



BDO McCabe Lo Limited
Certified Public Accountants
德豪嘉信會計師事務所有限公司

25th Floor Wing On Centre
111 Connaught Road Central
Hong Kong
Telephone : (852) 2541 5041
Facsimile : (852) 2815 2239

香港干諾道中111號
永安中心25樓
電話：(852) 2541 5041
傳真：(852) 2815 2239

**TO THE SHAREHOLDERS OF
GUANGDONG KELON ELECTRICAL HOLDINGS COMPANY LIMITED**

廣東科龍電器股份有限公司

(A joint stock limited company established in the People's Republic of China with limited liability)

We have audited the financial statements on pages 87 to 159 which have been prepared in accordance with International Financial Reporting Standards promulgated by the International Accounting Standards Board.

Respective responsibilities of directors and auditors

The Company's directors are responsible for the preparation of financial statements which give a true and fair view. In preparing financial statements which give a true and fair view it is fundamental that appropriate accounting policies are selected and applied consistently.

It is our responsibility to form an independent opinion, based on our audit, on those statements and to report our opinion solely to you, as a body, and for no other purpose. We do not assume responsibility towards or accept liability to any other person for the contents of this report.

Basis of opinion

We conducted our audit in accordance with Hong Kong Standards on Auditing issued by the Hong Kong Institute of Certified Public Accountants except that the scope of our work was limited as explained below.

An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgments made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the circumstances of the Company and its subsidiaries (collectively "the Group"), consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance as to whether the financial statements are free from material misstatement. However, the evidence available to us was limited as follows:

- a. The consolidated financial statements include the financial statements of Jiangxi Kelon Industrial Development Co., Ltd. ("Jiangxi Kelon"), the business of which was interrupted after the freezure of its assets by the Higher People's Court of Jiangxi Province in August 2005. The scope of our audit on Jiangxi Kelon was limited as personnel responsible for the operations of Jiangxi Kelon had left during the year and the management of the Group were unable to ascertain the accuracy and completeness of the books and records of Jiangxi Kelon. Due to this limitation, we were unable to obtain sufficient reliable evidence to assess whether the carrying amounts of the following significant financial statement

areas (after elimination of intra-group balances and transactions), relating to Jiangxi Kelon, were free from material misstatements:

- Property, plant and equipment of approximately RMB60 million;
 - Inventories of approximately RMB44 million;
 - Other receivables of approximately RMB49 million;
 - Amounts due from companies suspected to be connected with Mr. Gu (as defined in point (f) below) of approximately RMB85 million;
 - Cash and bank balances of approximately RMB1.5 million;
 - Trade payables of approximately RMB172 million;
 - Other payables of approximately RMB18 million;
 - Amounts due to companies suspected to be connected with Greencool Enterprise (as defined in point (f) below) of approximately RMB13 million;
 - Taxation payable of approximately RMB23 million;
 - Short-term bank borrowings of approximately RMB151 million; and
 - Net loss attributable to the Group of approximately RMB244 million.
- b. Included in leasehold land and buildings at 31 December 2005 were asset appreciation adjustments made in prior years of an aggregate gross amount and net book value of approximately RMB133 million and RMB96 million respectively. Those asset appreciation adjustments were initially recorded in lump sums without sufficient details as to the individual asset items they relate to. As no further information was available to us with respect to the lump sums, we were unable to determine with reasonable certainty whether the carrying amounts of the property, plant and equipment and revaluation reserve at 31 December 2005 were free from material misstatements and the possible impact on the Group's income statements in the current year and prior periods should adjustments be found necessary.
- c. The Company and certain of its subsidiaries did not maintain a proper costing system in respect of finished goods of sufficient reliability for financial reporting purpose. There were numerous negative quantities and negative unit costs in the inventory ledgers for certain of the Company's subsidiaries throughout the year. The carrying amounts of inventories at the balance sheet date were re-calculated based on the physical quantities at the balance sheet date and the weighted average cost of production in the year. Since both the carrying amounts of finished goods at 1 January 2005 and 31 December 2005 have direct impact on the cost of sales figure for the current year, and we could not place reliance on the Group's inventory system nor was it practical for us to perform other audit procedures to verify the carrying value of the Group's inventories at 1 January 2005, we were therefore unable to obtain sufficient information to assess whether the cost of sales for the current year was free from material misstatement. We have, however, performed alternative audit procedures to ascertain the existence, completeness and valuation of the closing inventories as at 31 December 2005 and our opinion is not qualified in this respect.
- d. At 31 December 2005, included in trade and other receivables under current assets were intra-group receivables of approximately RMB80 million and included in trade and other payables under current liabilities were intra-group payables of approximately RMB52 million. This resulted from an inability to eliminate balances among companies within the Group on consolidation. We were unable to obtain sufficient information and explanation concerning the timing and nature underlying the unreconciled receivables and payables. We were therefore unable to assess the validity and recoverability of the unreconciled receivables amount of approximately RMB80 million and the validity and completeness of the unreconciled payables amount of approximately RMB52 million and the possible impact on the Group's income statements in the current year and prior periods should adjustments be found necessary.

- e. Included in trade and other receivables at 31 December 2005 was a receivable arising from the sale of an interest in leasehold land under operating lease in Shunde, the People's Republic of China (the "PRC"), of gross amount and carrying amount of approximately RMB169 million and RMB85 million respectively. Although the land use right was registered in the name of the purchaser in June 2005, no settlement of the receivable has been recorded in the Company's books up to the date of this report. The carrying amount was stated net of an impairment loss, made in the current year, of approximately RMB84 million. During the course of our audit, we sought but were unable to obtain direct confirmation from the purchaser concerning the existence of the receivable. There were no other satisfactory audit procedures that we could adopt to satisfy ourselves concerning the continued existence of the receivable nor for us to assess its recoverability. Accordingly, we were unable to assess with reasonable certainty whether the carrying amount of such receivable at 31 December 2005 as well as the impairment loss made in the current year were free from material misstatement.
- f. It was reported by the Company that the controlling shareholder, Guangdong Greencool Enterprise Development Company Limited ("Greencool Enterprise"), had entered into a series of activities/transactions during the period from 2001 to 2005 which had been harmful to the Group, including but not limited to unauthorised use of the Group's funds, fictitious sales of goods and scrap materials, unreasonable prepayments and purchases of raw materials and property, plant and equipment at unreasonable quantities and prices. These transactions were conducted through Greencool Enterprise, its affiliates and/or companies suspected to be connected with the Company's former chairman, Mr. Gu Chu Jun ("Mr. Gu"). As at 31 December 2005, the aggregate amount of receivables and aggregate amount of payables due from/to these companies were approximately RMB680 million and RMB131 million respectively which are reflected in the consolidated balance sheet at 31 December 2005 as "Amounts due from Greencool Enterprise and its affiliates" and "Amounts due from companies suspected to be connected with Mr. Gu" within current assets and "Amounts due to Greencool Enterprise and its affiliates" and "Amounts due to companies suspected to be connected with Mr. Gu" within current liabilities. The management have made an impairment loss of approximately RMB374 million on the receivables. Due to the irregularity of the transactions mentioned above and limitation of information available to us, we were unable to satisfy ourselves concerning the validity of these transactions, the appropriateness of the impairment amount and the recoverability of the net carrying amounts.
- g. As a result of the alleged breaches of PRC securities laws and regulations and consequent upon the alleged economic crimes committed by the former chairman of the Company, the Company had appointed an independent professional firm to carry out an investigation on the material cash flows of the Group during the period from 1 October 2001 to 31 July 2005 (the "Investigation Period"). The results of the investigation, announced by the Company on 20 January 2006, revealed that there were significant cash flows which were inconsistent with or were irrelevant to the business of the Group: (1) between the Group and Greencool Enterprise and its affiliates ("Greencool Companies"); (2) between the Group and companies suspected to be connected with Greencool Companies; (3) between the Group and other companies; and (4) within the Group, during the Investigation Period.

The management considered that the results of the investigation indicated that (1) there could have been omissions of recording and disclosure of material related party transactions during the year ended 31 December 2005 and prior periods and (2) there could have been material misstatements under the cash flow statements in distinguishing operating, investing and financing cash flows during the year ended 31 December 2005 and prior periods.

In consequence, we were unable to obtain sufficient reliable information and explanations to assess (1) whether all material related party transactions have been properly disclosed in the financial statements during the year ended 31 December 2005; and (2) whether all material cash flows have been properly reflected in operating, investing and financing activities under the cash flow statement for the year ended 31 December 2005.

- h. Following a formal investigation into the Company for alleged breaches of securities laws and regulations in the PRC by the China Securities and Regulatory Commission, the management noted certain errors that had significant impact on the Group's prior years' financial statements. The financial statements for the year ended 31 December 2005 included a restatement of the 2004 financial statements to correct the errors noted by the management. The above restatements have, in aggregate, reduced the net assets of the Group as at 31 December 2004 by approximately RMB209 million, profit for the year ended 31 December 2004 by approximately RMB181 million and opening retained earnings as at 1 January 2004 by approximately RMB27 million. Details of the income statement and balance sheet line items being affected are disclosed in note 2 to the financial statements. Due to the irregularity of the transactions entered into by the Company as mentioned in the foregoing and in points (f) and (g) above, we were unable to obtain sufficient reliable evidence to satisfy ourselves concerning the appropriateness, completeness and accuracy of the prior year restatements. Further this will have a material impact on the financial statements for the year ended 31 December 2005. In addition, we were also unable to ascertain with reasonable accuracy as to whether the impairment losses on inventories of approximately RMB293 million and receivables of approximately RMB479 million as included in administrative expenses were under conditions that did not exist prior to 1 January 2005 and thus would not have led to prior year restatements.

Any adjustments found to be necessary to the matters set out in points (a) to (h) above would affect the net liabilities of the Group as at 31 December 2005 and/or the loss and cash flows of the Group for the year then ended.

Fundamental uncertainty relating to the going concern basis

In forming our opinion, we have considered the adequacy of the disclosures made in note 3(b) to the financial statements concerning the adoption of the going concern basis, being the basis on which the financial statements have been prepared. As explained in note 3(b) to the financial statements, the Group incurred losses of approximately RMB3,767 million and RMB237 million (restated) for the year ended 31 December 2005 and year ended 31 December 2004 respectively. As at 31 December 2005, the Group's current liabilities exceeded its current assets by approximately RMB3,307 million. In addition, the Group had outstanding short-term loans in the aggregate of approximately RMB2,161 million of which approximately RMB1,233 million were overdue as at 31 December 2005. The Group is in the process of negotiating with certain banks to restructure the amounts due to them and the Company's management confirmed that most of the Group's bankers have expressed their intention to reschedule overdue bank borrowings and/or renew/grant credit facilities to the Group. In addition, the successor single largest shareholder of the Company, Hisense Air-Conditioner Company Limited has expressed its intention to provide necessary financial support to the Group so as to enable it to continue as a going concern. Based on the above assessments, the directors are of the opinion that the Group will have sufficient working capital to finance its normal operations and to meet its financial obligations as they fall due for the foreseeable future and have prepared the consolidated financial statements on a going concern basis. We consider that appropriate estimates and disclosures have been made herein and our opinion is not qualified in this respect.

In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements. We believe that our audit provides a reasonable basis for our opinion.

Qualified opinion arising from limitation of audit scope and disclaimer on view given by consolidated income statement and consolidated cash flow statement

Except for any adjustments that might have been found to be necessary had we been able to obtain sufficient evidence concerning the matters set out in the basis of opinion section of this report, in our opinion the financial statements give a true and fair view of the state of affairs of the Group as at 31 December 2005 and have been properly prepared in accordance with the disclosure requirements of the Hong Kong Companies Ordinance.

Because of the significance of the possible effects of the limitation in scope in respect of reliable evidence outside the control of the directors on matters set out in points (f) to (h) above, we are unable to form an opinion as to whether the financial statements give a true and fair view of the Group's loss and cash flows for the year ended 31 December 2005.

In respect alone of the limitations on our work described in the basis of opinion section of this report:

- we have not obtained all the information and explanations that we considered necessary for the purpose of our audit; and
- we were unable to determine whether proper books of account had been kept.

BDO McCabe Lo Limited

Certified Public Accountants

Chow Tak Sing, Peter

Practising Certificate Number P04659

Hong Kong, 11 August 2006