances is one of them.
- ② Since March 2003, Kelon Mould, as one of Hisense Electrical Appliances’ qualified suppliers, has been participating in public tenders organized by Hisense Electrical Appliances. In consideration of Kelon Mould’s outstanding product quality, suitability, prices and services, Hisense Electrical Appliances has granted a number of mould processing contracts to Kelon Mould. However, as no connected relationship existed between the Company and Hisense Electrical Appliances or its connected parties before 9 September 2005, such transactions shall not be deemed as connected transactions.
- ③ The connected transactions of the Company are in compliance with the relevant laws, regulations and policies, and are fair and reasonable, without prejudice to the interests of the Company and non-related shareholders. Such transactions would not have a material adverse effect on the financial condition and operating results of the Company, either for the current period or in the future, nor would it affect the independence of the Company.
- ④ As at the date of this announcement, Kelon Mould has not become dependent on (nor been subject to the control of) the connected parties as a result of such transactions. The transactions with Hisense Electrical Appliances accounts for only a small portion of its whole business operations (it is estimated that for the year 2005, the connected transactions will only be 6% of the entire business operations).

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3. Continuing connected transactions with Huayi Compressor Holdings Company Limited (“Huayi Compressor”) and its subsidiaries

During the Reporting Period, the subsidiaries of the Company purchased raw materials from the Company’s associated company Huayi Compressor and its subsidiaries, in an amount of approximately RMB105 million, which amounted for less than 2.10% of the Company’s total purchase.

Such transactions may constitute connected transactions of the Company under the Listing Rules, the Company is in the process of obtaining professional advice in this regard.

### MODEL CODE FOR SECURITIES TRANSACTIONS BY DIRECTORS

The Company has adopted the Model Code as its code for securities transaction by Directors. After specific enquiries made to the Directors of the fifth Board, Mr. Liu Cong Meng, Mr. Li Zhen Hua, Mr. Fang Zhi Guo, Mr. Li Kung Man, Mr. Xu Xiao Lu and Mr. Chan Pei Cheong, Andy confirmed that they have complied with the Model Code during the year.

As at the date of this report, certain executive directors of the fifth Board, namely Mr. Gu Chu Jun, Mr. Yan You Song and Mr. Zhang Hong, were detained by the public security department for alleged economic crime, and none of them could be contacted, thus the Company was unable to confirm whether they have complied with the Model Code.

### SHARE CAPITAL STRUCTURE

As at 31 December 2005, the share capital structure of the Company was as follows:

	Number of shares	Percentage of total issued share capital (%)
Domestic legal person shares	337,915,755	34.06
H Shares	459,589,808	46.33
A Shares	194,501,000	19.61
<b>Total</b>	<b>992,006,563</b>	<b>100.00</b>

## Report of the Directors

### TOP TEN/SUBSTANTIAL SHAREHOLDERS

(1) As at 31 December 2005, there were 65,149 shareholders in total, of which the top ten/substantial shareholders were as follows:

**Total number of Shareholders: 65,149**

#### Shareholdings of the top ten shareholders

Name of shareholder	Nature of shareholder	Shareholdings percentage (%)	No. of shares held	No. of unlisted shares held	No. of pledged or frozen shares
Guangdong Greencool Enterprise Development Company Limited	Domestic legal person shares	26.43	262,212,194	262,212,194	262,212,194
Shunde Economic Consultancy Company	Domestic legal person shares	6.92	68,666,667	68,666,667	0
Shenyin Wanguo Securities (H.K.) Limited	Foreign Shareholder	5.53	54,851,000	0	Unknown
The Hongkong and Shanghai Banking Corporation Limited	Foreign Shareholder	5.15	51,092,925	0	Unknown
Bank of China (Hong Kong) Limited	Foreign Shareholder	4.96	49,242,000	0	Unknown
Guotai Junan Securities (Hong Kong) Limited	Foreign Shareholder	4.13	40,965,000	0	Unknown
HSBC Nominees (Hong Kong) Limited	Foreign Shareholder	4.04	40,106,904	0	Unknown
First Shanghai Securities Limited	Foreign Shareholder	2.61	25,878,000	0	Unknown
Hang Seng Securities Limited	Foreign Shareholder	2.04	20,235,000	0	Unknown
Standard Chartered Bank (HK) Ltd.	Foreign Shareholder	0.96	9,564,500	0	Unknown

## Report of the Directors

### Shareholdings of top ten listed Shareholders

Name of shareholder	Number of listed shares held	Class of shares
Shenyin Wanguo Securities (H.K.) Limited	54,851,000	Overseas listed foreign shares
The Hongkong and Shanghai Banking Corporation Limited	51,092,925	Overseas listed foreign shares
Bank of China (Hong Kong) Limited	49,242,000	Overseas listed foreign shares
Guotai Junan Securities (Hong Kong) Limited	40,965,000	Overseas listed foreign shares
HSBC Nominees (Hong Kong) Limited	40,106,904	Overseas listed foreign shares
First Shanghai Securities Limited	25,878,000	Overseas listed foreign shares
Hang Seng Securities Limited	20,235,000	Overseas listed foreign shares
Standard Chartered Bank (HK) Ltd.	9,564,500	Overseas listed foreign shares
BOCI Securities Limited	7,830,000	Overseas listed foreign shares
Sun Hung Kai Investment Services Limited	7,770,000	Overseas listed foreign shares

### Remarks on the connected relationship or action in concert for the above shareholders

The Company does not know whether any one of the top ten holders of listed shares is connected with each other or any one of them is a party acting in concert with any of the other nine shareholders as defined in Administrative Measures for Information Disclosure of the Shareholders of Listed Companies.

Notes:

- (1) On 3 August 2005, the Company received a notification from China Securities Depository and Clearing Corporation Limited Shenzhen Branch, informing the Company that the 262,212,194 promoter domestic legal person shares in the Company held by its single largest shareholder, Guangdong Greencool, had been frozen by the Intermediate People's Court of Shenzhen with effect from 28 July 2005 to 27 July 2006. On 21 September 2005, the Company received from the Intermediate People's Court of Foshan City of Guangdong Province a List of Foreclosure ((2005) Fo Zhong Fa Li Bao Zi No.265), thus ordering the foreclosure of 262,212,194 legal person shares in the Company and all bonus shares, placement shares and bonus dividends and other interests thereof. Save for the above-mentioned frozen legal person shares, the Company is not aware whether any shares in the Company held by the top ten shareholders have been pledged or under freezing orders during the reporting period.
- (2) Among the above-mentioned top ten shareholders, none of the legal person shareholders is connected with each other or is a party acting in concert with each other as defined under Administrative Measures for Information Disclosure of Changes in Shareholdings of Shareholders of Listed Companies (上市公司股東持股變動信息管理辦法) of the PRC. However, the Company is not aware whether the other shareholders are connected with each other or are parties acting in concert with each other as defined under Administrative Measures for Information Disclosure of Changes in Shareholdings of Shareholders of Listed Companies.

## Report of the Directors

- (3) Guangdong Greencool, the Company's single largest shareholder, and Hisense Air-Conditioner entered into the "Equity Transfer Agreement between Guangdong Greencool Enterprise Development Company Limited and Qingdao Hisense Air-Conditioner Company Limited in relation to the transfer of shares in Guangdong Kelon Electrical Holdings Company Limited" on 9 September 2005, and further entered into the "Supplemental Agreement" and the "Second Supplemental Agreement" on 28 September 2005 and 15 April 2006, respectively ("Equity Transfer Agreements"). Pursuant to the Equity Transfer Agreements, Guangdong Greencool intended to transfer 262,212,194 domestic legal person shares in the Company (representing 26.43% of the total issued share capital of the Company) to Hisense Air-Conditioner. The consideration for the above equity transfer was RMB680,000,000 as agreed by both parties with initial payment of RMB500,000,000. As at the date of this annual report, the Company has not received any notification from China Securities Depository and Clearing Corporation Limited Shenzhen Branch that the equity transfer was completed.
- (4) On 8 August 2005, the Company received a notice and a letter (the "Letter") from a shareholder of the Company, Shunde Economic Consultancy Company ("Economic Consultancy"), which informed the Company and the Board that Economic Consultancy held an aggregate of 68,666,667 legal person shares in the Company (those legal person shares were held in trust for ICBC Guangdong Branch by Economic Consultancy) as at July 2005. According to the share reform plan and financial restructuring plan of ICBC approved by the State Council, under the supervision of the head office of the People's Bank of China, the Ministry of Finance and other government authorities, ICBC Guangdong Branch legally transferred its holding of 68,666,667 legal person shares in the Company (representing 6.92% of the total issued share capital of the Company) to China Huarong Asset Management Corporation on 7 June 2005.

Upon completion of the transfer of legal person shares to China Huarong Asset Management Corporation, Economic Consultancy will no longer hold any share of the Company, while the number of legal person shares of the Company held by China Huarong Asset Management Corporation will be 68,666,667 shares, representing 6.92% of the total issued share capital of the Company.

As at the date of this report, the Company has not yet received any notice in relation to completion of the registration of the share transfer from China Securities Depository and Clearing Corporation Limited Shenzhen Branch.

### (2) Brief Introduction to the Controlling Shareholder of the Company

Guangdong Greencool, the single largest shareholder of the Company, was incorporated on 22 October 2001 with a registered capital of RMB1,200,000,000. Its registered address is 8/F, Rongshan Building, Shunde District, Foshan, Guangdong of the PRC. Guangdong Greencool is primarily engaged in the development, manufacturing and sales of refrigeration equipments and parts and cholrofluorocarbonfree (CFC-free) refrigerants, research and development of refrigerating technology, and the development, manufacturing and sales of computer and broadband networking facilities.

Guangdong Greencool is a limited liability company jointly invested by Mr. Gu Chu Jun and Greencool Refrigerant (China) Company Limited ("Greencool Refrigerant") with Mr. Gu Chu Jun holding 60% of its equity interests and Greencool Refrigerant holding 40% of its equity interests.

Greencool Refrigerant is a foreign-invested company incorporated in Tianjin of the PRC on 3 March 1995 by GCT Investment Company Limited (a company incorporated in the British Virgin Islands), of which Mr. Gu Chu Jun is an absolute controlling shareholder. Greencool Refrigerant has a registered capital of US\$150,000,000. It is primarily engaged in the development, manufacturing and sales of Gushi refrigerants, various cholrofluorocarbon (CFC) substitutes, new refrigerants, thermal elements, thermal cycling intermediate and their respective raw materials, and the development, manufacturing and sales of the ancillary equipment and application equipment for the above products.

Mr. Gu Chu Jun graduated from Tianjin University of the PRC with a master's degree in engineering. Mr. Gu is the founder of the Greencool Group. He is the chairman of Guangdong Greencool, Greencool Refrigerant, Yangzhou Yaxing Motor Coach Company Limited, and Greencool Technology Holdings Limited.

Mr. Gu Chu Jun cannot be contacted as at the date of this announcement, and the relevant information has not been confirmed by him.

## Report of the Directors

### SUBSTANTIAL SHAREHOLDERS

As at 31 December 2005, as shown in the register of substantial shareholders kept according to Section 336 under the Securities and Futures Ordinance (the "SFO"), the following shareholders maintained long positions in the issued share capital of the Company:

Name of Shareholder	Class of shares	Number of issued ordinary shares held	Percentage of the relevant class of issued shares of the Company (%)	Percentage of the total issued share capital of the Company (%)
Guangdong Greencool Enterprise Development Company Limited	Domestic legal person shares	262,212,194	77.60	26.43
Shunde Economic Consultancy Company	Domestic legal person shares	68,666,667	20.32	6.92
Shenyin Wanguo Securities (H.K.) Limited	H Shares	54,851,000	11.93	5.53
The Hongkong and Shanghai Banking Corporation Limited	H Shares	51,092,925	11.12	5.15
Bank of China (Hong Kong) Limited	H Shares	49,242,000	10.71	4.96
Guotai Junan Securities (Hong Kong) Limited	H Shares	40,965,000	8.91	4.13
HSBC Nominees (Hong Kong) Limited	H Shares	40,106,904	8.73	4.04
First Shanghai Securities Limited	H Shares	25,878,000	5.63	2.61

Save as disclosed above, the Company was not aware of any relevant interests or short positions in the issued share capital of the Company held by the shareholders as recorded in the register of substantial shareholders maintained pursuant to Section 336 of the SFO as at 31 December 2005.

## Report of the Directors

### INTERESTS OF DIRECTORS, SUPERVISORS AND CHIEF EXECUTIVES IN THE SHARES

As at 31 December 2005, the interests and short positions of the fifth Board, supervisors and the chief executive of the Company and their associates in the shares, underlying shares and debentures of the Company and its associated corporations, as recorded in the register maintained by the Company pursuant to Section 352 of the SFO or as otherwise notified to the Company and the Stock Exchange pursuant to the Model Code for Securities Transactions by Directors of Listed Companies, were as follows:

Name	Capacity	Number of issued ordinary shares held	Percentage of the relevant class of issued share capital of the Company (%)	Percentage of total issued share capital of the Company (%)
Gu Chu Jun	Held by controlled corporation	262,212,194 legal person shares (Note a)	77.60	26.43
	Held by controlled corporation	3,830,000 H shares (Note b)	0.83	0.39
He Si	Beneficial owner	50,000 A shares	0.03	0.005

Notes:

- (a) Gu Chu Jun directly owns 60% equity interest in Guangdong Greencool Enterprise Development Company Limited ("Guangdong Greencool") a company incorporated in the PRC with limited liability and the single largest shareholder of the Company. As at 31 December 2005, Guangdong Greencool owned 262,212,194 legal person shares of the Company.
- (b) Gu Chu Jun owns approximately 63.6% of the issued share capital of Greencool Technology Holding Limited ("Greencool Technology"), a company listed on the GEM of the Stock Exchange. As at 31 December 2005, two subsidiaries of Greencool Technology held together 3,830,000 H shares of the Company.

Save as disclosed above, none of the Directors, supervisors, chief executives or their associates held any interests or short positions in any shares, underlying shares or debentures of the Company or its associated corporations as at 31 December 2005.

### RIGHTS OF THE DIRECTORS AND SUPERVISORS TO ACQUIRE SHARES OR DEBENTURES

As at the date of this annual report, the Company was unable to contact executive Directors of the fifth Board Mr. Gu Chu Jun, Mr. Yan You Song, Mr. Zhang Hong or the supervisor Mr. Zeng Jun Hong, except that, at no time during the year 2005 was the Company or any of its subsidiaries a party to any arrangement to enable the remaining Directors and supervisors of the Company to acquire benefits by means of acquisition of shares in, or debentures of, the Company or any other body corporate.

### MAJOR CUSTOMERS AND SUPPLIERS

During the year ended 31 December 2005, the aggregate amount of the Company's purchases from the top five suppliers was RMB678,000,000, representing 13.53% of total purchase amount of the Company for the year and the aggregate sales amount of the top five customers was RMB2,224,000,000, representing 31.78% of total sales amount of the Company for the year. Among them the largest customer is Hisense Agent, which accounted for 12.80% of the Company's total sales. As at 31 December 2005, none of the Directors, associates of the Directors or shareholders of the Company, who to the knowledge of the Company hold 5% or more of the shares in the Company, have any interest in the above suppliers or customers.

## Report of the Directors

### PURCHASE, SALE OR REDEMPTION OF SHARES

During the year ended 31 December 2005, neither the Company nor any of its subsidiaries has purchased, sold, redeemed or cancelled any of the Company's listed shares.

### PRE-EMPTIVE RIGHTS

There is no provision for pre-emptive rights under the Articles of Association of the Company.

### TAX RELIEF AND EXEMPTION

The Company is not aware of any particulars of tax relief and exemption available to shareholders by reason of their holding of the Company's H shares.

### AUDITORS

The appointment of Shenzhen Dahua Tiancheng Certified Public Accountants and BDO McCabe Lo Limited as the Company's local and foreign auditors respectively was reviewed and approved by the 2004 AGM of the Company, while the retiring local and foreign auditors of the Company were Deloitte Touche Tohmatsu CPA Limited and Deloitte Touche Tohmatsu respectively.

*Note: The financial information contained in the Report of the Directors is calculated in accordance with PRC GAAP.*

### OPERATION DURING THE REPORTING PERIOD

#### 1. Scope of primary operations and the operations

The Company is principally engaged in the development, manufacturing, domestic and overseas sales and provision of after-sales services of electrical home appliances and relevant components and products of refrigerators, air conditioners, freezers and small sized electrical home appliances.

#### 2. Analysis of income and profit from the primary operations of the Company by geographic and product segments

##### (1) Income and profit from primary operations by geographic segments

Operation indicators	<i>(Unit: RMB thousand)</i>	
	Income from primary operations	Increase Rate %
Domestic market	4,154,956.84	(6.92%)
Overseas market	2,823,414.88	(18.37%)
Total	6,978,371.72	(11.92%)

## Report of the Directors

### (2) Primary businesses and products

Primary products	Income from sale of products ('000)	Cost of sale of products ('000)	Gross Profit Ratio %
Refrigerators	2,542,838.90	2,571,065.12	(1.11%)
Air Conditioners	3,600,489.21	3,423,931.36	4.90%
Freezers	261,112.61	237,960.72	8.87%
Others	573,931.00	581,286.36	(1.28%)

### 3. Operations and results of the major subsidiaries and associates

Major subsidiaries or associates	Interest	Nature of business	Principal products or services	Registered capital	Scale of assets (RMB)	Net profit (RMB)
Guangdong Kelon Refrigerator Co., Ltd.	100%	Manufacturing	Manufacture and sale of refrigerators	US\$26,800,000	2,062,689,710	(279,211,061)
Guangdong Kelon Air-Conditioner Co., Ltd.	60%	Manufacturing	Manufacture and sale of air-conditioners	US\$36,150,000	1,679,323,195	(265,082,867)
Guangdong Kelon Fittings Co., Ltd.	100%	Manufacturing	Manufacture and sale of components of air-conditioners and refrigerators	US\$5,620,000	456,029,795	(82,673,164)
Guangdong Kelon Mould Co., Ltd.	70%	Manufacturing	Manufacture of moulds	US\$15,000,000	190,278,825	(8,366,207)
Shunde Rongsheng Plastic Products Co., Ltd.	70%	Manufacturing	Manufacture of plastic components	US\$15,800,000	394,388,073	(7,934,669)
Guangdong Kelon Freezers Co., Ltd.	100%	Manufacturing	Manufacture and sale of freezers	RMB237,000,000	279,453,012	(86,775,674)
Shunde Jiake Electronic Company Limited	100%	Manufacturing	IT and communication technology, and micro-electronics technology development	RMB60,000,000	53,577,317	39,182
Shunde Wangao Import & Export Co., Ltd.	100%	Import and export	Import and export business	RMB3,000,000	86,819,431	(5,216,575)
Shunde Kelon Household Electrical Appliance Company Limited	100%	Manufacturing	Manufacture and sale of household electrical appliances	RMB10,000,000	41,509,945	(23,730,919)
Huayi Compressor Holdings Company Limited	22.73%	Manufacturing	Manufacture and sale of compressors	RMB260,854,000	1,790,560,606	(142,742,665)

### 4. Major Suppliers and Customers

Aggregate purchases attributable to the Group's five largest suppliers were RMB678,000,000, representing 13.53% of total purchases. Aggregate sales attributable to the Group's five largest customers were RMB2,224 million, representing 31.87% of total sales.

## Report of the Directors

### 5. Problems arising from operations and resolutions of such problems

During the Reporting Period, due to the alleged economic crimes of the former chairman of the Board, Mr. Gu Chu Jun, and other parties, the CSRC filed an investigation against the Company in early April for the alleged violation of the Securities Law of the PRC. The matters had a direct impact on the confidence of financial institutions, suppliers and distributors etc. towards the Group, resulting in the Group facing enormous difficulties in raising capital, while the tight cash flow conditions faced by the Group directly affected the Group's working relationship with suppliers and distributors. Therefore, the Group was not able to operate under normal conditions during the Reporting Period, and the Group also faced a large decrease in the level of sales.

In order to resolve the above problems, for the interests of its shareholders, the Company used great efforts to initiate numerous measures to minimise staff turnover, to maintain business operations as far as possible, and to strengthen communication with investors. A new management team took up their posts in September, and has implemented effective measures such as increasing turnover of capital, disposing idle assets and reducing costs, improving internal control in order to restore the confidence of financial institutions, distributors and suppliers in the Group's prospects. Such measures have improved the Group's external operating environment, as a result of which the Group's production and operations have gradually restored. As a result there has been a remarkable increase in both the Group's production and sales in the fourth quarter of 2005.

### INVESTMENTS OF THE COMPANY DURING THE REPORTING PERIOD

1. During the Reporting Period, the Company did not raise any capital and no capital raised during any prior periods were used during the Reporting Period.
2. During the Reporting Period, there were no major investments funded by internal capital and thus there are no reports on the progress and income received from such investments.

### FINANCIAL SITUATION AND OPERATING RESULTS DURING THE REPORTING PERIOD.

Items	31 December 2005	31 December 2004	Unit: RMB Change (%)
Total assets	5,420,343,170.97	11,160,351,150.00	(51.43%)
Shareholders' equity	(1,089,851,539.58)	2,594,003,282.00	(142.01%)
Profit from principal activities	163,429,468.39	1,660,428,838.00	(90.16%)
Net profit	(3,693,615,437.69)	(245,798,150.77)	N/A
Net increase in cash and cash equivalents	(833,249,474.47)	290,628,826.00	(386.71%)

Note: All major indicators in the Reporting Period fell sharply when compared with the corresponding period of last year. The reasons were as follows:

## Report of the Directors

(l) As there are discrepancies between the accounting records as confirmed by the former management and actual operating activities, and due to the lack of internal control in the prior periods, there are many inconsistencies in the accounting records. The book values of the Company's assets, liabilities and equity failed to reflect the actual financial position and operating results of the Company. In order for the actual financial position and operating results to be reflected in the accounting records, the new management of the Company since commencing its offices has undertaken an overall stock-count and inspection of assets. As a result, the following factors and amounts were discovered to have major impact on the Company's financial position and results:

1. Rectification of accounting errors from previous periods resulting in a reduction of net assets in the beginning of the year:

Discrepancies were revealed between some of the accounting records which had been confirmed by the former management of the Company and the actual operating activities, the Company discovered an overstatement of principal operating income of RMB513,402,667; an overstatement of profit from the sales of scrap material of RMB22,537,714; an understatement of advertising expenses of RMB7,370,000; and an understatement of corporate income tax loss of RMB17,435,805. For 2003 and prior years an overstatement of the profits from the sales of scrap material of RMB21,900,316 and an understatement of corporate income tax loss of RMB5,615,218. For 2003 and 2004, accrued accounts receivable and accounts payable amounting to RMB65,000,000.00 were not recorded. In preparing the comparable financial statements of the current year as against the previous year, the Company has rectified the above material errors. Due to such errors, the Company's retained earnings for the year were overstated by RMB209,153,478.

2. The effect of the provision for assets impairment and provision for accrued charges on the net assets and profit in 2005 was RMB1,777,587,700. Please refer to the table below (unit: RMB ten thousand):

Item	Balance at the beginning of 2005	Balance at the end of 2005	Increase at the end of the year compared with the beginning of the year (increase for the year)	Expense category
Provision for bad debt	19,020.65	76,291.85	57,271.21	Management expense
Provision for impairment of inventories	13,376.84	40,902.03	27,525.19	Management expense
Provision for impairment of long-term investment	6,721.95	7,821.95	1,100.00	Investment gain
Provision for impairment of fixed assets	6,401.18	21,044.22	14,643.04	Non-operating expense
Provision for impairment of intangible assets	810.77	31,280.57	30,469.80	Non-operating expense
Provision for impairment of construction in progress	0	8,480.24	8,480.24	Non-operating expense
Accrued charges	19,036.07	48,247.54	29,211.47	Operating expense, management expense and financial expense
Provision for liabilities	11,933.75	20,991.57	9,057.82	Operating expense and management expense
Total	77,301.21	255,059.57	177,758.77	

## Report of the Directors

(1) Provision for bad debt:

According to the accounting policies and accounting estimates of the Company, the Company made provisions for bad debts of the trade receivables according to the age of the debt and made provisions for bad debt of other receivables according to individual analysis. As approved by the Board of the Company during the year a provision for bad debt was made, amounting to 50% of the alleged embezzlement of the Company's fund by companies related to Greencool and other third parties. As of 31 December 2005, provision for bad debt amounting to RMB762,918,500 was made by the Company, which means a further provision for bad debt amounting to RMB572,712,100 for the year shall be made by the Company in addition to the provision for bad debt amounting to RMB190,206,500 made by the Company at the beginning of the year. It was mainly attributable to (1) provision for bad debt, which amounted to RMB374,000,000, was made for the alleged embezzlement of the Company's fund by companies related to Greencool and other third parties; (2) an increase in provision for decrease in land value in the amount of RMB84,000,000 was made (the above matters were mainly incurred before September 2005); (3) provision for bad debt amounting to RMB 17,590,000 for the Company's commercial acceptance notes from previous periods which were converted to trade receivables when due; (4) the remaining provision for bad debt was principally incurred as a result of an increase in the age of trade receivables (Please refer to Item 3 of Note 6 to the financial statements "Particulars of consolidated amounts of trade receivables").

## Report of the Directors

### (2) Accrued charges

Due to poor management of the Company by the previous management team, there were inconsistencies between the accounting records and operating activities of the Company and a large sum of unrecorded accruals. After clearing the off-balance-sheet expenses, provisions have been made according to the Company's actual business operations. The Company carried out an investigation on accrued charges and verified the relevant charges by evidence such as contracts etc. The aforesaid accrued charges were subject to approval by the relevant departments of the Company and the relevant responsible officer. To reflect the actual situation of the expense of the Company, the Company has therefore made further provisions to its accrued charges. The principal items of accrued charges of the Company as follows:

Items	As at year end	As at the beginning of the year	Reasons for non-settlement
Maintenance charges	59,126,811.59		Payable to definite customers, incurred but yet to be paid
Advertising fee	71,492,819.19	43,368,605.00	Payable to definite customers, incurred but yet to be paid
Logistic charges	43,516,605.66	34,997,050.00	Payable to definite customers, incurred but yet to be paid
Listing expenses	12,154,179.92		Payable to definite customers, incurred but yet to be paid
Litigation fees	3,298,457.90		Payable to definite customers, incurred but yet to be paid
Trademark license fee	5,200,000.00		Payable to definite customers, incurred but yet to be paid
Installation costs	63,743,988.70	31,931,696.45	Installation costs provided for products sold but yet to be paid
Sales discounts	96,030,139.85	59,775,725.00	Incurred but yet to be paid
Transportation costs	8,011,859.63	—	Incurred but yet to be paid
Auditors's fee	7,150,220.00	6,149,350.00	Incurred but yet to be paid
Business fee	22,188,399.88	—	Incurred but yet to be paid
Interest and default interest	22,206,757.05	—	Incurred but yet to be paid
Sales incentives	31,526,778.51	—	Incurred but yet to be paid
Agency charge and difference in prices**	13,402,831.68	—	Incurred but yet to be paid
Expenses for used capital**	3,409,550.50	—	Use Hisense appropriations
Others	20,015,979.92	18,472,999.00	Incurred but yet to be paid
Total	482,475,379.98	190,360,711.45	

## Report of the Directors

(3) Provision for liabilities

Provision - Provision for maintenance represents the expected provision for warranty of products. The Company offers 3 years warranty for all products sold. During the warranty period, customers are entitled to maintenance services free of charge. In line with common industry practice and the data available from previous periods, the provision for maintenance is determined on the basis of 3 years of warranty and the estimated repair cost. According to the accounting policy of the Company and accounting estimations as confirmed by the auditors, as at 31 December 2005, provision for maintenance of the Company was RMB209,915,700, an increase of RMB90,578,200 as compared with RMB119,337,500 as at the beginning of 2005.

(4) Provision for inventories

Provision for inventories for the year was RMB275,251,900, which mainly comprises:

Provisions in the amount of RMB1,760,000, RMB26,300,000 and RMB5,440,000 respectively were made in respect of exported freezers, air-conditioners and refrigerators with book values of RMB12,600,000, RMB119,760,000 and RMB49,540,000, respectively, due to deferred delivery and cancellation of orders by client or quality defects found in products resulting in products not being sold at their original price and resulted in their net realizable value falling below their book value;

Provision of RMB26,740,000 in respect of freezers for domestic sales with an original value of RMB51,190,000 due to quality defects and return of stocks by clients, some of which were found non-repairable and which resulted in their net realizable value falling below their book value.

Provision of RMB32,490,000 in respect of air-conditioners with book value of RMB68,870,000. The reasons were because our main customer in the United States had ceased their partnership with the Company, quality defects found in some of the stocks and higher maintenance fees in the United States, as a result, the net realizable value of the air-conditioners have fallen below their book value.

The Company had inventories with carrying value of RMB812,820,000 at the end of 2005. After a stock count of raw materials, it was found that some raw materials purchased for the production of exporting products, mainly comprised of air-conditioners and refrigerator compressors for export purpose with a total book value of RMB120,030,000 and ancillary equipment for export purpose with a total carrying value of RMB46,090,000, could no longer be used and became obsolete due to the restrictions imposed by international environmental protection standards. As such, the Company made provisions for impairment of RMB72,510,000 and RMB27,670,000 respectively for the above two items and RMB646,700,000 for other raw materials, which represents the difference between the realizable value and book value. Also, some of the raw materials did not match the launch program of the Company's products which rendered such materials redundant and obsolete, the Company made provisions for impairment of RMB60,590,000, which represents the difference between the realizable value and book value.

## Report of the Directors

### (5) Fixed Assets

Fixed assets with original cost of RMB3,882,260,000 and net value of RMB1,800,120,000, were made a provision for impairment of RMB146,430,000 for the year. This was due to the severe depreciation of certain facilities which needed replacement and also due to the cease of certain operations of the Company which resulted in the speeding up of impairment. As such, the affected facilities with cost of RMB2,056,440,000 and net value of RMB505,830,000 were made a provision for impairment of RMB151,510,000, using the lower value calculated under replacement method and discounted cash flow method. The Company also made an inspection of fixed assets and discovered a large amount of unused moulds. The affected moulds with original cost of RMB194,340,000 and net value of RMB98,480,000 were made a provision for impairment of RMB26,290,000. According to the relevant rules of accounting system, the Company made the above provisions for impairment on fixed assets based on the appraised value provided by an independent third party 北京眾華資產評估有限公司 (Beijing Zhong Hua Asset Appraisal Co., Ltd).

### (6) Intangible Assets

As the assumptions on which valuation of intangible assets of the Company had not realized and the alleged violation of law by the former chairman causing damage to the Company's brand name, the value of trademarks fell sharply. Trademarks of the Company, being "Kelon" and "Rongsheng" with original cost of RMB521,860,000 and amortized amount of RMB117,420,000 were made a provision for impairment in an aggregate of RMB286 million based on the result of a valuation made by an independent third party 山東正源和信評估事務所 (Shangdong Zheng Yuan He Xin Appraisal Co).

商丘科龍電器有限公司 (Shangqiu Kelon Electrical Appliance Co. Ltd.) ("Shangqiu Kelon") received a notice from the local court in August 2005 that 商丘經濟技術開發區管委會 (the Management Committee of Shangqiu Economic and Technology Development Zone) has filed proceedings against Shangqiu Kelon, requesting the land of 200 arcs located at Shangqiu Economic and Technology Development Zone acquired by Shangqiu Kelon from Shangqiu Bing Xiong Freezing Facilities Company Limited. The court took control of the relevant land use rights. Accordingly, a total of provision for impairment of RMB18,210,000 was made on the land use right with book value of RMB47,470,000.

### (7) Work in Progress

A provision for impairment of RMB84,800,000 was made to work in progress with cost of RMB403,690,000. This was due to the fact that certain work in progress items were obsolete equipment which needed replacement and also due to cease of certain operations of the Company which resulted in provisions made under the accounting system and results of appraisal made by independent third parties. Among which provision for impairment of RMB33,340,000 was made to items of Jianxi Kelon with cost of RMB81,860,000, provision for impairment of RMB35,100,000 was made to items of Yangzhou Kelon with cost of RMB242,280,000 (including work in progress of the Company in Yangzhou), provision for impairment of RMB16,150,000 was made to items of Zhuhai Kelon with cost of RMB30,220,000.

### (8) Long-term Investment

The Company made investments of RMB11,000,000 to 江西科龍康拜恩有限公司 (Jiangxi Combine Electrical Appliance Co., Ltd.) ("Jiangxi Combine") but Jiangxi Combine had never began effective operation since its incorporation. Due to the alleged violation of law by the former chairman of the Company, the Company lost control of Jiangxi Combine and therefore a provision for impairment of long-term investment of RMB11,000,000 was made;

## Report of the Directors

### 3. Outstanding Rebates

In the course of the inspection on outstanding rebates, the Company discovered that the former management did not effectively exercised supervision and control. The former management did not procure settlement of rebates in a timely manner and there were serious discrepancies between accounting records and operating results. According to the rebate policy agreed with external merchants and the actual conditions, a provision for rebate payable of RMB87,504,500 was made in the current year.

### 4. In addition to the above corrections of accounting errors and provisions for impairment, there were other major adjustments which affected the performance of the Company as described below:

(1) Investment loss: The Company accounted for its two associated companies namely Huayi Compressor Holdings Company Limited (“Huayi Compressor”) and 廣州安泰達物流有限公司 (Guangzhou Antai Da Logistics Co., Ltd) (“Antaida”) using equity accounting method. Based on the operating conditions of Huayi Compressor and Antaida, an investment loss of RMB32,440,000 was recognized for Huayi Compressor and an investment gain of RMB730,000 was recognized for Antaida for the year 2005.

(2) Loss arising from retirement of fixed assets and unused fixed assets amounted to RMB50,530,000.

As required by the Board and management of the Company to deal with the redundant fixed assets, each subsidiary had examined its fixed assets thoroughly and invited public biddings for disposal of the idle fixed assets and obsolete fixed assets after being approved under the various approval procedures. The obsolete fixed assets with a net value of RMB35,260,000 were disposed of, resulting in a loss of RMB15,270,000 in fixed assets. The impact of the above assets on the net profit for the Reporting Period was -RMB50,530,000. The disposed assets had become idle before September 2005.

(3) Loss of RMB109,030,000 arisen from the claims for defective products.

The loss of RMB109,000,000 arisen from the claim for the defective products in export business was due to the client refusing to make payment for the defective products of the Company and requesting compensation. The loss had occurred prior to September 2005.

(4) The counters and advertisement boards made by the Company and Wetherell Development Limited in previous years had the amortised balances of RMB25,260,000 and RMB14,770,000 respectively, which together amounted to RMB40,030,000. There was no assets in kind when conducting a thorough stock-count in 2005. According to the accounting policy and accounting estimates of the Company, such amounts were fully recognised as an expense. It was before September 2005 when the loss had occurred.

(5) As former Chairman of the Company Mr. Gu Chu Jun was subject to procedures for alleged economic crimes, the Company was involved in a number of litigations which led to operating difficulties. As at 31 December 2005, the Company had overdue borrowings amounting to RMB1,233,237,604.98, resulting in a major increase in the finance cost of the Company for the year, which amounted to RMB166,680,000.

## Report of the Directors

- (6) Adjustment of the book value of cost: the new management of the Company found out, after taking office, that there were severe defects in the internal control of the Company's inventory audit for the previous periods, i.e. the accounting system for cost audit does not match the stock maintenance records, as a result, the Company was unable to determine the cost of its principal operations with the ordinary financial audit method. When preparing the annual report, the Company adopted a method with which the year-end inventory is calculated with the amount of year-end finished products and the weighted purchase price, and the cost of principal operations of the Company for 2005 was then figured out based on the result. Such method may justify the year-end inventory, but will possibly include the cost incurred in previous years in the cost of principal operations for the year, as the Company was unable to clearly separate the cost for 2005 and that for the previous years.
- (II) With the impact of the Company's former Chairman Mr. Gu Chu Jun being suspected of having committed economic crimes as well as Mr. Gu and the Greencool Companies under his control misappropriating the Company's capital, the Company has had cash flow difficulties, and financial institutes, suppliers and distributors have lost their confidence in the Company. Such serious situation has resulted in the suspension in the production of refrigerators and air-conditioners during the Reporting Period, as a result of which the normal operation and production of the Company was adversely affected and income from principal operations dropped significantly, and thus bringing forth huge loss.

As a result of the aforesaid issues, the Company suffered great loss during the Reporting Period.

**The auditor's report issued by Shenzhen Dahua Tiancheng Certified Public Accountants for the Company containing emphasised matters and qualified opinion. The Board explained the matters relating to the qualified auditors' opinion in detail as follows:**

### **Specific Explanation of the Board of Directors of Guangdong Kelon Electrical Holdings Company Limited Relating to the Auditors' Report with Emphasised Matters and Qualified Opinion**

The auditors, after having audited the Company's financial statements for 2005, issued a report with emphasised matters and qualified opinion as follows:

**Reserved Matter 1: As described in Note 5 to the financial statements "Particulars of subsidiaries and associates and scope of consolidated financial statements for the year", Jiangxi Kelon Industrial Development Company Limited ("Jiangxi Kelon") is a subsidiary of the Company consolidated into the financial statements of the Company for 2005. We were unable to conduct an on-site audit on Jiangxi Kelon as its assets have been seized by the court and the relevant financial personnel have left the Company. As at 31 December 2005, the financial statements of Jiangxi Kelon showed a total asset value of RMB586,000,000, accounting for 10.81% of the total consolidated assets, and its net profit for 2005 was - RMB199,600,000, accounting for 5.41% of the consolidated net profit. The specific data of the financial statements of Jiangxi Kelon for the Year 2005 are disclosed in detail in Note 5.2 to the financial statements.**

Upon the revelation of former chairman's involvement in illegal acts, Jiangxi Kelon's business was discontinued by the Company after its assets were frozen by the court. As one of the major companies through which the Company's former management had made fraudulent accounts and embezzled funds, the situation of Jiangxi Kelon was complicated and has brought about significant outstanding issues. Affected by this event, the remaining staff of the Company felt threatened about their personal security. Furthermore, as former management and accountants had resigned, we were unable to have a full understanding of many issues, and hence lacking the requisite conditions for carrying the on-site audit. We can only consolidate the accounts based on financial statements presented by Jiangxi Kelon.

## Report of the Directors

The Company's newly appointed management have attached great importance on the above problems in relation to Jiangxi Kelon. They have sent staff repeatedly to Jiangxi Kelon to negotiate with local banks and suppliers and to seek local government's support. In order to improve Jiangxi Kelon's external environment, safeguard the security of its financial resources and minimise Jiangxi Kelon's losses, the Company has employed a new security company to be responsible for Jiangxi Kelon's security. With respect to the indebtedness caused by the outstanding issues, the Company was in active coordination with local government, banks and other creditors for the purpose of working out solutions on an individual basis. Currently, some of the Company's debts have been settled through negotiation, while the Company is in active negotiation with respect to other outstanding debts. The Company's accounts are also being thoroughly tidied up. It is expected that the tidying-up will be completed by the end of the year 2006.

**Reserved Matter 2: As described in Item 9 of Note 6 to the financial statements "Fixed assets, accumulated depreciation and provision for impairment loss", the Company has since 1999 had certain of its fixed assets restated at valuation, and such fixed assets had an increase of RMB133,284,123.42 over its original cost, and an increase of RMB96,154,813.34 over its net value. As no breakdown information was recorded for the asset valuation when they were accounted for, the Company could not provide a detailed breakdown of such fixed assets, nor could it identify the corresponding fixed assets, and hence we were unable to acquire adequate evidence to determine whether such amounts should be included in the fixed asset value of the Company.**

In 1999, the Company valued its assets for the purpose of its issuance of shares. As no breakdown information was recorded for the asset valuation when they were accounted for, the Company could not provide a detailed breakdown of such fixed assets, nor could it identify the corresponding fixed assets. Thus there exists a possibility that some fixed assets were not written off despite having scrapped or disposed of.

The Company's management paid serious attention to such matter. The Company arranged for financial personnel to sort out and identify all the relevant documents at that time. In addition, relevant personnel were appointed to search for original documentation held by the organisation then responsible for valuation but no breakdown can be provided either. The present accountants of the Company were not involved in the matter, and as the matters occurred too long ago, it is difficult for the particulars to be made clear, so it is impossible to verify the accounts.

Although the former management was responsible for such huge divergence in the valuation of the Company's assets, the Company will continue to follow up such matter to find out the causes and it is expected that the tidying-up will be completed by the end of the year 2006.

**Reserved Matter 3: As described in Item 4 "Other receivables", Item 18 "Other payables" of Note 6 to the financial statements, the accounting records confirmed by the former management of the Company were not in line with its actual operations; there were material imparities found in the inter-company balances between the Company and its subsidiaries; and the transactions and inter-company balances between the Company's headquarters and its regional sales branches were difficult to match. The Company temporarily recorded the unreconciled debit balances of RMB80,043,221.73 for the year ended 31 December 2005 into other receivables, and the unreconciled credit balances of RMB51,504,170.08 into other payables. The reason for such difference is still under investigation.**

In addition, as stated in the section headed "Principal Business Revenue and Costs" in explanatory item 28 of note 6 to the accounting statements, the Company calculated the inventory for the year by counting the quantity of the finished products for the year as well as the weighted purchasing price thereof. Based on such calculation, the Company estimated the amounts of costs in respect of principal businesses for 2005. Even if such accounting method has no impact on the recognition of the balance of inventory for the year, we are not able to implement satisfactory auditing procedures to determine whether the sales costs incurred are all belong to 2005 due to the unreliability of the inventory control system.

## Report of the Directors

As the accounting records acknowledged by the former management of the Company were not in line with its actual operations, the Company's new management found that there were defects in internal control of the inventory calculation. The accounting system of cost calculation and inventory in and out records did not match, as a result, the Company was unable to determine the cost of principal operations according to normal financial calculation methods. Therefore, the inventory is calculated on the basis of year-end stock takes and the weighted purchase unit price, and such method has superseded the accounting methods for 2005. Such method can ensure the verification of inventory as at year-end, however, under such method, the accrued cost for previous years may be included in the cost of principal operations for the current year.

Similarly, as a result of the former management's failure in its financial management, the new management found that the Company recognised sales income based on delivery of goods, but there were material imparities found in the inter-company balances between the Company and its subsidiaries due to delayed issuance of invoice and the delayed reconciliation and improper reconciliation method. Also, as the former management made use of Jiangxi Kelon and other companies for fraudulent operations, the Company's cash flows were not in line with its logistics, consequently, the transactions and inter-company balances between the Company's headquarters and its regional sales branches were in poor match. Adjustment will be made when the reason for the difference is ascertained after the accounts are sorted out by the Company.

In light of the above objective facts, the auditors were unable to determine whether the consolidated financial statements and the Company's financial statements as at 31 December 2004 should be adjusted accordingly.

For the above opinion, the Company has adopted remedial measures as follows:

- 1) The Company's management has paid serious attention and has set up current accounts clearing group, to fully clear out the above problems in the Company's former finance and operation, to investigate into the existing debit differences and credit differences of current accounts, and to adjust the accounts according to actual business operation.
- 2) In relation to its problems in the former in-and-out of inventory and cost calculations, the Company will set clear procedures in respect of the in-and-out of inventory and cost calculations, control stock-take and such basic management works of the Company, strengthen its internal control, and ensure consistency of fund liquidity and logistics, so as to make sure that accounts are in line with the actual facts.

As at the date of this report, the Company has completed rectification of its in-and-out system and cost calculation system. For existing unreconciled inter-company balances, it is expected to be settled by the end of 2006.

**Reserved Matter 4: As described in Note 10.4 to the financial statements, the previous land use right for the land with an area of 254,600 square meters under Shun Fu Guo Yong (2004) No. 1002282 of the Company. In respect of the transfer in June 2005, the transferee, namely Foshan Shunde Jiegao Investments Company Limited (佛山市順德區捷高投資有限公司) has finished the registration of title as per the reply of the Land and Resources Bureau of Foshan City, Shunde Branch regarding the enquiry of the title of the relevant land. Pursuant to the transfer agreement entered into between the Company and Foshan Shunde Jiegao Investments Company Limited, the price for the transfer shall be RMB169 million. As at the date the audit report, the Company has no record of having received any payment of the price for the transfer, and therefore the Company has made provision for such receivables in the sum of RMB84 million. We have made a written enquiry to the transferee but received no reply. As the Company failed to provide us with further information, we cannot carry out other alternative auditing procedures to judge whether the receivables of RMB169 million arising from the transfer of the land still exist as at 31 December, 2005, and whether the provision made is sufficient.**

The Company previously held the land use right of 266,668 square meters under Shun Fu Guo Yong (2004) No. 1002282. On 22 June 2005, the Company transferred 254,629.68 square meters of which to Foshan Shunde Jiegao Investment Company at the consideration of RMB168,855,132.63, however, the Company has not yet received the relevant land transfer payment. There is risk that such amount will become bad debts due to the age of the amount. The Company is currently negotiating with the relevant authorities to strive to collect the consideration for the land transfer as soon as possible.

## Report of the Directors

**Reserved Matter 5: As described in Notes 6.3, 6.4, and 7 to the financial statements, a series of related party transactions and abnormal cash flow occurred during the period from October 2001 to July 2005 between the Company and its largest shareholder, Guangdong Greencool Enterprise Development Limited and its related parties (the “Greencool Companies”) and specified third parties, such as Tianjin Lixin Commercial Trading Development Company Limited. Such transactions and abnormal cash flow as well as the suspected fund embezzlement have been and are now under investigation of the relevant authority and the investigation has not completed as at present. As at 31 December 2005, the accounts receivable in connection with the Company and the Greencool Companies and the above specified third party companies amounted to RMB680 million. The Company has made a provision of RMB374 million in respect of the accounts receivable from Greencool Companies and the above specified third party companies. The Company also had noted financing without trading background. Given the case was still under investigation, the Company was not able to provide sufficient information. We were unable to carry out appropriate audit procedures to ascertain whether the above specified third party were related parties. We were also unable to ascertain whether such related party transactions were valid, whether sufficient disclosure has been made, whether the accounts receivable and payable were the full amount or whether sufficient provision has been made. We were unable to ascertain whether there was any material misstatement as to the Company’s consolidated accounts for 2005 in relation to the cash flow from operating activities and financing activities under the Company’s cash flow statement.**

As a result of the series of related party transactions and abnormal cash flow occurred during the period from 2001 to 2005 between the Company and its largest shareholder, Guangdong Greencool, and its related parties or third party companies, such transactions and abnormal cash flow above as well as the suspected fund embezzlement have been investigated by the relevant authority.

Based on initial results of investigations made by the police and court and the information currently available to the Company, the balance of payables due from the Greencool companies and specific third parties to the Company was RMB680.04 million, including receivables of RMB40 million due from the Finance Bureau of Yangzhou Economic Development Zone to Yangzhou Kelon; receivables of RMB2 million due from Beijing De Heng Solicitors to Jiangxi Kelon; receivables of RMB2 million due from Beijing De Heng Solicitors to the Company; receivables of RMB9.5 million due from Zhejiang Yuhuan Compressors Factory (“Zhejiang Yuhuan”) to Chengdu Kelon Refrigerator Co. Ltd. (“Chengdu Kelon”), Yingkou Kelon Refrigerator Co. Ltd. (“Yingkou Kelon”) and Guangdong Kelon Refrigerator Ltd. (“Kelon Refrigerator”); receivables of RMB15.61 million due from Hefei Weixi Electrical Appliance Company Limited (“Hefei Weixi”) to the Company; receivables of RMB470,000 due from Hefei Weixi to Guangdong Kelon Weili Electrical Appliances Company Limited (“Kelon Weili”); receivables of RMB29.84 million due from Wuhan Changrong Electrical Appliances Company Limited to the Company. The amounts due to the Greencool companies and the specified third parties amounted to RMB131.17 million, including payables of RMB7.37 million due from the Company to Zhuhai Defa; payables of RMB2.59 million due from Kelon Refrigerator to Zhongshan Dongyue Electrical Company Limited (“Zhongshan Dongyue”); payables of RMB2.32 million due from Guangdong Kelon Refrigerators Co. Ltd. (“Kelon Refrigerators”) to Zhuhai Longjia Coolant Facility Company Ltd (“Zhuhai Longjia”); payable of RMB220,000 due from Kelon Refrigerators to Zhejiang Yuhuan; payables of RMB620,000 due from Guangdong Kelon Air-Conditioner Co. Ltd. (“Kelon Air-Conditioner”) to Jiangxi Keda Plastic Technology Company Limited (Jiangxi Keda), where:

1. The cash flow-out of Zhongshan Dongyue amounted to RMB80 million. As at 31 December 2005, Kelon Air-Conditioner had actually received sheet metal materials in the value of RMB67.32 million. Zhongshan Dongyue is already a normal supplier of Kelon Air-Conditioner;
2. The cash flow-out of Foshan Shunde Jingyi Wanxi Copper Co. Ltd. (“Foshan Jingyi”) amounted to RMB21 million. As at 31 December 2005, Foshan Jingyi had actually provided Kelon Air-Conditioner with products in the value of RMB17.65 million. Foshan Jingyi has as always been the normal supplier of Kelon Air-Conditioner;
3. The cash out-flow of Hainan Greencool Environmental Protection Engineering Co. Ltd. (“Hainan Greencool”) amounted to RMB13.44 million. Hainan Greencool has actually been providing Kelon Air-Conditioner with refrigerant in the actual value of RMB1.15 million. The cash out-flow of Jinan San Ai Fu Petrochemical Co., Ltd. (“Jinan San Ai Fu”) amounted to RMB122.4 million. Jinan San Ai Fu has actually been providing Kelon Air-Conditioner with refrigerant in the actual value of RMB900,000;

## Report of the Directors

4. The cash out-flow of Tianjin Xiangrun Commercial Trading Development Company Limited (“Tianjin Xiangrun”) amounted to RMB97.4122 million. Tianjin Xiangrun has actually been providing Guangdong Kelon Fittings Co., Ltd. (“Kelon Fittings”) with 95 tons steel products in the actual value of RMB0.51 million;
5. The cash out-flow of Jiangxi Kesheng Industry and Trading Company Limited (“Jiangxi Kesheng”) amounted to RMB31.46 million. However, Jiangxi Kesheng has actually been providing Kelon Air-Conditioner with refrigerant in the actual value of RMB5.89 million;
6. The cash out-flow of Guangdong Greencool amounted to RMB42 million, of which RMB34 million has been collected from certain repairers and the remaining RMB8 million is yet to be collected. In addition, as the agreement entered into between the Company and the repairers is for a term of five years, which remains effective as at 31 December 2005, the customer service department of the Company intends to refund the entering fees paid by category A repairers as a form of compensation for the early termination of the agreements entered into between the Company and category A repairers. An estimated amount of approximately RMB7,900,000 is to be refunded.

In addition, the bill of acceptance of 西安飛達仕東方空調壓縮機有限公司(Xi'an Feidashi Dongfang Air-Conditioner Compressor Company Limited) in the amount of RMB44 million had been fully accepted before December 2005. Kelon Air-Conditioner has received all of the products.

As the investigation conducted by the police and court is yet to be completed, certain information could not be immediately obtained due to the requirement of criminal investigation. The Company will, according to the progress of the investigation by the police and court, use its best endeavors to strengthen settlement measures particularly to minimise the loss of the Company. The Company will make timely disclosure in accordance with the latest development of the settlement.

The Company has currently taken the following settlement measures:

1. In respect of funds which have been transferred to the Greencool Companies or transferred through third parties, the Company has collected relevant evidence and engaged solicitors for further investigation. The Company has taken legal actions with sufficient legal evidence against the Greencool Companies or third parties to recover the funds. Meanwhile, in order to safeguard creditor's rights in the Company and its subsidiaries, Gu Chu Jun was sued as one of the defendants in every litigation, as well as the Greencool Companies which was associated with the business of the Company. To avoid unnecessary litigation costs, the Company is looking into the possibility of recovery of debts and selectively applying to the court for asset protection measures.
2. Checking creditor's rights and debts with the Greencool Companies and settling the outstanding debts by set-off.
3. In respect of abnormal expenditures, the Company has taken actions to check whether relevant companies have provided respective services pursuant to relevant agreements entered into by the Company. Upon release of the relevant results, solicitors of the Company will consider the possibility and means of recovery.
4. Striving for the support from local governments.
5. In respect of previous abnormal capital transfers of the Company, the Company has established a corresponding internal mechanism to regulate capital transfers and eliminate financing without trade backgrounds.

Through the above measures, the Company will settle the outstanding debts actively and make its best efforts to reduce loss.

## Report of the Directors

**Reserved Matter 6: As described in Note 14 “Comparative Information” and Note 3 “Rectification of Significant Accounting Errors “ to the financial statements, the Company restated the financial statements for 2004 and the prior years, and adjusted the items such as income from principal activities, profit from other activities and cost of sales for 2004 and prior years. Due to the correction of the above accounting errors, consolidated net assets of the Company as at 31 December 2004 was adjusted by a decrease of RMB209,000,000. Due to the pending investigation into the suspected infringement of laws of certain former management of the Company and the outstanding final verdict, we cannot ascertain whether the Company has adjusted all the accounting errors.**

Adjustment is made according to the preliminary outcome of the investigation by the relevant departments of the government in the PRC on the suspected case of fraud committed by Gu Chu Jun and other relevant persons. The items and reasons of the adjustment are as follows:

Revealed by the discrepancy between some of the accounting records recognised by the Company’s former management and the actual operating activities, the Company discovered an overstatement of principal operating income of RMB513,402,667, an overstatement of profit from the sales of scraps of RMB22,537,714, an understatement of advertising expenses of RMB7,370,000; an understatement of corporate income tax loss of RMB17,435,805 in 2004; an overstatement of the profits of the sales of scraps of RMB21,900,316 and an understatement of corporate income tax loss of RMB5,615,218 for 2003 and prior years; and an accrual of accounts receivable and payable amounted to RMB65,000,000.00 were not recorded for 2003 and 2004. In preparing for the comparable financial statements for the prior years and the comparable financial statements of the current year as against the previous year, the Company has adjusted the above material misstatements. The Company has adjusted the above material accounting errors. Due to such misstatements, the Company’s retained earning in the operating balance was overstated by RMB209,153,478.

As the case in relation to allegations of unlawful acts by the former management of the Company is still under investigation and the accounts of the Company are being cleared up comprehensively, the Company cannot make any assurance as to the completeness of the rectifications made in respect of the accounting errors. The Company will make timely disclosure and rectification in the event of findings of new significant accounting errors in accordance with the progress of the investigation.

**Given the matters 1-6, we were unable to ascertain whether adjustment to the opening balance has to be made after the Company has cleared its accounts. Any adjustments to the opening balance of the Company’s and the consolidated financial statements in 2005 would impact the net profit as stated in the consolidated and in the Company’s accounts in 2005. Besides, the consolidated and the Company’s opening balance on the balance sheets, the income statements and profit appropriation statements and cash flow statements for the current year may not be comparable with those of the previous year.**

In view of the inconformity between some of the accounting records recognised by certain former management and the actual operations, the new management of the Company discovered that there were previously defects in the internal control over the inventory check; the reconciliation of the current accounts was not done in a timely manner; the methods were not correct; the accounting system for cost check was not in line with the records of receipt, dispatch and stock in the warehouses; there are substantial financing without trade background; the accounts are not clear; and as such it is unable to determine the principal operation costs according to normal financial audit methods.

The newly appointed management of the Company strives to arrange the operation and finance departments for the full clearing of the accounts of the Company. The Company will make adjustments to the accounts according to the outcome of the clearing.

## Report of the Directors

**Emphasised matters:** It is pointed out in the paragraph of emphasised matters in the audit report provided by the auditors: “furthermore, we would like to draw the attention of the financial statements users to the following: as stated in Note 6.13, Note 8 and Note 11 to the financial statements, Kelon Electrical recorded losses in the years of 2004 and 2005. Net assets of Kelon Electrical was RMB-1.090 billion as at 31 December 2005; short-term borrowings of RMB1.233 billion were overdue; and there were substantial litigations for the debts. If all these matters cannot be resolved in a short time, the continuous operations of Kelon Electrical may be affected. Kelon Electrical has disclosed the proposed improvement measures in Note 11 to its financial statements. The contents of the paragraph does not affect the published audit opinions”.

In the opinion of the Company, although the Company recorded huge losses and net assets turned out to be a negative value in 2005, the credit risk caused by the suspected law breaking and infringement of the interests of the Group committed by the single largest shareholder, Guangdong Greencool, and Mr. Gu Chu Jun, former chairman of the Group, will be tremendously reduced owing to the upcoming change of the single largest shareholder of the Group. The Company will take the following improvement measures subsequently:

- (1) as Hisense Air-Conditioner will become the controlling shareholder of the Company, the management of the Company will implement thorough reform, strengthen the operation and management and enhance the operation quality in all aspects through the edges in management and experiences of Hisense.
- (2) The Company will immediately negotiate with its new shareholder Hisense Air-Conditioner after the change of the single largest shareholder to formulate and implement the assets and business reorganisation plan with Hisense. Upon the implementation of the reorganisation, the quality assets and business input by Hisense Air-Conditioner will evidently improve the Company’s assets and financial position and enhance its business scale and competitiveness as well as its credit level, thus create advantageous conditions for financing.
- (3) The Company will, according to the requirements of its strategic development, focus its activities on clearing the excessive investments in previous years, focus its vigor and resources on leading operations, reduce the Company’s cash outflow to the largest extent, reduce funds appropriation and enhance the use efficiency of funds, thus ensure the requirements of normal production and operation of the Company’s principal operations.
- (4) The Company will strengthen its planing management and connection between production and sales, strictly control appropriation of its funds, accelerate liquidity of its funds, and enhance the efficiency of fund application.
- (5) The Company will seek support from all parties and obtain more working capital. As of the end of July, mutual understanding with major banks have been achieved, and most of overdue loans have been or are in the process of being converted into normal loans. The Company will gain greater support from major creditors such as banks and suppliers in its future operations.

The management believes that taking the above measures will eliminate the effects on its continuous operation by the above-mentioned matters.

## Report of the Directors

### WORK PROGRESS OF THE BOARD DURING THE REPORTING PERIOD

#### 1. Meetings held by the Board and resolutions during the Reporting Period

During the Reporting Period, the Board held nine meetings.

- (1) The Company convened a meeting of the Board at the conference room of the Company's head office at Shunde District, Foshan City, Guangdong Province on 15 January 2005. The announcement of the resolutions passed at the meeting was published in China Securities Journal, Securities Times, Hong Kong Commercial Daily and China Daily dated 18 January 2005;
- (2) The Company convened a meeting of the Board at the conference room of the Company's head office at Shunde District, Foshan City, Guangdong Province on 28 April 2005. The announcement of the resolutions passed at the meeting was published in China Securities Journal, Securities Times, Hong Kong Commercial Daily and China Daily dated 29 April 2005;
- (3) The Company convened a meeting of the Board at the conference room of the Company's head office at Shunde District, Foshan City, Guangdong Province on 3 June 2005. The announcement of the written resolutions passed at the meeting was published in China Securities Journal, Securities Times, Hong Kong Commercial Daily and China Daily dated 4 June 2005;
- (4) The Company convened a meeting of the Board at the conference room of the Company's head office at Shunde District, Foshan City, Guangdong Province on 12 August 2005. The announcement of the resolutions passed at the meeting was published in China Securities Journal, Securities Times, Hong Kong Commercial Daily and China Daily dated 15 August 2005;
- (5) The Company convened a meeting of the Board at the conference room of the Company's head office at Shunde District, Foshan City, Guangdong Province on 30 August 2005. The announcement of the resolutions passed at the meeting was published in China Securities Journal, Securities Times, Hong Kong Commercial Daily and China Daily dated 31 August 2005;
- (6) The Company convened a meeting of the Board at the conference room of the Company's head office at Shunde District, Foshan City, Guangdong Province on 16 September 2005. The announcement of the resolutions passed at the meeting was published in China Securities Journal, Securities Times, Hong Kong Commercial Daily and China Daily dated 22 September 2005;
- (7) The Company convened a meeting of the Board at the conference room of the Company's head office at Shunde District, Foshan City, Guangdong Province on 15 October 2005. The announcement of the resolutions passed at the meeting was published in China Securities Journal, Securities Times, Hong Kong Commercial Daily and China Daily dated 18 October 2005;
- (8) The Company convened a meeting of the Board at the conference room of the Company's head office at Shunde District, Foshan City, Guangdong Province on 28 October 2005. The announcement of the resolutions passed at the meeting was published in China Securities Journal, Securities Times, Hong Kong Commercial Daily and China Daily dated 31 October 2005;
- (9) The Company convened a meeting of the Board at the conference room of the Company's head office at Shunde District, Foshan City, Guangdong Province on 1 December 2005. The announcement of the resolutions passed at the meeting was published in China Securities Journal, Securities Times, Hong Kong Commercial Daily and China Daily dated 2 December 2005;

## Report of the Directors

### 2. The execution of the resolutions passed at general meetings by the Board

During the Reporting Period, two general meetings were convened, being the 2004 AGM and first 2005 EGM.

#### 1. First 2005 EGM

The Company convened the First 2005 EGM in the conference room of the head office of the Company in Shunde, Foshan, Guangdong Province on 15 January 2005 at 11 a.m.

The announcement of the resolutions of the first 2005 extraordinary general meeting was published on “China Securities Journal” and “Securities Times”, “Hong Kong Commercial Daily” and “China Daily” on 18 January 2005.

#### 2. 2004 AGM

The Company convened the 2004 annual general meeting at the conference room of the head office of the Company in Shunde District, Foshan City, Guangdong Province on 28 June 2005 at 11 a.m.

The announcement of the resolutions of the 2004 annual general meeting was published on “China Securities Journal” and “Securities Times”, “Hong Kong Commercial Daily” and “China Daily” on 29 June 2005.

During the Reporting Period, the Board has fully implemented all the resolutions passed at the shareholders’ meeting by strictly adhering to the articles of association of the Company and, the Company Law of the PRC according to the powers conferred by the shareholders’ meeting, with the exception of the resolution mentioned below.

In the Company’s 2004 AGM held on 28 June 2005, the Company reviewed and passed the “Resolution Authorising the Board of Directors to Repurchase H Shares with Internal Capital”, however the aforesaid resolution had not been implemented because of the Company’s deteriorating operating environment.

## Report of the Directors

### OTHER DISCLOSEABLE MATTERS

1. Specific explanation of Shenzhen Dahua Tiancheng Certified Public Accountants on the use of funds by the controlling shareholders and other related parties of the Company:

**Specific explanation on the use of funds by the controlling shareholders  
and related parties of Guangdong Kelon Electrical Holdings Company Limited**

Shen Hua (2006) Zhuan Shen Zi No. 121

To the Board of Directors of Guangdong Kelon Electrical Holdings Company Limited:

We have been appointed to carry out the audit of the balance sheets of Guangdong Kelon Electrical Holdings Company Limited (the "Company") and the Group as at 31 December 2005 and the income statement and profit apportionment and the cash flow statement of the Company and the Group for the year in accordance with Independent Auditing Standards for Chinese Certificated Public Accountants and issued a qualified auditor's report which included an explanatory paragraph, document number Shen Hua (2006) Gu Shen Zi No.036 on 11 August 2006.

According to the "Notice of Issues in Relation to the Regulation of Capital Exchange between Listed Companies and Related Parties and External Guarantees made by Listed Companies" (Zheng Jian Fa (2003) No 56) promulgated by the China Securities Regulatory Commission, as the registered accountants responsible for auditing the financial statements of the Company in 2005, have issued a specific explanation on the use of funds by the controlling shareholders and the related parties of the Company. Annex I of this specific explanation was issued pursuant to "Memorandum on the Requirements of Information Disclosure No.2 of 2006 (amended version): the Disclosure and Reporting Requirements of the Use of Extraordinary Capital and the Capital Exchange with Related Parties" issued by the Shenzhen Stock Exchange. The Company is responsible for the preparation and the disclosure of the summary statements and is also responsible for ensuring its accuracy, legality and the completeness. We have reconciled the information provided in the summary statements with the accounting information reviewed in connection with our audit of the Company's financial statements for the year ended 31 December 2005 and the relevant information as stated in the audited accounting reports, and have found no significant discrepancies. Save for the audit procedures on the related party transactions carried out in connection with our audit of the financial statements for the year ended 31 December 2005, we did not carry out additional audit procedures for the information provided in the summary statements.

The Company had a series of related party transactions and abnormal cash inflows and outflows with its substantial shareholder, namely Guangdong Greencool Enterprise Development Co., Ltd and its related parties (collectively "Greencool Companies") and Tianjin Lixin Trading Development Company Limited (天津立信商貿發展有限公司), etc. from October 2001 to July 2005. During this period, the Greencool Companies, through Tianjin Lixin Trading Development Company Limited and other third party companies, had a series of abnormal cash inflows and outflows with the Company. Such transactions and abnormal cash inflows and outflows and suspected misappropriation of funds are in the process of being investigated by relevant authorities. Such issues involve the accounts receivable and accounts payable between the Company and the Greencool Companies and the above third party companies as at 31 December 2005. In order to accurately present the financial statement, the Company included the above dealings with third parties into the master statements.

This report has been prepared in accordance with the requirements of CSRC (including its representative organisation) and Shenzhen Stock Exchange, and cannot be used for any other purpose. The certified public accountants and accounting firm who have prepared this report, shall not be responsible for any consequences arising from the inappropriate use of this report.

Shenzhen Dahua Tiancheng  
Certified Public Accountants  
China Shenzhen

Chinese Certified Public Accountant  
  
Chinese Certified Public Accountant

Hu Chun Yuan  
  
Wu Jian Hui

11 August 2006

# Report of the Directors

## Annex I: Summary of the Use of Extraordinary Capital and the Capital Exchange of the Other Related Party of the Company in 2005

### Summary of the Use of Non-operating Capital and the Capital Exchange of the Other Related Party of the Company in 2005

*in ten thousand RMB*

Non-operating fund occupation	Names of related parties	Relationship	Account items	Balance at	Increase	Interest for the year 2005 (if any)	Repayment during the year 2005	Balance at	Reason	Nature
				the beginning of the year 2005	during the year 2005 (exclusive of interest)			the end of the year 2005		
Controlling shareholder and its subsidiaries	Guangdong Greencool Enterprise Development Company Limited	Controlling shareholder	Other receivables	1,592.59				1,592.59	Joining fee	Non-operating use
	Hefei Meiling Co., Ltd		Receivables	11.56				11.56	Sales receipt	Operating account
	Greencool Technology Environmental Protection Engineering (Shenzhen) Co., Ltd.	Subsidiary of the controlling shareholder	Other receivables	3,300.00				3,300.00	Transfer	Non-operating use
	Greencool Technology Development (Shenzhen) Company Limited	Subsidiary of the controlling shareholder	Other receivables	3,200.00				3,200.00	Transfer	Non-operating use
	Hainan Greencool Environmental Protection Engineering Company Limited	Subsidiary of the controlling shareholder	Other receivables		1,343.79		114.85	1,228.94	Prepayment	Non-operating use
Sub-Total	-	-	-	8,104.15	1,343.79	0	114.85	9,333.09		-
Total	-	-	-	8,104.15	1,343.79	0	114.85	9,333.09		-
Beneficial Controller and its subsidiaries	Qingdao Hisense Marketing Company Limited	Beneficial Controller	Receivables		101,707.34		81,272.41	20,434.92	Sales receipt	Operating accounts
	Sub-total				101,707.34	-	81,272.41	20,434.92		
Other related parties and other subsidiaries	Chengdu Xinxing Electrical Appliance Holdings Company Limited	Subsidiaries of minority shareholders of fellow subsidiaries	Other receivables	3,400.00	0	0	0	3,400.00	Loan	Non-operating use
	Shunde Yunlong Consultancy Service Company Limited	Minority shareholders of fellow subsidiaries	Other receivables	468.58	0	0	0	468.58	Advancement	Non-operating use
Sub-total				3,868.58	-	-	-	3,868.58		
Specified third parties*	Hefei Weixi Electrical Appliance Company	Specified third party*	Trade receivables	1,561.02				1,561.02	Sales receipt	Non-operating use
			Others		46.52			46.52	Sales receipt	Non-operating use
	Wuhan Changrong Electrical Appliance Company Limited	Specified third party*	Trade receivables	2,984.37				2,984.37	Sales receipt	Non-operating use
					2,000.00			2,000.00	Sales receipt	Non-operating use

## Report of the Directors

Non-operating fund occupation	Names of related parties	Relationship	Account items	Balance at the beginning of the year 2005	Increase during the year 2005 (exclusive of interest)	Interest for the year 2005 (if any)	Repayment during the year 2005	Balance at the end of the year 2005	Reason	Nature
	Jiangxi Kesheng Industry and Trading Company Limited	Specified third party*	Other receivables	1,154.25	1,863.00	-	459.97	2,557.28	Prepayment	Non-operating use
	Zhongshan Dongyue Electrical Company	Specified third party*	Other receivables	-	8,000.00	-	6,732.17	1,267.83	Materials fee	Non-operating use
	Jinan San Ai Fu Petrochemical Co., Ltd.	Specified third party*	Other receivables	-	12,240.00	-	90.35	12,149.65	Prepayment	Non-operating use
	Tianjin Xiangrun Commercial Trading Development Company Limited	Specified third party*	Other receivables	-	9,741.22	-	50.69	9,690.53	Prepayment	Non-operating use
	Tianjin Lixin Trading Development Company Limited	Specified third party*	Other receivables	-	8,960.03	-	-	8,960.03	Prepayment	Non-operating use
	Jiangxi Keda Plastic Technology Company Limited	Specified third party*	Other receivables	-	1,300.02	-	-	1,300.02	Transfer	Non-operating use
	Zhuhai City Longjia Refrigerant Facilities Co., Ltd.	Specified third party*	Other receivables	2,860.00	-	-	-	2,860.00	Materials fee	Non-operating use
	Beijing De Heng Solicitors	Specified third party*	Other receivables	-	400.00	-	-	400.00	Service fee	Non-operating use
	Zhejiang Yuhuan Compressors Factory	Specified third Party*	Receivables	-	239.81	-	-	239.81	Prepayment	Non-operating use
			Other receivables	116.99	593.56	-	-	710.55	Materials fee	Non-operating use
	Shangqiu Bing Xiong Freezing Facilities Company Limited	Specified third Party*	Other receivables	-	5,803.00	-	-	5,803.00	Land and facilities fee	Non-operating use
	Zhuhai Defa	Specified third Party*	Other receivables	2,140.00	-	-	-	2,140.00	Materials fee	Non-operating use
	Yangzhou Economic Development Zone Finance Bureau**	Specified third Party*		4,000.000	-	-	-	4,000.000	Land fee	Non-operating use
Sub-total	-	-	-	14,816.63	51,187.16	0.00	7,333.18	58,670.61		-
Total				18,685.21	152,894.50	-	88,605.59	82,974.12		

\* Note: Specified third party is the abbreviation of the abovementioned companies through which abnormal cashflow between the Greencool Companies controlled by the former beneficial controller and the Company were incurred.

\*\* The payables of RMB 40 million to Yangzhou Economic Development Zone Finance Bureau is, indeed, an amount embezzled, not an amount used for acquiring a piece of land.

\*\*\* The actual purchase price of the refrigerants is substantially lower than the contract price, The balance of the amount, after deducting the actual price, was embezzled.

## Report of the Directors

### 2. Specific explanation and independent opinions of the independent non-executive Directors of the Company regarding external guarantees

#### **Specific Explanation and Independent Opinions of the Independent Non-executive Directors of the Company Regarding the Accumulated External Guarantees and the External Guarantees for the Current Period of the Company as well as the Progress of the Execution of the Provisions set out in Document (Zheng Jian Fa (2003) No.56)**

In accordance with the requirements of the “Notice on Issues concerning the Regulating of the Capital Exchange between Listed Companies and their Connected Parties and External Guarantees of Listed Companies” (Zheng Jian Fa (2003) No.56), as independent non-executive Directors of the Company, holding a pragmatic and diligent attitude, have carried out a thorough investigation on the external guarantees provided by the Company, details of which are set out as follows:

- (1) During the Reporting Period, the Company did not provide guarantees to any of its controlling shareholders, other related parties in which the Company held interests of less than 50%, or any non legal entities or individuals;
- (2) As the net assets in the consolidated financial statements of the latest financial year is negative, the total amount of the external guarantees made by the Company as of 31 December 2005 amounted to RMB687,575,000, which exceeds 50% of the net assets in the consolidated financial statements of the latest financial year.
- (3) The accumulated guarantee and the guarantee for the current period of the Company amounted to RMB687,575,000;
- (4) The Company provided guarantees amounting to RMB600,329,700 to entities with a gearing ratio of over 70%. The outstanding external guarantees directly provided by the Company to entities with a gearing ratio of over 70% amounted to RMB600,329,700.
- (5) The balance of loan guarantees provided by Guangdong Greencool, being a related party, for the Company and its subsidiary amounted to RMB327,971,300 as at 31 December 2005.
- (6) Save for the external guarantees mentioned above, we are not aware of other external guarantees during the Reporting Period.
- (7) The Board has a strict approval procedure in relation to the Company’s external guarantees and has implemented the procedures in compliance with the “Notice on the Regulation of External Guarantees of Listed Companies” (Zheng Jian Fa (2005) No.120) in order to control the associated risks of such external guarantees.

Independent non-executive Directors: Zhang Sheng Ping, Lu Qing and Cheung Yui Kai, Warren.  
11 August 2006

# Report of the Directors

## MATERIAL MATTERS

### (I) Material litigations and arbitrations of the Company

#### 1. Information on material litigations involving an amount in dispute exceeding RMB10,000,000

*in RMB*

Number	Name of case	Amount in Counterparty	disputeDescription of progress	
<b>Litigations between Greencool Companies and Specified Third Parties</b>				
1	Claims initiated by Kelon Air-Conditioner against Guangdong Greencool, Gu Chu Jun and Jiangxi Kesheng Industry and Trading Company Limited ("Jiangxi Kesheng")	Guangdong Greencool, Gu Chu Jun and Jiangxi Kesheng	18,630,000.00	Under the authorisation by Gu Chu Jun, on 20 February 2005, Kelon Air-conditioner purchased 14.1 tons of refrigerants from Jiangxi Kesheng at a price of RMB18,630,000, however, Kelon Air-conditioner has not received the goods under the contract. The plaintiff considered that Guangdong Greencool has benefited from its role as the substantial shareholder to embezzle the capital of the plaintiff and use the name of Jiangxi Kesheng to avoid the regulatory restrictions on related party transactions.
2	Claims initiated by Jiangxi Kelon against Guangdong Greencool, Gu Chu Jun, Greencool Refrigerant (China) Company Limited ("Tianjin Greencool"), Hainan Greencool Environmental Protection Engineering Co., Ltd. ("Hainan Greencool") and Jinan San Ai Fu Petrochemical Co., Ltd. ("Jinan San Ai Fu")	Guangdong Greencool, Gu Chu Jun, Tianjin Greencool, Hainan Greencool and Jinan San Ai Fu	81,600,000.00	On 20 January 2005, under the direction of Gu Chu Jun and Guangdong Greencool, Tianjin Greencool and Jinan San Ai Fu entered into a sale and purchase contract to sell 700 tons of refrigerant to Jinan San Ai Fu, of which 600 tons were sold by Jinan San Ai Fu to the plaintiff. The plaintiff claimed that the five defendants had embezzled its funds by fraud.
3	Claims initiated by Shenzhen Kelon Procurement Co., Ltd against Guangdong Greencool, Tianjin Lixin Commercial Trading Development Company Limited ("Tianjin Lixin"), Greencool Procurement Centre (Shenzhen) Co., Ltd. ("Greencool Shenzhen Procurement Centre") and Gu Chu Jun	Guangdong Greencool, Shenzhen Procurement Centre and Gu Chu Jun	89,600,300.00	The plaintiff entered into a sale and purchase contract with Tianjin Lixin to purchase 12,700 tons of steel. The plaintiff made two payments to Tianjin Lixin on 26 April 2005 and 27 April 2005, respectively, and Tianjin Lixin transferred the funds to Greencool Shenzhen Procurement Centre. The plaintiff has not received any steel supply from Tianjin Lixin. The plaintiff claimed that the four defendants had embezzled its funds by fraud.

## Report of the Directors

Number	Name of case	Amount in Counterparty	disputeDescription of progress	
4	Claims initiated by Guangdong Kelon Fittings Co., Ltd against Guangdong Greencool, Tianjin Xiangrun Commercial Trading Development Company Limited ("Tianjin Xiangrun"), Greencool Shenzhen Procurement Centre and Gu Chu Jun	Guangdong Greencool, Tianjin Xiangrun, Greencool Shenzhen Procurement Centre and Gu Chu Jun	97,412,200.00	The plaintiff entered into a sale and purchase contract with Tianjin Xiangrun to purchase 8,820 tons of steel from Tianjin Xiangrun. The plaintiff made instalment payments to Tianjin Xiangrun on 26, 27 and 28 April 2005, respectively, but it has not received any steel supply from Tianjin Xiangrun. The plaintiff claimed that the four defendants had embezzled its funds by fraud.
5	Claims initiated by Kelon Air-Conditioner against Guangdong Greencool, Jinan San Ai Fu, Tianjin Greencool, Hainan Greencool and Gu Chu Jun	Guangdong Greencool, Jinan San Ai Fu, Tianjin Greencool, Hainan Greencool and Gu Chu Jun	40,800,000.00	The plaintiff entered into a sale and purchase contract with Jinan San Ai Fu to purchase 300 tons of environment-friendly refrigerant, and paid purchase price of RMB40,800,000 on 1 April 2005, but Jinan San Ai Fu failed to deliver of the goods. The plaintiff claimed that the five defendants had embezzled its funds through the use of fraud.
6	Jiangxi Kelon	Guangdong Greencool and others	90,000,000.00	The Company alleged that Aike Enterprises (Tianjin) Co., Ltd. had embezzled its funds and Guangdong Greencool was jointly and severally liable. The first trial was conducted on 24 July 2006
7	Jiangxi Kelon	Guangdong Greencool and others	75,000,000.00	The Company alleged that Greencool Refrigerant (China) Company Limited had embezzled its funds and Guangdong Greencool was jointly and severally liable. The first trial was conducted on 24 July 2006.
<b>Other litigations</b>				
1	Claims against Kelon Air- Conditioner by Dongguan Xinnong Motors Company Limited ("Dongguan Xinnong") in relation to a sale and purchase contract	Dongguan Xinnong	10,463,130.79	As a result of the claim by Dongguan Xinnong, both parties involved confirmed upon verification on 31 May 2005, Kelon Air-Conditioner defaulted a total purchase price of RMB10,463,359.99 and deposit amounted to RMB499,770.80. RMB500,000 has been repaid, however, the balance remained unsettled. Dongguan Xinnong initiated proceedings against Kelon Air-Conditioner for payment of the unpaid purchase price and all costs of the legal proceedings and security.

## Report of the Directors

Number	Name of case	Counterparty	Amount in dispute	Description of progress
2	Claims against Yangzhou Kelon and the Company by China Merchants Bank Co., Ltd. ("China Merchants Bank") Nanjing Branch in relation to loan agreement	China Merchants Bank Nanjing Branch	21,000,000.00	The plaintiff claimed that on 22 March 2005, Yangzhou Kelon entered into a loan agreement in the amount of RMB20,000,000 for a term of one year. The loan was guaranteed by the Company. The plaintiff had granted the loan and subsequently as a result of material events affecting the repayment ability of Yangzhou Kelon and the Company, the plaintiff demanded early repayment of the loan plus interests thereon in the amount of RMB253,100 as well as all costs of the legal proceedings. At the same time, the plaintiff applied a court order to freeze bank deposit of RMB21,000,000 or seize its assets.
3	Claims against Yangzhou Kelon and the Company by Bank of China Limited Yangzhou Branch in relation to a loan agreement	Bank of China Limited Yangzhou Branch	12,000,000.00	The plaintiff claimed that a letter of credit was issued on behalf of Yangzhou Kelon pursuant to the Banking Facility Agreement entered into by the two parties, with the Company as guarantor. Several letters of credit were issued by Bank of China Limited Yangzhou Branch on behalf of Yangzhou Kelon in favour of Nanjing Hongbaoli Company Limited and the accepting bank produced the bills under those letters of credit to the plaintiff. Yangzhou Kelon failed to make payment.
4	Claims against the Company initiated by Zhejiang Hangzhou Xiu Ganggou Holdings Company Limited ("Zhejiang Hangxiu") in relation to a construction contract	Zhejiang Hangxiu	19,853,000.00	The plaintiff alleged that it had undertaken the construction works of the Company's plain warehouse factories No. 1 and No. 2 pursuant to a construction contract with the Company and the Company defaulted in payment of RMB1,193,000 in construction fees. The plaintiff sued the Company for payment of RMB1,193,000 in construction fees and RMB17,660,000 in default penalties and the cost of legal proceedings.
5	Claims against Jiangxi Kelon Industrial Development Co., Ltd. ("Jiangxi Kelon") and the Company by China Merchants Bank Nanchang Branch Dieshanlu Sub-branch on a loan agreement	China Merchants Bank Nanchang Branch Dieshanlu Sub-branch	31,000,000.00	The plaintiff applied a pre-trial order from the court to freeze or seize assets with an amount of RMB31,000,000. The court ordered to seize 30,105 sets of air-conditioners from Jiangxi Kelon. On 22 August, the Company received documents from the court. The plaintiff alleged that it had discounted certain bank acceptance bills issued by Jiangxi Kelon to the amount of RMB43,013,270.97, Jiangxi Kelon has only paid a deposit of 30% of the total value and the balance of RMB30,109,289.68 remains outstanding. Although part of the acceptance bill has yet to fall due, the plaintiff demanded immediate settlement by Jiangxi Kelon pursuant to the agreement and demanded the Company to take over the collateral liabilities.

## Report of the Directors

Number	Name of case	Counterparty	Amount in dispute	Description of progress
6	Claims against Jiangxi Kelon and the Company initiated by China Construction Bank Corporation Nanchang Changbei Branch in relation to the loan contract and guarantee contract	China Construction Bank Corporation Nanchang Changbei Branch	140,000,000.00	China Construction Bank Corporation Nanchang Changbei Branch applied to the court for pre-trial security order on the basis of dispute over the loan contract and guarantee contract. On 5 August, the High Court of Jiangxi Province ordered to freeze Jiangxi Kelon's 80% shareholdings in Shangqiu Kelon. During the freezing period, such shareholdings shall not be pledged or transferred without the court's prior consent.
7	Claims against Jiangxi Kelon and Kaifeng Kelon Air-Conditioner Co., Ltd. ("Kaifeng Kelon") by Kaifeng Economic Technology Development (Group) Company in relation to joint venture contract	Henan Province Kaifeng Economic Technology Development (Group) Company	18,000,000.00	The plaintiff applied for a pre-trial security order from the court to seize properties worth of RMB18,000,000 of Jiangxi Kelon and Kaifeng Kelon. The equipments, factory and the land use right of Kaifeng Kelon were seized.
8	Claims initiated by CNA/MC Appliance Corporation against the Company and Kelon International Incorporation	Can International. inc./MC Appliance Corporation	221,942,108.01	The plaintiff alleged that it had entered into a contract with the defendant on 29 December 2003 to purchase 108,108 units of MCBR1000W refrigerators, that the defendant failed to perform its obligations as set out in the contract on a timely basis and that the goods delivered were defective.

### 2. General status of the litigations

As at 23 June 2006, the Company and its subsidiaries were involved in 93 litigations with a total claim amount of RMB1,099,030,302.90.

Among the aforementioned litigations involving the Company and its subsidiaries, the Company and its subsidiaries acted as plaintiffs in 12 litigations involving a total amount of RMB503,106,995.57 and as defendants in 81 litigations involving an amount of RMB595,923,307.333.

Among the litigations involving the Company and its subsidiaries, save for the 15 material litigations and arbitrations as disclosed above involving an amount exceeding RMB10,000,000 each (with a total amount of RMB967,300,738.80), the remaining 78 litigations involved an amount less than RMB10,000,000 each (with a total amount of RMB131,729,564.10).

## (II) Particulars on the disposal of assets, takeover and merger during the Reporting Period

### 1. Acquisition of assets, takeovers and mergers by the Company during the Reporting Period

No acquisition of assets, takeovers and mergers were made by the Company during the Reporting Period.

### 2. Disposal of assets

## Report of the Directors

Unit: RMB ten thousand

Transaction counterpart	Disposed assets	Date of disposal	Price of disposal	Net profit attributable to the disposed asset from the beginning of the year to the date of disposal	Gain on disposal	Connected transaction or not	Basis of pricing	Completion of transfer of relevant assets title	Completion of transfer of relevant indebtedness
(辰峰五金綜合機械購銷部) Chanfeng Wugin Combination Machinery Purchase and Sales Department	Equipment	December 2005	5.15	-	(87.20)	No	Tender	Yes	Yes
(佛山市順德區容桂精亮拋磨材料廠) Foshan City Shunde District Rongjia Jing Liang Pao Mo Material Factory	Equipment	December 2005	1.5	-	(8.1)	No	Tender	Yes	Yes
(佛山市順德區大良精發辦公用品經營部) Foshan City Shunde District Da Lang Jing Fa Office Works Department	Equipment	December 2005	69.4	-	(1,425.67)	No	Tender	Yes	Yes
(成都鎰宏辦公) Chengdu Kai Hong Office	Equipment	December 2005	64.99	-	(0.49)	No	Tender	Yes	Yes
(吉林科龍電器有限公司) Jilin Kelon Electrical Co Ltd.	Equipment	July 2005	35.5	-	-	No	Tender	Yes	Yes
(江西省鑫霸車業有限公司) Jiangxi Province Xin Ba Vehicle Industry Company Limited	Equipment	December 2005	0.42	-	(5.55)	No	Tender	Yes	Yes
Total			176.98		(1,527)				

Note: Disposal mainly consisted of obsolete assets and had no impact on the continuity and stability of the business operation of the Company.

## Report of the Directors

### (III) Material contracts and their performance

#### 1. External guarantees

*Unit: ten thousand*

Particulars of external guarantees provided by the Company (not including guarantees provided for subsidiaries of the Company)

Name of guaranteed entity	Inception date (Date of agreement)	Amount of guarantee	Type of guarantee	Guarantee period	Discharged or not	Given to related parties or not
nil	nil	nil	nil	nil	nil	nil

Total amount of guarantees incurred during the Reporting Period –

Total balance of guarantees as at the end of the Reporting Period –

#### **Particulars of guarantees provided for subsidiaries by the Company**

Total amount of guarantees provided for subsidiaries during the Reporting Period 204,032.53

Total balance of guarantees as at the end of the Reporting Period 68,757.70

#### **Particulars of the total amount of guarantees provided by the Company (including guarantees provided for subsidiaries)**

Total amount of guarantees 68,757.70

Proportion of total guarantees within net assets of the Company

where:

Amount of guarantees provided for shareholders, beneficial owners and their related parties –

Amount of loan guarantees provided, directly or indirectly, for secured parties having a gearing ratio of more than 70% 60,032.97

Amount of guarantees in excess 50% of net assets 68,757.70

Total amount of guarantees of above 3 items 68,757.70

The balance of loan guarantees provided by Guangdong Greencool, a related party, to the Company and its subsidiaries amounted to RMB327,971,300 as at 31 December 2005.

## Report of the Directors

### 2. Particulars of liability balance between the Company and related parties

Unit: ten thousand

Name of Related Party	Loans from listed company to related parties		Loans from related party to listed company	
	Amount	Balance	Amount	Balance
Guangdong Greencool Enterprise Development Company Limited	-	1,592.59	-	-
Mefei MeiLing Co. Ltd	-	11.56	-	-
Greencool Environmental Protection Engineering (Shenzhen) Company Limited	-	3,300.00	-	-
Greencool Technology Development (Shenzhen) Company Limited	-	3,200.00	-	-
Hainan Greencool Environmental Protection Engineering Company Limited	1,343.79	1,228.94	-	-
Chengdu Xinxing Electrical Appliance Holdings Company Limited	-	3,400.00	-	-
Shunde Yunlong Consultancy Service Company Limited	-	468.58	-	-
Wuhan Changrong Electrical Appliance Company Limited	2,000.00	4,984.37	-	-
Jiangxi Kesheng Trading Company Limited	1,863.00	2,557.28	-	-
Zhongshan Dongyue Electrical Company Limited	8,000.00	1,267.83	-	-
Jinan San'ai'fu Chemical Company Limited	12,240.00	12,149.65	-	-
Tianjin Xiangrun Trading Development Company Limited	9,741.22	9,690.53	-	-
Tianjin Lixin Trading Development Company Limited	8,960.03	8,960.03	-	-
Jiangxi Keda Plastic Technology Company Limited	1,300.02	1,300.02	-	-
Zhuhai Longjia Refrigerating Plant Company Limited	-	2,860.00	-	-
Beijing De Heng Solicitors	400	400	-	-
Hefei Weixi Electrical Appliance Company	46.52	1,607.54	-	-
Zhuhai Defa Air-conditioning Accessories Company Limited	-	2,140	-	-
Shangqiu Bing Xiong Freezing Facilities Company Limited	-	5,803	-	-
Zhejiang Yuhuan Compressors Factory	833.37	950.36	-	-
Yangzhou Economic Development Zone Finance Bureau	-	4,000.00	-	-
<b>Total</b>	<b>46,727.95</b>	<b>71,872.29</b>	<b>0.00</b>	<b>0.00</b>

Included loans provided by the Company to the controlling shareholder and its subsidiaries during the period of RMB13.4379 million and balance of RMB93.3309 million.

## Report of the Directors

### 3. Proposals for the settlement of embezzled funds

Planned re-payment schedule	Settlement methods	Settlement amount (in ten thousand RMB)	Remarks
As at the end of February 2006	Litigation	The specific amounts and schedules for settlement cannot be determined as they are contingent on the litigation lodged by relevant authorities against Gu Chu Jun and overall disposal arrangement of assets by the Greencool Companies	<p>There were 5 cases of litigation lodged against Gu Chu Jun, Guangdong Greencool and its related companies and third party companies in relation to their illegal embezzlement of the Company's funds, involving an amount of RMB331,596,600 (details are set out in the announcement of the Company dated 28 February 2006).</p> <p>The Company has applied to the court to seal up and preserve the lands, properties and bank deposits of Gu Chu Jun and Greencool companies, so as to ensure recovery of debt.</p>
As at the end of March 2006		0	
As at the end of April 2006		0	
As at the end of May 2006	Litigation	The specific amounts and schedules for settlement cannot be determined as they are contingent on the litigation lodged by relevant authorities against Gu Chu Jun and overall disposal arrangement of assets by the Greencool Companies	A litigation was lodged against Gu Chu Jun and Beijing De Heng Solicitors, a third party, of the Greencool Companies in relation to their illegal embezzlement of the Company's funds, in the amount of RMB4 million.
As at the end of June 2006	Litigation	The specific amounts and schedules for settlement cannot be determined as they are contingent on the litigation lodged by relevant authorities against Gu Chu Jun and overall disposal arrangement of assets by the Greencool Companies	<p>There were 3 cases of litigation lodged against Gu Chu Jun, the Greencool related parties and third parties of Greencool companies in relation to their illegal embezzlement of the Company's funds, involving an amount of RMB170.00 million (details are set out in the announcement of the Company dated 16 June 2006).</p> <p>The Company has applied to the court to seal up and preserve the land, properties and bank deposits of Gu Chu Jun and the Greencool Companies, so as to ensure recovery of debt.</p>

## Report of the Directors

Planned re-payment schedule	Settlement methods	Settlement amount (in ten thousand RMB)	Remarks
As at the end of July 2006	Cash settlement	1,267.83	Settlement of embezzled funds of the Company by Zhongshan Dongyue Electrical Appliance Company Limited was completed.
As at the end of August 2006		0	
As at the end of September 2006	Litigation	The specific amounts and schedules for settlement cannot be determined as they are contingent on the litigation lodged by relevant authorities against Gu Chu Jun and overall disposal arrangement of assets by Greencool Companies	<p>The Company has collected evidence to lodge proceedings against Gu Chu Jun, Greencool Companies and the third parties in relation to their illegal embezzlement of the Company's funds in 3 cases, the amount of the claim will be determined on the basis of supporting evidence. The embezzled amount of RMB107.51 million is composed of:</p> <p>(1) RMB16.07 million in relation to Hefei Weixi Electrical Appliance Company Limited and others; (2) RMB49.84 million in relation to Wuhan Changrong Electrical Appliances Company Limited and others, and the final amount of which is to be determined upon the settlement of debts of Wuhan Changrong Electrical Appliances Company Limited owe to/from Jiangxi Kelon and Kelon Refrigerator;</p> <p>(3) RMB13.00 million in relation to Jiangxi Keda Plastic Technology Company Limited; and</p> <p>(4) RMB28.60 million in relation to Zhuhai Longjia Refrigerating Plant Company Limited.</p> <p>The Company has applied to the court to seal up and preserve the land, properties and bank deposits of Gu Chu Jun and the Greencool companies, so as to ensure its recovery of debts.</p>

## Report of the Directors

Planned re-payment schedule	Settlement methods	Settlement amount (in ten thousand RMB)	Remarks
As at the end of October 2006		0	
As at the end of November 2006		0	
As at the end of December 2006	Others	13,117	The Company will check the current accounts with Greencool companies and make a settlement by way of offsetting RMB131.17 million of the Company's debts owed to Greencool companies.
Total	–	–	

4. During the Reporting Period, the Company was not entrusted or underwritten with assets of other companies, and no assets of the Company were entrusted, underwritten or leased to other companies.
5. During the Reporting Period, the Company has not appointed any outside party to manage its monetary assets.
6. The Company has not entered into any other material contracts during the Reporting Period.

### (IV) Undertakings given by the Company or shareholders holding 5% of shares in the Company in respect of shareholding reform

#### 1. Undertakings to shareholding reform

- (1) Guangdong Greencool, the single largest shareholder of the Company intends to transfer 26.43% of its shares in the Company to Hisense Air-Conditioner. Hisense Air-Conditioner has obtained authorization from Guangdong Greencool to carry out a share reform on the Company. The Company has been promised by Hisense Air-Conditioner that it would undertake the obligation of share reform on the Company and immediately initiate the share reform in accordance with the relevant laws, regulations and provisions of PRC.
- (2) Shunde Economic Consultancy Company, the second largest shareholder of domestic legal person shares of the Company, has undertaken to the Company that it will perform all its obligation of being the second largest shareholder of domestic legal person shares of the Company according to the relevant laws, regulations and rules of the PRC in respect of the shareholding reform of the Company upon completion of the equity transfer.

#### 2. Other undertakings

During the Reporting Period, no material undertakings have been given by the Company or shareholders holding more than 5% of shares in the Company which have been published on relevant newspapers and websites.

## Report of the Directors

- (V) During the Reporting Period, the Company appointed Shenzhen Dahua Tiancheng Certified Public Accountants and BDO McCabe Lo Limited as the Company's PRC and HK auditors, respectively, for the financial year 2005. It was the first time for the corporate auditors to provide auditing service for the Company. A total remuneration of HK\$5.6 million was agreed to pay to Shenzhen Dahua Tiancheng Certified Public Accountants and BDO McCabe Lo Limited for the provision of review and audit services on the financial statements for the six months ended 30 June 2005 and year ended 31 December 2005, and related operating costs and traveling expenses were borne by the Company.
- (VI) Since 5 April 2005, the Company has been formally investigated by CSRC due to alleged breach of certain securities law of the PRC. The Company's former chairman Mr. Gu Chu Jun and former executive Directors Mr. Zhang Hong and Mr. Yan You Song, have been formally investigated by the PRC police department and are subject to procedures relating to criminal offences due to alleged economic crimes.