## 1. CORPORATE INFORMATION

Air China Limited (the "Company") was incorporated as a joint stock limited company in Beijing, the People's Republic of China (the "PRC"), on 30 September 2004. The Company's H shares are listed on The Stock Exchange of Hong Kong Limited (the "Stock Exchange") and the London Stock Exchange. In the opinion of the Directors, the Company's parent and ultimate holding company is China National Aviation Holding Company ("CNAHC"), a PRC state-owned enterprise under the supervision of the State Council.

On 18 August 2006, 1,639,000,000 A shares of the Company were issued at an offer price of RMB2.80 per share and listed on the Shanghai Stock Exchange. The net proceeds from the initial public offering of A shares, after deducting shares issue expenses of RMB76,004,278, amounted to RMB4,513,195,722, within which RMB1,639,000,000 (note 38(a)) and RMB2,874,195,722 were credited to the Company's paid-up capital and capital reserve, respectively.

On 8 June 2006, the Company together with China National Aviation Company Limited ("CNAC", a 69%-owned subsidiary of the Company listed on the Stock Exchange and was then privatised by the Company with effect from 24 January 2007 after the balance sheet date (note 49(a)), Cathay Pacific Airways Limited ("Cathay"), CITIC Pacific Limited ("CITIC") and Swire Pacific Limited ("SPAC") enter into a conditional agreement for the following transactions:

- sale of the Group's entire interest in Hong Kong Dragon Airlines Limited ("Dragonair") held by CNAC to Cathay for 288,596,335 shares issued by Cathay at a price of HK$13.5 per share and cash consideration of approximately HK$433 million;
- acquisition of 359,170,636 shares and 40,128,292 shares in Cathay by the Company from CITIC and SPAC, respectively, at a price of HK$13.5 per share;
- payment of a special interim dividend by Cathay of HK$0.32 per share following completion of the above transactions; and
- issue of 1,179,151,364 H shares of the Company to Cathay at a price of HK$3.45 per H share (note 38(b)).

The above transactions became unconditional and were completed on 28 September 2006 except for the issue of 1,179,151,364 H shares of the Company to Cathay which was completed on 27 September 2006. After completion of the above transactions, the Company has acquired, through its subsidiaries, an aggregate of 687,895,263 shares or 17.5% equity interest in Cathay which is accounted for as an associate in the Group's consolidated financial statements with effect from 28 September 2006 (note 20(b)).

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

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

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### Basis of preparation

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

These financial statements have been prepared on a historical cost basis, except for derivative financial instruments which have been measured at fair value in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*.

### Impact of New and Revised IFRSs

The Group has adopted the following new and revised IFRSs for the first time for the current year's financial statements. Except for in certain cases giving rise to new and revised accounting policies and additional disclosures, the adoption of these new and revised standards and interpretations has had no material effect on these financial statements.

| | |
|---|---|
| IAS 39 and IFRS 4 Amendments | Financial Guarantee Contracts |
| IAS 39 Amendment | Cash Flow Hedge Accounting of Forecast Intragroup Transactions |
| IAS 39 Amendment | The Fair Value Option |
| IFRIC – Int 4 | Determining whether an Arrangement contains a Lease |

(a) IAS 39 and IFRS 4 Amendments have revised the scope of IAS 39 to require financial guarantee contracts that are not considered as insurance contracts to be recognised initially at fair value and to be measured at the higher of (i) the amount determined in accordance with IAS 37 "Provisions, Contingent Liabilities and Contingent Assets"; and (ii) the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with IAS 18 "Revenue". The adoption of this amendment has had no material impact on these financial statements.

The accounting policy for financial guarantee contracts is set out below under the heading of "Financial Guarantee Contracts".

(b) IAS 39 Amendment for cash flow hedges of forecast intragroup transactions permits the foreign currency risk of a highly probable intragroup forecast transaction to qualify as the hedged item in a cash flow hedge, provided that the transaction is denominated in a currency other than the functional currency of the entity entering into that transaction and that the foreign currency risk will affect the entity's financial statements. As the Group currently has no such transactions, the amendment has had no effect on these financial statements.

(c) IAS 39 Amendment for the fair value option has changed the definition of a financial instrument classified as fair value through profit and loss and has restricted the use of the options to designate any financial asset or any financial liability to be measured at fair value through the income statement. The Group had not previously used this option, and hence the amendment has had no effect on these financial statements.

(d) IFRIC – Int 4 provides guidance for determining whether arrangements contain a lease to which lease accounting must be applied. This interpretation has had no effect on these financial statements.

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### Impact of Issued but not yet Effective IFRSs

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

| | |
|---|---|
| IFRS 7 | Financial Instruments: Disclosures |
| IFRS 8 | Operating Segments |
| IAS 1 Amendment | Capital Disclosures |
| IFRIC – Int 7 | Restatement Approach under IAS 29 Financial Reporting in Hyperinflationary Economies |
| IFRIC – Int 8 | Scope of IFRS 2 |
| IFRIC – Int 9 | Reassessment of Embedded Derivatives |
| IFRIC – Int 10 | Interim Financial Reporting and Impairment |
| IFRIC – Int 11 | IFRS 2 – Group and Treasury Share Transactions |
| IFRIC – Int 12 | Service Concession Arrangements |

IFRS 7 shall be applied for annual periods beginning on or after 1 January 2007. The standard requires disclosures that enable users of the financial statements to evaluate the significance of the Group's financial instruments and the nature and extent of risks arising from those financial instruments and also incorporates many of the disclosures requirements of IAS 32.

IFRS 8 shall be applied for annual periods beginning on or after 1 January 2009. The standard requires disclosures that include general information about how an entity identifies its operating segments, the types of products and services from which each operating segment derives its revenue and the information to be disclosed in the identified segments.

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

IFRIC – Int 7, IFRIC – Int 8, IFRIC – Int 9, IFRIC – Int 10, IFRIC – Int 11 and IFRIC – Int 12 shall be applied for annual periods beginning on or after 1 March 2006, 1 May 2006, 1 June 2006, 1 November 2006, 1 March 2007 and 1 January 2008 respectively.

The Group is in the process of making an assessment of the impact of these new and revised IFRSs upon initial application. So far, it has concluded that while the adoption of IAS 1 Amendment, IFRS 8 and IFRS 7 may result in new or amended disclosures, these new and revised IFRSs are unlikely to have a significant impact on the Group's results of operations and financial position.

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### Basis of consolidation

The consolidated financial statements comprise the financial statements of the Company, its subsidiaries and joint ventures for the year ended 31 December 2006. The financial statements of the subsidiaries and joint ventures are prepared for the same reporting year as the Company. Adjustments are made to bring into line any dissimilar accounting policies that may exist.

Subsidiaries are fully consolidated from the date on which control is transferred to the Group and cease to be consolidated from the date on which control is transferred out of the Group. Joint ventures are proportionally consolidated from the date on which joint control is transferred to the Group and cease to be proportionally consolidated from the date on which joint control is transferred out of the Group. All significant inter company transactions and balances within the Group are eliminated on consolidation.

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

### Foreign currency translation

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

The functional currencies of certain overseas subsidiaries, and associates are currencies other than RMB. As at the balance sheet date, the assets and liabilities of these entities are translated into RMB at the rate of exchange ruling at the balance sheet date and their income statements are translated into RMB at the weighted average exchange rates for the year. The exchange differences arising on the translation are included in the foreign exchange translation reserve within equity. On disposal of a foreign entity, the deferred cumulative amount recognised in equity relating to that particular foreign entity is recognised in the income statement.

For the purpose of the consolidated cash flow statement, the cash flows of overseas subsidiaries are translated into RMB at the exchange rates ruling at the dates of the cash flows. Frequently recurring cash flows of overseas subsidiaries which arise throughout the year are translated into RMB at the weighted average exchange rates for the year.

### Subsidiaries

A subsidiary is a company whose financial and operating policies the Company controls, directly or indirectly, so as to obtain benefits from its activities.

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

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### Interests in joint ventures

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

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

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

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

The results of joint ventures are included in the Company's income statement to the extent of dividends received and receivable. The Company's investments in joint ventures are treated as non-current assets and are stated at cost less any impairment losses.

### Interests in associates

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

Under the equity method, the interests in associates are carried in the consolidated balance sheet at cost plus post-acquisition changes in the Group's share of net assets of the associates, less any impairment losses. Goodwill relating to the associates is included in the carrying amounts of the investments and is not amortised. The consolidated income statement reflects the share of the results of operations of the associates until the date on which the Group ceases to have significant influence over the associates. Where there has been a change recognised directly in the equity of the associates, the Group recognises its share of any changes and disclose this, when applicable, in the consolidated statement of changes in equity.

The financial statements of the associates are prepared for the same reporting year as the Company. Adjustments are made to bring into line any dissimilar accounting policies that may exist.

The results of associates are included in the Company's income statement to the extent of dividends received and receivable. The Company's interests in associates are treated as non-current assets and are stated at cost less any impairment losses.

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### Goodwill

Goodwill acquired in a business combination is initially measured at cost being the excess of the cost of the business combination over the Group's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities. Following initial recognition, goodwill is measured at cost less any accumulated impairment losses. In the case of associates and joint ventures, goodwill is included in the carrying amount thereof, rather than as a separately identified asset on the consolidated balance sheet. Goodwill is reviewed for impairment annually or more frequently if events or changes in circumstances indicate that the carrying amount may be impaired.

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

- represents the lowest level within the Group at which the goodwill is monitored for internal management purposes; and
- is not larger than a segment based on either the Group's primary or the Group's secondary reporting format determined in accordance with IAS 14 *Segment Reporting*.

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

An impairment loss recognised for goodwill is not reversed in a subsequent period.

### Related parties

A party is considered to be related to the Group if:

(a) the party, directly or indirectly through one or more intermediaries, (i) controls, is controlled by, or is under common control with, the Group; (ii) has an interest in the Group that gives it significant influence over the Group; or (iii) has joint control over the Group;

(b) the party is an associate;

(c) the party is a jointly-controlled entity;

(d) the party is a member of the key management personnel of the Group or its parent;

(e) the party is a close member of the family of any individual referred to in (a) or (d); or

(f) the party is an entity that is controlled, jointly controlled or significantly influenced by or for which significant voting power in such entity resides with, directly or indirectly, any individual referred to in (d) or (e).

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### Property, plant and equipment and depreciation

Property, plant and equipment other than construction in progress are stated at cost less accumulated depreciation and any impairment losses. The cost of an item of property, plant and equipment comprises its purchase price and any directly attributable costs of bringing the asset to its working condition and location for its intended use. Expenditure incurred after items of property, plant and equipment have been put into operation, such as repairs and maintenance, is normally charged to the income statement in the period in which it is incurred. In situations where it can be clearly demonstrated that the expenditure has resulted in an increase in the future economic benefits expected to be obtained from the use of an item of property, plant and equipment, and where the cost of the item can be measured reliably, the expenditure is capitalised as an additional cost of that asset or as a replacement.

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

Depreciation is calculated on the straight-line basis to write off the cost of each item of property, plant and equipment to its residual value over its estimated useful life. The principal estimated useful lives and residual values used for this purpose are as follows:

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

Where parts of an item of property, plant and equipment have different useful lives, the cost of that item is allocated on a reasonable basis among the parts and each part is depreciated separately.

The asset's residual values, useful lives and depreciation method are reviewed, and adjusted if appropriate, at each year end.

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

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

The carrying amounts of property, plant and equipment are reviewed for impairment when events or changes in circumstances indicate that the carrying amounts may not be recoverable.

### Lease prepayments

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

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### Leases

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

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

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

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

### Advance payments for aircraft and related equipment

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

### Impairment of non-financial assets other than goodwill

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

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

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### Investments and other financial assets

Financial assets in the scope of IAS 39 are classified as either financial assets at fair value through profit or loss, loans and receivables, held-to-maturity investments and available-for-sale financial assets, as appropriate. When financial assets are recognised initially, they are measured at fair value, plus, in the case of investments not at fair value through profit or loss, directly attributable transactions costs. The Group considers whether a contract contains an embedded derivative when the Group first becomes a party to it. The embedded derivatives are separated from the host contract which is not measured at fair value through profit or loss when the analysis shows that the economic characteristics and risks of embedded derivatives are not closely related to those of the host contract.

The Group determines the classification of its financial assets after initial recognition and, where allowed and appropriate, re-evaluates this designation at the balance sheet date.

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

*Financial assets at fair value through profit or loss*

Financial assets at fair value through profit or loss include financial assets held for trading and financial assets designated upon initial recognition as at fair value through profit or loss. Financial assets are classified as held for trading if they are acquired for the purpose of selling in the near term. Derivatives, including separated embedded derivatives, are also classified as held for trading unless they are designated as effective hedging instruments or financial guarantee contracts. Gains or losses on investments held for trading are recognised in income.

Financial assets may be designated upon initial recognition as at fair value through profit or loss if the following criteria are met: (i) the designation eliminates or significantly reduces the inconsistent treatment that would otherwise arise from measuring the assets or recognising gains or losses on them on a different basis; (ii) the assets are part of a group of financial assets which are managed and their performance evaluated on a fair value basis, in accordance with a documented risk management strategy; or (iii) the financial asset contains an embedded derivative that would need to be separately recorded.

*Loans and receivables*

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. Such assets are subsequently carried at amortised cost using the effective interest method. Amortised cost is calculated taking into account any discount or premium on acquisition and includes fees that are an integral part of the effective interest rate and transaction costs. Gains and losses are recognised in the income statement when the loans and receivables are derecognised or impaired, as well as through the amortisation process.

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### Investments and other financial assets (Continued)

*Held-to-maturity investments*

Non-derivative financial assets with fixed or determinable payments and fixed maturity are classified as held-to-maturity when the Group has the positive intention and ability to hold to maturity. Investments intended to be held for an undefined period are not included in this classification. Held-to-maturity investments are subsequently measured at amortised cost. This cost is computed as the amount initially recognised minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between the initially recognised amount and the maturity amount. This calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate, transaction costs and all other premiums and discounts. Gains and losses are recognised in the income statement when the investments are derecognised or impaired, as well as through the amortisation process. As at 31 December 2006, the Group had no held-to-maturity investments (2005: Nil).

*Available-for-sale financial assets*

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

When the fair value of unlisted equity securities cannot be reliably measured because (a) the variability in the range of reasonable fair value estimates is significant for that investment or (b) the probabilities of the various estimates within the range cannot be reasonably assessed and used in estimating fair value, such securities are stated at cost less any impairment losses.

*Fair value*

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

### Impairment of financial assets

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

*Assets carried at amortised cost*

If there is objective evidence that an impairment loss on loans and carried at amortised cost has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate (i.e., the effective interest rate computed at initial recognition). The carrying amount of the asset is reduced either directly or through the use of an allowance account. The amount of the impairment loss is recognised in the income statement.

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### Impairment of financial assets (Continued)

*Assets carried at amortised cost* (Continued)

The Group first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant, and individually or collectively for financial assets that are not individually significant. If it is determined that no objective evidence of impairment exists for an individually assessed financial asset, whether significant or not, the asset is included in a group of financial assets with similar credit risk characteristics and that group is collectively assessed for impairment. Assets that are individually assessed for impairment and for which an impairment loss is or continues to be recognised are not included in a collective assessment of impairment.

If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, the previously recognised impairment loss is reversed. Any subsequent reversal of an impairment loss is recognised in the income statement, to the extent that the carrying value of the asset does not exceed its amortised cost at the reversal date.

In relation to accounts receivable, a provision for impairment is made when there is objective evidence (such as the probability of insolvency or significant financial difficulties of the debtor) that the Group will not be able to collect all of the amounts due under the original terms of an invoice. The carrying amount of the receivables is reduced through the use of an allowance account. Impaired debts are derecognised when they are assessed as uncollectible.

*Assets carried at cost*

If there is objective evidence that an impairment loss on an unquoted equity instrument that is not carried at fair value because its fair value cannot be reliably measured, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the current market rate of return for a similar financial asset. Impairment losses on these assets are not reversed.

*Available-for-sale financial assets*

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

### Derecognition of financial assets and liabilities

*Financial assets*

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

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

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### Derecognition of financial assets and liabilities (Continued)

*Financial assets* (Continued)

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

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

*Financial liabilities*

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

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

*Financial liabilities at amortised cost (including interest-bearing loans and borrowings)*

Financial liabilities including air traffic liabilities, accounts payable, other payables and accruals, bills payable, amounts due to related companies and interest-bearing loans and borrowings are initially stated at fair value less directly attributable transaction costs and are subsequently measured at amortised cost, using the effective interest method unless the effect of discounting would be immaterial, in which case they are stated at cost.

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

*Financial liabilities at fair value through profit or loss*

Financial liabilities at fair value through profit or loss include financial liabilities held for trading and financial liabilities designated upon initial recognition as at fair value through profit or loss.

Financial liabilities are classified as held for trading if they are acquired for the purpose of sale in the near term. Derivatives, including separated embedded derivatives, are also classified as held for trading unless they are designated as effective hedging instruments. Gains or losses on liabilities held for trading are recognised in the income statement.

Where a contract contains one or more embedded derivatives, the entire hybrid contract may be designated as a financial liability at fair value through profit or loss, except where the embedded derivative does not significantly modify the cash flows or it is clear that separation of the embedded derivative is prohibited.

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### Derecognition of financial assets and liabilities (Continued)

*Financial liabilities at fair value through profit or loss* (Continued)

Financial liabilities may be designated upon initial recognition as at fair value through profit or loss if the following criteria are met: (i) the designation eliminates or significantly reduces the inconsistent treatment that would otherwise arise from measuring the liabilities or recognising gains or losses on them on a different basis; (ii) the liabilities are part of a group of financial liabilities which are managed and their performance evaluated on a fair value basis, in accordance with a documented risk management strategy; or (iii) the financial liability contains an embedded derivative that would need to be separately recorded.

### Financial guarantee contracts

Financial guarantee contracts in the scope of IAS 39 are accounted for as financial liabilities. A financial guarantee contract is recognised initially at its fair value plus transaction costs that are directly attributable to the acquisition or issue of the financial guarantee contract, except when such contract is recognised at fair value through profit or loss. Subsequent to initial recognition, the Group measures the financial guarantee contract at the higher of: (i) the amount determined in accordance with IAS 37 *Provision, Contingent Liabilities and Contingent Assets*; and (ii) the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with IAS 18 *Revenue*.

### Derivative financial instruments and hedging

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

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

The fair value of such derivatives financial instruments is determined by reference to market values for similar instruments.

At the inception of a hedge relationship, the Group formally designates and documents the hedge relationship to which the Group wishes to apply hedge accounting, the risk management objective and its strategy for undertaking the hedge. The documentation includes identification of the hedging instrument, the hedged item or transaction, the nature of the risk being hedged and how the Group will assess the hedging instrument’s effectiveness in offsetting the exposure to changes in the hedged item’s fair value or cash flows attributable to the hedged risk. Such hedges are expected to be highly effective in achieving offsetting changes in fair value or cash flows and are assessed on an ongoing basis to determine that they actually have been highly effective throughout the financial reporting periods for which they were designated.

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### Derivative financial instruments and hedging (Continued)

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

- fair value hedges, when hedging the exposure to changes in the fair value of a recognised asset or liability or an unrecognised firm commitment (except for foreign currency risk); or

- cash flow hedges, when hedging exposure to variability in cash flows that is either attributable to a particular risk associated with a recognised asset or liability or a highly probable forecast transaction, or a foreign currency risk in an unrecognised firm commitment; or

- hedges of a net investment in a foreign operation.

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

*Fair value hedges*

The change in the fair value of a hedging derivative is recognised in the income statement. The change in the fair value of the hedged item attributable to the risk hedged is recorded as a part of the carrying amount of the hedged item and is also recognised in the income statement.

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

Amortisation may begin as soon as an adjustment exists and shall begin no later than when the hedged item ceases to be adjusted for changes in its fair value attributable to the risk being hedged. If the hedged item is derecognised, the unamortised fair value is recognised immediately in the income statement.

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

*Cash flow hedges*

The effective portion of the gain or loss on the hedging instrument is recognised directly in equity, while the ineffective portion is recognised immediately in the income statement.

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

If the forecast transaction or firm commitment is no longer expected to occur, amounts previously recognised in equity are transferred to the income statement. If the hedging instrument expires or is sold, terminated or exercised without replacement or rollover, or if its designation as a hedge is revoked, amounts previously recognised in equity will remain in equity until the forecast transaction or firm commitment occurs.

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### Derivative financial instruments and hedging (Continued)

*Hedges of a net investment*

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

### Treasury shares

Own equity instruments which are reacquired (treasury shares) are deducted from equity. No gain or loss is recognised in the income statement on the purchase, sale, issue or cancellation of the Group's own equity instruments.

### Inventories

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

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

### Cash and cash equivalents

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

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

### Manufacturers' credits

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

### Provisions

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

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### Employee benefits

*(a) Pension obligations*

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

*(b) Termination and early retirement benefits*

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

*(c) Housing benefits*

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

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

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

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

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### Maintenance and overhaul costs

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

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

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

### Frequent flyer programme

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

### Revenue recognition

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

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

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

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

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

Revenue is stated net of business tax.

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### Revenue recognition (Continued)

*(b) Sale of goods*

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

*(c) Interest income*

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

*(d) Dividend income*

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

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

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

### Government grants

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

### Income tax

*Current tax*

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

*Deferred tax*

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

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

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

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

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### Income tax (Continued)

*Deferred tax* (Continued)

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

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

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

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

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

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

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

### Borrowing costs

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

Where funds have been borrowed generally, and used for the purpose of obtaining qualifying assets, a capitalisation rate of ranging between 4.5% and 6% (2005: 4.5%) has been applied to the expenditure on the individual asset.

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

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### Dividends

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

Interim dividends are recognised immediately as a liability when they are proposed and declared.

### Significant accounting estimates

*Estimation uncertainty*

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

(a) Impairment of goodwill

The Group determines whether goodwill is impaired at least on an annual basis. This requires an estimation of the value in use of the cash-generating units to which the goodwill is allocated. Estimating the value in use requires the Group to make an estimate of the expected future cash flows from the cash-generating unit and also to choose a suitable discount rate in order to calculate the present value of those cash flows. The carrying amount of goodwill as at 31 December 2006 was RMB1,630 million (2005: RMB1,444 million). More details are given in note 20 to these financial statements.

(b) Deferred tax assets

Deferred tax assets are recognised for all unused tax losses to the extent that it is probable that taxable profit will be available against which the losses can be utilised. Significant management judgement is required to determine the amount of deferred tax assets that can be recognised, based upon the likely timing and level of future taxable profits together with future tax planning strategies. The carrying value of deferred tax assets relating to recognised tax losses as at 31 December 2006 was RMB16 million (2005: RMB10 million). The amount of unrecognised tax losses as at 31 December 2006 was RMB4 million (2005: RMB13 million). Further details are contained in note 23 to the financial statements.

## 3. SEGMENT INFORMATION

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

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

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

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

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

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

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

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

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

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

## 3. SEGMENT INFORMATION (Continued)

### Business segments

The following tables present revenue, profit and certain asset, liability and expenditure information for the Group's business segments for the years ended 31 December 2006 and 2005:

**Year ended 31 December 2006**

| | Airline operations *RMB'000* | Engineering services *RMB'000* | Airport terminal services *RMB'000* | Others *RMB'000* | Eliminations *RMB'000* | Total *RMB'000* |
|---|---|---|---|---|---|---|
| **REVENUE** | | | | | | |
| Sales to external customers | 43,708,683 | 481,021 | 496,741 | 250,161 | – | 44,936,606 |
| Intersegment sales | – | 620,302 | – | 186,000 | (806,302) | – |
| Total revenue | 43,708,683 | 1,101,323 | 496,741 | 436,161 | (806,302) | 44,936,606 |
| **PROFIT FROM OPERATIONS** | | | | | | |
| Segment results | 2,281,754 | 655,137 | 175,445 | 211,670 | (806,302) | 2,517,704 |
| Finance revenue | 1,161,287 | 9,456 | – | 7,128 | – | 1,177,871 |
| Finance costs | (1,863,002) | (11,606) | – | (1,879) | – | (1,876,487) |
| Gain on disposal of an associate | 1,592,633 | – | – | – | – | 1,592,633 |
| Share of profits and losses of associates | 365,639 | 4,797 | 135,169 | 11,895 | – | 517,500 |
| Profit before tax | 3,538,311 | 657,784 | 310,614 | 228,814 | (806,302) | 3,929,221 |
| Tax | | | | | | (624,124) |
| Minority interests | | | | | | (617,256) |
| Profit attributable to equity holders of the Company | | | | | | 2,687,841 |
| **ASSETS** | | | | | | |
| Segment assets | 73,567,864 | 1,126,923 | 136,643 | 872,875 | (1,546,400) | 74,157,905 |
| Interests in associates | 8,663,367 | 112,336 | 170,115 | 309,656 | – | 9,255,474 |
| Unallocated assets | | | | | | 550,222 |
| Total assets | | | | | | 83,963,601 |
| **LIABILITIES** | | | | | | |
| Segment liabilities | (51,130,149) | (639,936) | (475,015) | (994,935) | 1,546,400 | (51,693,635) |
| Unallocated liabilities | | | | | | (534,273) |
| Total liabilities | | | | | | (52,227,908) |
| **OTHER SEGMENT INFORMATION** | | | | | | |
| Capital expenditure (including additions to property, plant and equipment and advance payments for aircraft, and related related equipment) | 16,440,786 | 89,754 | 27,521 | 28,191 | – | 16,586,252 |
| Depreciation of property, plant and equipment | 5,223,438 | 41,834 | 1,017 | 7,744 | – | 5,274,033 |
| Amortisation of lease prepayments | 21,495 | – | – | – | – | 21,495 |
| Impairment loss on available-for-sale investments | – | – | – | 15,562 | – | 15,562 |
| Decrease in fair value of financial assets, net | 268,041 | – | – | – | – | 268,041 |
| Provision/(write-back of provision) for doubtful debts, net | 3,536 | (3,579) | – | (1,859) | – | (1,902) |
| Recognition of deferred income | 76,943 | – | – | – | – | 76,943 |

## 3. SEGMENT INFORMATION (Continued)

### Business segments (Continued)

Year ended 31 December 2005

| | Airline operations *RMB'000* | Engineering services *RMB'000* | Airport terminal services *RMB'000* | Others *RMB'000* | Eliminations *RMB'000* | Total *RMB'000* |
|---|---|---|---|---|---|---|
| **REVENUE** | | | | | | |
| Sales to external customers | 37,380,669 | 376,437 | 320,477 | 213,383 | – | 38,290,966 |
| Intersegment sales | – | 619,098 | – | 108,873 | (727,971) | – |
| Total revenue | 37,380,669 | 995,535 | 320,477 | 322,256 | (727,971) | 38,290,966 |
| **PROFIT FROM OPERATIONS** | | | | | | |
| Segment results | 3,367,949 | 772,877 | 123,679 | 137,282 | (727,971) | 3,673,816 |
| Finance revenue | 1,231,986 | 8,512 | 37 | 8,072 | – | 1,248,607 |
| Finance costs | (1,762,481) | (7,504) | (2,320) | (794) | – | (1,773,099) |
| Share of profits and losses of associates | 81,645 | (8,628) | 148,096 | 3,817 | – | 224,930 |
| Profit before tax | 2,919,099 | 765,257 | 269,492 | 148,377 | (727,971) | 3,374,254 |
| Tax | | | | | | (903,874) |
| Minority interests | | | | | | (64,124) |
| Profit attributable to equity holders of the Company | | | | | | 2,406,256 |
| **ASSETS** | | | | | | |
| Segment assets | 63,703,084 | 1,046,799 | 122,474 | 668,200 | (1,630,942) | 63,909,615 |
| Interests in associates | 3,312,608 | 18,700 | 192,084 | 270,565 | – | 3,793,957 |
| Unallocated assets | | | | | | 498,371 |
| Total assets | | | | | | 68,201,943 |
| **LIABILITIES** | | | | | | |
| Segment liabilities | (46,191,851) | (489,320) | (404,229) | (775,802) | 1,630,942 | (46,230,260) |
| Unallocated liabilities | | | | | | (421,077) |
| Total liabilities | | | | | | (46,651,337) |
| **OTHER SEGMENT INFORMATION** | | | | | | |
| Capital expenditure (including additions to property, plant and equipment and advance payments for aircraft, and related related equipment) | 13,222,058 | 37,219 | 855 | 30,836 | – | 13,290,968 |
| Depreciation of property, plant and equipment | 4,409,021 | 38,381 | 61,303 | 3,975 | – | 4,512,680 |
| Amortisation of lease prepayments | 19,555 | – | – | – | – | 19,555 |
| Increase in fair value of financial assets, net | 125,868 | – | – | – | – | 125,868 |
| Provision/(write-back of provision) for doubtful debts, net | 14,836 | 118 | - | (231) | – | 14,723 |
| Recognition of deferred income | 76,943 | – | – | – | – | 76,943 |

## 3. SEGMENT INFORMATION (Continued)

### Geographical segments

The following tables present the Group's consolidated revenue by geographical segment for the years ended 31 December 2006 and 2005:

**Year ended 31 December 2006**

| | Mainland China RMB'000 | Hong Kong and Macau RMB'000 | Europe RMB'000 | North America RMB'000 | Japan and Korea RMB'000 | Asia Pacific and others RMB'000 | Total RMB'000 |
|---|---|---|---|---|---|---|---|
| Sales to external customers and total revenue | **23,868,328** | **2,770,579** | **6,203,536** | **3,806,678** | **4,256,753** | **4,030,732** | **44,936,606** |

Year ended 31 December 2005

| | Mainland China RMB'000 | Hong Kong and Macau RMB'000 | Europe RMB'000 | North America RMB'000 | Japan and Korea RMB'000 | Asia Pacific and others RMB'000 | Total RMB'000 |
|---|---|---|---|---|---|---|---|
| Sales to external customers and total revenue | 20,490,055 | 2,269,256 | 5,081,774 | 2,964,247 | 4,250,255 | 3,235,379 | 38,290,966 |

## 4. AIR TRAFFIC REVENUE

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

| | Group 2006 RMB'000 | Group 2005 RMB'000 |
|---|---|---|
| Passenger | **37,564,903** | 31,584,426 |
| Cargo and mail | **4,041,227** | 3,716,400 |
| | **41,606,130** | 35,300,826 |

Pursuant to the relevant PRC business tax rules and regulations, air traffic revenue for all domestic and outbound international flights is subject to business tax at a rate of 3%. All inbound international, Hong Kong and Macau regional flights are exempted from business tax. Business tax incurred and set off against air traffic revenue for the years ended 31 December 2006 and 2005 amounted to approximately RMB1,039 million and RMB846 million, respectively.

## 5. OTHER OPERATING REVENUE

| | Group | |
|---|---|---|
| | **2006** | 2005 |
| | ***RMB'000*** | *RMB'000* |
| Bellyhold income from a joint venture *(note 48)* | **1,518,925** | 1,496,302 |
| Aircraft engineering income | **481,021** | 376,437 |
| Ground service income | **496,741** | 320,477 |
| Air catering income | **136,581** | 109,591 |
| Government grants: | | |
| Recognition of deferred income *(note 37)* | **76,943** | 76,943 |
| Others | **124,420** | 41,250 |
| Service charges on return of unused flight tickets | **110,825** | 97,951 |
| Cargo handling service income | **63,938** | 67,822 |
| Sale of materials | **15,055** | 11,899 |
| Import and export service income | **10,676** | 12,311 |
| Training service income | **17,839** | 19,029 |
| Aircraft and related equipment lease income | **1,323** | 7,072 |
| Gain on disposal of property, plant and equipment, net | **17,353** | 74,474 |
| Others | **258,836** | 278,582 |
| | **3,330,476** | 2,990,140 |

## 6. EMPLOYEE COMPENSATION COSTS

An analysis of the Group's employee compensation costs, including the emoluments of Directors and Supervisors, is as follows:

| | Group | |
|---|---|---|
| | **2006** | 2005 |
| | ***RMB'000*** | *RMB'000* |
| Wages, salaries and social security costs | **4,037,553** | 3,200,391 |
| Retirement benefit costs *(note 11)* | **276,330** | 206,434 |
| | **4,313,883** | 3,406,825 |

## 7. PROFIT FROM OPERATIONS

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

| | Group | |
|---|---|---|
| | **2006** | 2005 |
| | ***RMB'000*** | *RMB'000* |
| Auditors' remuneration | **10,658** | 11,029 |
| Depreciation *(note 16)* | **5,274,033** | 4,512,680 |
| Gain on disposal of property, plant and equipment, net | **(17,353)** | (74,474) |
| Loss on derecognition of property, plant and equipment | **70,206** | 430,010 |
| Amortisation of lease prepayments *(note 17)* | **21,495** | 19,555 |
| Minimum lease payments under operating leases: | | |
| Aircraft and engines | **2,069,639** | 1,530,754 |
| Land and buildings | **323,752** | 211,177 |
| Repair and maintenance costs | **2,556,487** | 2,078,382 |
| Impairment loss on available-for-sale investments | **15,562** | – |
| Provision/(write-back of provision) for doubtful debts, net | **(1,902)** | 14,723 |

## 8. FINANCE REVENUE AND FINANCE COSTS

An analysis of the Group's finance revenue and finance cost during the year is as follows:

### Finance revenue

| | Group | |
|---|---|---|
| | **2006** | 2005 |
| | ***RMB'000*** | *RMB'000* |
| Exchange gains, net | **983,692** | 918,297 |
| Interest income | **80,689** | 108,481 |
| Gains on fuel derivatives, net | **113,225** | 221,661 |
| Dividend income from available-for-sale investments | **265** | 168 |
| | **1,177,871** | 1,248,607 |

### Finance costs

| | Group | |
|---|---|---|
| | **2006** | 2005 |
| | ***RMB'000*** | *RMB'000* |
| Interest on bank loans, other loans and corporate bonds | **601,153** | 663,465 |
| Interest on finance leases | **1,380,781** | 1,128,943 |
| Total interest | **1,981,934** | 1,792,408 |
| Less: Interest capitalised | **(105,447)** | (19,309) |
| | **1,876,487** | 1,773,099 |

The interest capitalisation rates ranging from 4.5% to 6.0% (2005: at 4.5%) per annum represent the cost of related borrowings.

## 9. GAIN ON DISPOSAL OF AN ASSOCIATE

The gain on disposal of an associate relates to the sale of the Group's equity interest in Dragonair to Cathay, details of which are set out in note 1 and note 43(b).

## 10. REMUNERATION OF DIRECTORS, SUPERVISORS AND FIVE HIGHEST PAID EMPLOYEES

Remuneration of the Company's Directors and Supervisors for the year disclosed pursuant to the Rules Governing the Listing of Securities on the Stock Exchange and Section 161 of the Hong Kong Companies Ordinance is as follows:

| | Group | |
|---|---|---|
| | **2006** | 2005 |
| | ***RMB'000*** | *RMB'000* |
| Fees | **179** | 150 |
| Basic salaries, housing benefits, other allowances and benefits in kind | **4,561** | 4,443 |
| Discretionary bonuses | **1,674** | 787 |
| Retirement benefits | **94** | 69 |
| | **6,508** | 5,449 |

## 10. REMUNERATION OF DIRECTORS, SUPERVISORS AND FIVE HIGHEST PAID EMPLOYEES (Continued)

| | Fees<br>*RMB'000* | Basic salaries, housing benefits, other allowances and benefits in kind<br>*RMB'000* | Discretionary bonuses<br>*RMB'000* | Retirement benefits<br>*RMB'000* | Total<br>*RMB'000* |
|---|---|---|---|---|---|
| **Year ended 31 December 2006** | | | | | |
| **Directors** | | | | | |
| Li Jiaxiang | – | – | – | – | – |
| Kong Dong | – | 2,095 | – | – | 2,095 |
| Wang Shixiang | – | – | – | – | – |
| Yao Weiting | – | – | – | – | – |
| Christopher Dale Pratt | – | – | – | – | – |
| Ma Xulun | – | 121 | 543 | 19 | 683 |
| Cai Jianjiang | – | 121 | 504 | 19 | 644 |
| Fan Cheng | – | 113 | 441 | 19 | 573 |
| Hu Hung Lick, Henry | 50 | 138 | – | – | 188 |
| Wu Zhipan | 50 | – | – | – | 50 |
| Zhang Ke | 50 | – | – | – | 50 |
| Jia Kang | 29 | – | – | – | 29 |
| | 179 | 2,588 | 1,488 | 57 | 4,312 |
| **Supervisors** | | | | | |
| Zhang Xianlin | – | 1,739 | – | – | 1,739 |
| Liao Wei | – | – | – | – | – |
| Zhang Huilan | – | – | – | – | – |
| Liu Feng | – | 157 | 141 | 19 | 317 |
| Liu Guoqing | – | 77 | 45 | 18 | 140 |
| | – | 1,973 | 186 | 37 | 2,196 |
| | 179 | 4,561 | 1,674 | 94 | 6,508 |

## 10. REMUNERATION OF DIRECTORS, SUPERVISORS AND FIVE HIGHEST PAID EMPLOYEES (Continued)

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

Fees of approximately RMB179,000 (2005: RMB150,000) were paid or payable to the Company's independent Non-Executive Directors during the year. Except for allowances of RMB138,000 (2005: RMB63,000) paid to Dr. Hu Hung Lick, Henry, there were no other emolument payable to other independent non-executive Directors during the year.

An analysis of the five highest paid employees within the Group is as follows:

| | **Group** | |
|---|---|---|
| | **2006**<br>***Number of individuals*** | 2005<br>*Number of individuals* |
| Director | **1** | 1 |
| Supervisor | **1** | 1 |
| Employees | **3** | 3 |

## 10. REMUNERATION OF DIRECTORS, SUPERVISORS AND FIVE HIGHEST PAID EMPLOYEES (Continued)

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

| | Group | |
|---|---|---|
| | **2006** | 2005 |
| | ***RMB'000*** | *RMB'000* |
| Basic salaries, housing benefits, other allowances and benefits in kind | **4,274** | 4,729 |
| Retirement benefits | **428** | 216 |
| | **4,702** | 4,945 |

The remuneration of these three (2005: three) non-director and non-supervisor highest paid employees for the year fell within the following bands:

| | Group | |
|---|---|---|
| | **2006** | 2005 |
| | ***Number of individuals*** | *Number of individuals* |
| HK$1,000,001 to HK$1,500,000 (equivalent to 2006: RMB1,022,501 to RMB1,533,750; 2005: RMB1,051,701 to RMB1,575,550) | **2** | 2 |
| HK$1,500,001 to HK$2,000,000 (equivalent to 2006: RMB1,533,751 to RMB2,045,000; 2005: RMB1,575,551 to RMB2,103,400) | **1** | 1 |
| | **3** | 3 |

There was no arrangement under which a Director or a Supervisor waived or agreed to waive any remuneration during the year (2005: Nil).

## 11. RETIREMENT BENEFIT COSTS

All of the Group's full-time employees in Mainland China are covered by a government-regulated defined contribution retirement scheme, and are entitled to an annual pension determined by their basic salaries upon their retirement. The PRC government is responsible for the pension liabilities to these retired employees. The Group is required to make annual contributions to the government-regulated defined contribution retirement scheme at rates ranging from 15% to 20% (2005: 15% to 20%) of the employees' basic salaries during the year and has no further obligation for post-retirement benefits in respect of the above. The related pension costs are expensed as incurred. Contributions to other defined contribution retirement schemes operated by the Group are charged to the income statement in the year in which the contributions relate to.

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

The retirement benefit costs in relation to the defined contribution retirement scheme and the early retirement benefits are as follows:

| | Group | |
|---|---|---|
| | **2006** | 2005 |
| | ***RMB'000*** | *RMB'000* |
| Contributions to defined contribution retirement scheme | **264,274** | 202,535 |
| Early retirement benefit | **12,056** | 3,899 |
| Total retirement benefit costs | **276,330** | 206,434 |

Forfeited contributions totalling RMB1,407,000 (2005: RMB1,633,000) were utilised during the year. As at 31 December 2006, the Group had forfeited contributions totalling RMB164,000 (2005: Nil) available to reduce its contributions to the defined contribution retirement schemes operated by the Group in future years.

## 12. TAX

According to the PRC Enterprise Income Tax Law, the Company, its subsidiaries, joint ventures and associates established in the PRC are subject to enterprise income tax at rates ranging from 12% to 33% (2005: 15% to 33%) on their taxable income.

Hong Kong profits tax has been provided at a rate of 17.5% (2005: 17.5%) on the estimated assessable profits arising in Hong Kong during the year.

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

## 12. TAX (Continued)

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

| | Group | |
|---|---|---|
| | **2006** | 2005 |
| | ***RMB'000*** | *RMB'000* |
| Current income tax – Mainland China | **675,975** | 626,161 |
| Deferred income tax – origination and reversal of temporary differences *(note 23)* | **(51,851)** | 277,713 |
| Income tax charge for the year | **624,124** | 903,874 |

The share of tax attributable to associates amounting to RMB113,577,000 (2005: RMB33,640,000) is included in the "Share of profit and losses of associates" on the face of the consolidated income statement.

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

| | Group | | | |
|---|---|---|---|---|
| | **2006** | | 2005 | |
| | ***RMB'000*** | **%** | *RMB'000* | % |
| Profit before tax | **3,929,221** | | 3,374,254 | |
| At statutory income tax rate of 33% | **1,296,643** | **33.0** | 1,113,504 | 33.0 |
| Tax effect of share of profits and losses of associates, net | **(170,775)** | **(4.3)** | (74,227) | (2.2) |
| Lower income tax rates of other territories | **(20,718)** | **(0.5)** | (15,024) | (0.4) |
| Tax exemption | **–** | **–** | (49,558) | (1.5) |
| Income not subject to tax | **(614,323)** | **(15.6)** | (115,131) | (3.4) |
| Expenses not deductible for tax purposes | **125,004** | **3.2** | 26,941 | 0.8 |
| Tax losses not recognised | **8,293** | **0.2** | 12,537 | 0.4 |
| Effect on opening deferred income tax assets due to decrease in other territories' income tax rates | **–** | **–** | 4,832 | 0.1 |
| At the Group's effective income tax rate | **624,124** | **16.0** | 903,874 | 26.8 |

As at 31 December 2006, there was no significant unrecognised deferred tax liability (2005: Nil) for taxes that would be payable on the unremitted earnings of certain of the Group's subsidiaries and joint ventures as the Directors of the Company have no intention to request remittance of any significant amount of earnings to the Company in the foreseeable future.

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

## 13. PROFIT ATTRIBUTABLE TO EQUITY HOLDERS OF THE COMPANY

The consolidated profit attributable to the equity holders of the Company for the year ended 31 December 2006 includes a profit of approximately RMB1,226 million (2005: RMB1,978 million), which was arrived at after deducting dividend income received from subsidiaries, joint ventures and associates aggregating approximately RMB39 million (2005: RMB135 million) from the Company's profit of approximately RMB1,265 million (2005: RMB2,113 million), that has been dealt with in the financial statements of the Company (note 40).

## 14. APPROPRIATIONS

| | Company | |
|---|---|---|
| | **2006** | 2005 |
| | ***RMB'000*** | *RMB'000* |
| Proposed final dividend – RMB0.492 (2005: RMB0.2383) per 10 shares | **602,767** | 224,793 |

(a) The proposed final dividend of RMB0.492 (2005: RMB0.2383) per 10 shares for the year is subject to the approval of the Company's shareholders at the forthcoming annual general meeting.

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

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

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

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

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

(iii) In the prior year, allocations of 5% to 10% of after-tax profit, as determined under PRC Accounting Standards and Regulations, to the Company's statutory public welfare fund, which was established for the purpose of providing for the Company's employees collective welfare benefits such as the construction of dormitories, canteens and other staff welfare facilities. The fund forms part of the shareholders' equity as only individual employees can use these facilities, while the title of such facilities is held by the Company. The transfer to this fund was made before any distribution of dividends to shareholders. Pursuant to the relevant PRC regulations, the appropriation of public welfare fund was discontinued with effect from 1 January 2006; and

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

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

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

## 15. EARNINGS PER SHARE ATTRIBUTABLE TO EQUITY HOLDERS OF THE COMPANY

The calculation of basic earnings per share for the year ended 31 December 2006 is based on the profit attributable to equity holders of the Company for the year ended 31 December 2006 of approximately RMB2,688 million, and the weighted average number of 10,256,259,793 ordinary shares in issue during the year, as adjusted to reflect the new issue of 1,639,000,000 A shares and 1,179,151,364 H shares during the year (note 38 (a) and (b)) and the effect of reciprocal shareholding with Cathay (note 39).

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

Diluted earnings per share for the years ended 31 December 2006 and 2005 have not been disclosed because no diluting events existed during these years.

## 16. PROPERTY, PLANT AND EQUIPMENT

### Group

| | Aircraft and flight equipment RMB'000 | Buildings RMB'000 | Machinery RMB'000 | Transportation equipment RMB'000 | Office equipment RMB'000 | Construction in progress RMB'000 | Total RMB'000 |
|---|---|---|---|---|---|---|---|
| As at 1 January 2005, net of accumulated depreciation | 38,718,863 | 2,684,860 | 963,467 | 315,542 | 92,055 | 666,850 | 43,441,637 |
| Additions | 7,185,603 | 10,022 | 112,533 | 72,122 | 32,270 | 1,394,017 | 8,806,567 |
| Disposals | (469,378) | (44,861) | (4,542) | (15,975) | (273) | – | (535,029) |
| Transfer from construction in progress | 467,440 | 71,898 | 67,571 | 5,147 | 22,724 | (634,780) | – |
| Exchange adjustment | (6,542) | (1,826) | – | (1,399) | – | – | (9,767) |
| Depreciation charge for the year | (4,128,357) | (147,542) | (156,489) | (56,501) | (23,791) | – | (4,512,680) |
| As at 31 December 2005 and 1 January 2006, net of accumulated depreciation | 41,767,629 | 2,572,551 | 982,540 | 318,936 | 122,985 | 1,426,087 | 47,190,728 |
| Additions | 10,507,612 | 20,333 | 96,578 | 117,456 | 54,354 | 2,453,470 | 13,249,803 |
| Disposals | (335,251) | (30,208) | (12,416) | (10,393) | (2,336) | – | (390,604) |
| Transfer from construction in progress | 1,241,246 | 222,893 | 65,434 | 131,257 | 296 | (1,661,126) | – |
| Exchange adjustment | (5,846) | (1,608) | – | (776) | – | – | (8,230) |
| Depreciation charge for the year | (4,837,545) | (125,234) | (176,362) | (92,940) | (41,952) | – | (5,274,033) |
| As at 31 December 2006, net of accumulated depreciation | 48,337,845 | 2,658,727 | 955,774 | 463,540 | 133,347 | 2,218,431 | 54,767,664 |
| As at 31 December 2005 and 1 January 2006 | | | | | | | |
| Cost | 70,705,988 | 3,698,597 | 2,192,095 | 1,076,728 | 276,239 | 1,426,087 | 79,375,734 |
| Accumulated depreciation | (28,938,359) | (1,126,046) | (1,209,555) | (757,792) | (153,254) | – | (32,185,006) |
| Net book value | 41,767,629 | 2,572,551 | 982,540 | 318,936 | 122,985 | 1,426,087 | 47,190,728 |
| As at 31 December 2006 | | | | | | | |
| Cost | 81,308,583 | 3,873,170 | 2,310,773 | 1,265,628 | 318,382 | 2,218,431 | 91,294,967 |
| Accumulated depreciation | (32,970,738) | (1,214,443) | (1,354,999) | (802,088) | (185,035) | – | (36,527,303) |
| Net book value | 48,337,845 | 2,658,727 | 955,774 | 463,540 | 133,347 | 2,218,431 | 54,767,664 |

## 16. PROPERTY, PLANT AND EQUIPMENT (Continued)

### Company

| | Aircraft and flight equipment RMB'000 | Buildings RMB'000 | Machinery RMB'000 | Transportation equipment RMB'000 | Office equipment RMB'000 | Construction in progress RMB'000 | Total RMB'000 |
|---|---|---|---|---|---|---|---|
| As at 1 January 2005, net of accumulated depreciation | 38,154,296 | 2,055,172 | 767,849 | 204,132 | 72,731 | 654,248 | 41,908,428 |
| Additions | 6,444,967 | 2,209 | 85,229 | 46,376 | 20,404 | 1,347,614 | 7,946,799 |
| Disposals | (460,726) | (39,100) | (1,898) | (15,096) | (197) | – | (517,017) |
| Transfer from construction in progress | 467,440 | 63,320 | 57,033 | 5,147 | 22,706 | (615,646) | – |
| Depreciation charge for the year | (3,997,538) | (130,020) | (129,145) | (36,615) | (19,429) | – | (4,312,747) |
| As at 31 December 2005 and 1 January 2006, net of accumulated depreciation | 40,608,439 | 1,951,581 | 779,068 | 203,944 | 96,215 | 1,386,216 | 45,025,463 |
| Additions | 9,792,550 | 12,631 | 60,439 | 82,326 | 43,139 | 2,358,575 | 12,349,660 |
| Disposals | (328,114) | (27,310) | (3,134) | (3,303) | (2,133) | – | (363,994) |
| Transfer from construction in progress | 1,231,652 | 168,976 | 57,168 | 122,504 | 296 | (1,580,596) | – |
| Depreciation charge for the year | (4,664,092) | (90,451) | (137,759) | (62,901) | (34,051) | – | (4,989,254) |
| As at 31 December 2006, net of accumulated depreciation | 46,640,435 | 2,015,427 | 755,782 | 342,570 | 103,466 | 2,164,195 | 52,021,875 |
| As at 31 December 2005 and 1 January 2006 | | | | | | | |
| Cost | 68,020,677 | 2,839,822 | 1,649,825 | 823,159 | 172,910 | 1,386,216 | 74,892,609 |
| Accumulated depreciation | (27,412,238) | (888,241) | (870,757) | (619,215) | (76,695) | – | (29,867,146) |
| Net book value | 40,608,439 | 1,951,581 | 779,068 | 203,944 | 96,215 | 1,386,216 | 45,025,463 |
| As at 31 December 2006 | | | | | | | |
| Cost | 77,931,225 | 2,961,806 | 1,749,995 | 993,787 | 205,304 | 2,164,195 | 86,006,312 |
| Accumulated depreciation | (31,290,790) | (946,379) | (994,213) | (651,217) | (101,838) | – | (33,984,437) |
| Net book value | 46,640,435 | 2,015,427 | 755,782 | 342,570 | 103,466 | 2,164,195 | 52,021,875 |

As at 31 December 2006, certain of the Group's aircraft and buildings with an aggregate net book value of approximately RMB17,625 million (2005: RMB16,471 million) were pledged to secure certain bank loans of the Group (note 34(a)).

The aggregate net book value of aircraft held under finance leases included in the property, plant and equipment of the Group amounted to RMB16,589 million (2005: RMB10,487 million) (note 33(a)).

As at 31 December 2006, the Group was in the process of applying for the title certificates of certain of its buildings with an aggregate net book value of approximately RMB131 million (2005: RMB270 million) transferred from Air China International Corporation, the predecessor of the Company, upon incorporation of the Company. The Group was also in the process of applying for title certificates of certain buildings acquired by the Group after incorporation with an aggregate net book value of approximately RMB178 million (2005: Nil). The Directors of the Company are of the view that the Group is entitled to lawfully and validly occupy and use the above-mentioned buildings. The Directors of the Company are also of the opinion that the aforesaid matter did not have any significant impact on the Group's financial position as at 31 December 2006.

## 17. LEASE PREPAYMENTS

| | Group | | Company | |
|---|---|---|---|---|
| | **2006** | 2005 | **2006** | 2005 |
| | ***RMB'000*** | *RMB'000* | ***RMB'000*** | *RMB'000* |
| **Cost** | | | | |
| As at 1 January | **1,096,715** | 938,992 | **1,076,850** | 924,895 |
| Additions | **57,334** | 157,723 | **54,860** | 151,955 |
| Disposal | **(97,491)** | – | **(97,491)** | – |
| As at 31 December | **1,056,558** | 1,096,715 | **1,034,219** | 1,076,850 |
| **Accumulated amortisation** | | | | |
| As at 1 January | **24,649** | 5,094 | **24,357** | 5,024 |
| Amortisation for the year | **21,495** | 19,555 | **21,093** | 19,333 |
| Disposal | **(3,115)** | – | **(3,115)** | – |
| As at 31 December | **43,029** | 24,649 | **42,335** | 24,357 |
| **Net book value** | | | | |
| As at 31 December | **1,013,529** | 1,072,066 | **991,884** | 1,052,493 |

As at 31 December 2006, certain of the Group's land use rights, which are accounted for as lease prepayments in the Group's consolidated financial statements, with an aggregate net book value of approximately RMB37 million (2005: Nil) were pledged to secure certain of the Group's bank loans (note 34(a)).

As at 31 December 2006, the Group was in the process of applying for the title certificates of certain land use rights acquired by the Group after incorporation with an aggregate net book value of approximately RMB51 million (2005: RMB Nil). The Directors of the Company are of the view that the Group is entitled to lawfully and validly occupy and use the above-mentioned land use rights. The Directors of the Company are of the opinion that the aforesaid matter did not have any significant impact on the Group's financial position as at 31 December 2006.

## 18. INTERESTS IN SUBSIDIARIES

| | Company | |
|---|---|---|
| | **2006** | 2005 |
| | ***RMB'000*** | *RMB'000* |
| Listed shares in Hong Kong, at cost | **579,472** | 579,472 |
| Unlisted investments, at cost | **5,600,895** | 137,707 |
| Due from subsidiaries | **55,080** | 11,519 |
| Due to subsidiaries | **(499,087)** | (588,623) |
| | **5,736,360** | 140,075 |
| Market value of listed shares | **6,325,255** | 3,580,957 |

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

As at 31 December 2005, the Group was in the process of completing the registration of its equity interests in certain subsidiaries with an aggregate investment cost of approximately RMB504,000 transferred from Air China International Corporation. The registration of such equity interest was completed in the current year.

## 18. INTERESTS IN SUBSIDIARIES (Continued)

Particulars of the principal subsidiaries at 31 December 2006 are as follows:

| Company name | Place of incorporation/ registration and operations | Legal status | Nominal value of paid-up capital (in thousands) | Percentage of equity interests attributable to the Company Direct | Percentage of equity interests attributable to the Company Indirect | Principal activities |
|---|---|---|---|---|---|---|
| CNAC (中航興業有限公司) | Hong Kong | Limited liability company | HK$331,268 | 69 | – | Investment holding |
| Air Macau Company Limited ("Air Macau")* (澳門航空股份有限公司) | Macau | Limited liability company | MOP400,000 | – | 35 | Airline operator |
| Air China Group Import and Export Trading Co. ("AIE") (國航集團進出口貿易公司) | PRC/ Mainland China | Limited liability company | RMB95,081 | 100 | – | Import and export trading |
| Zhejiang Air Services Co., Ltd.# (浙江航空服務有限公司) | PRC/ Mainland China | Limited liability company | RMB20,000 | 100 | – | Provision of airline catering and shuttle bus services |
| Beijing Aviation Passenger Services Corporation** (北京航空旅客服務公司) | PRC/ Mainland China | Limited liability company | RMB3,000 | 100 | – | Provision of passenger transportation services |
| Air China Shantou Industrial Development Company (中國國際航空汕頭實業發展公司) | PRC/ Mainland China | Limited liability company | RMB18,000 | 51 | – | Manufacture and retail of aircraft supplies |
| China National Aviation Air Passenger and Cargo Services Agency Company** (中國民航客貨運輸銷售代理公司) | PRC/ Mainland China | Limited liability company | RMB6,980 | 100 | – | Provision of travel agency and freight forwarding services |
| Beijing Air China Engineering Technology Development Centre ** (北京國航工程技術發展中心) | PRC/ Mainland China | Limited liability company | RMB1,500 | 100 | – | Provision of engineering consultancy services |
| Beijing Civil Aviation Blue Sky Air Travel Services Company** (北京民航藍天空運服務公司) | PRC/ Mainland China | Limited liability company | RMB5,533 | 100 | – | Provision of air ticketing services |

## 18. INTERESTS IN SUBSIDIARIES (Continued)

| Company name | Place of incorporation/ registration and operations | Legal status | Nominal value of paid-up capital (in thousands) | Percentage of equity interests attributable to the Company Direct | Indirect | Principal activities |
|---|---|---|---|---|---|---|
| Air China Development Corporation (Hong Kong) Limited (國航香港發展有限公司) | Hong Kong | Limited liability company | HK$500 | 95 | – | Provision of air ticketing services |
| Shanghai Air China Base Development Centre# (上海國航基地開發中心) | PRC/ Mainland China | Limited liability company | RMB2,000 | 100 | – | Provision of ground services, air passenger, cargo and consultancy services |
| Beijing Gold Phoenix Labour Services Co., Ltd.# (北京金鳳凰人才交流有限責任公司) | PRC/ Mainland China | Limited liability company | RMB1,700 | 100 | – | Provision of labour services |
| Total Transform Group Limited (國航海外控股有限公司) | British Virgin Islands/ Hong Kong | Limited liability company | HK$5,391,072 | 99.9 | – | Investment holding |
| Angel Paradise Limited * | British Virgin Islands/ Hong Kong | Limited liability company | US$10 | – | 69 | Investment holding |

* Air Macau and Angel Paradise Limited are 51%-owned and 100%-owned by CNAC, respectively.

** These subsidiaries became dormant during the current year and were in the process of deregistration as at 31 December 2006.

\# The English names are direct translations of the Chinese names of these companies.

The above table lists the subsidiaries of the Company which, in the opinion of the Directors, principally affected the results for the year ended 31 December 2006 or formed a substantial portion of the net assets of the Group at 31 December 2006. To give details of other subsidiaries would, in the opinion of the Directors, result in particulars of excessive length.

## 19. INTERESTS IN JOINT VENTURES

| | Company 2006 RMB'000 | Company 2005 RMB'000 |
|---|---|---|
| Unlisted investments, at cost | **1,403,788** | 1,398,595 |

Particulars of the joint ventures of the Group at 31 December 2006 are as follows:

| Company name | Place of incorporation/ Registration and operations | Legal status | Nominal value of paid-up capital (in thousands) | Percentage of equity interests attributable to the Group Direct | Percentage of equity interests attributable to the Group Indirect | Principal activities |
|---|---|---|---|---|---|---|
| Aircraft Maintenance and Engineering Corporation, Beijing (北京飛機維修工程有限公司) | PRC/ Mainland China | Limited liability company | US$137,533 | 60 | – | Provision of aircraft overhaul and maintenance services |
| Air China Cargo (中國國際貨運航空有限公司) | PRC/ Mainland China | Limited liability company | RMB2,200,000 | 51 | – | Provision of cargo carriage services |
| Beijing Air Catering Co., Ltd.* (北京航空食品有限公司) | PRC/ Mainland China | Limited liability company | US$8,000 | – | 41 | Provision of airline catering services |
| Southwest Air Catering Co., Ltd.* (西南航空食品有限公司) | PRC/ Mainland China | Limited liability company | RMB70,000 | – | 41 | Provision of airline catering services |
| Macau Asia Express Limited** | Macau | Limited liability company | MOP100,000 | – | 30 | Airline operator |

* Beijing Air Catering Co., Ltd. and Southwest Air Catering Co., Ltd. are both 60%-owned joint ventures of CNAC.

** Macau Asia Express Limited is a 43%-owned joint venture of CNAC.

## 19. INTERESTS IN JOINT VENTURES (Continued)

As at the balance sheet date and for the two years ended 31 December 2006, the Group's proportionate share of the assets, liabilities, and the Group's proportionate share of the revenue and expenses of the joint ventures are as follows:

| | Group | |
|---|---|---|
| | **2006** | 2005 |
| | ***RMB'000*** | *RMB'000* |
| Current assets | **1,647,132** | 1,654,865 |
| Non-current assets | **2,835,754** | 2,147,711 |
| Total assets | **4,482,886** | 3,802,576 |
| Current liabilities | **(1,546,322)** | (1,349,440) |
| Non-current liabilities | **(571,646)** | (444,475) |
| Net assets attributable to the Group | **2,364,918** | 2,008,661 |
| Revenue | **5,001,632** | 4,248,167 |
| Operating expenses | **(4,798,109)** | (3,929,313) |
| Finance revenue | **25,876** | 10,616 |
| Finance costs | **(44,121)** | (25,460) |
| Profit before tax | **185,278** | 304,010 |
| Tax | **(80,541)** | (35,767) |
| Profit attributable to the Group | **104,737** | 268,243 |

## 20. INTERESTS IN ASSOCIATES

| | Group | | Company | |
|---|---|---|---|---|
| | **2006** | 2005 | **2006** | 2005 |
| | ***RMB'000*** | *RMB'000* | ***RMB'000*** | *RMB'000* |
| Listed shares in Mainland China, at cost | **–** | – | **163,477** | 163,477 |
| Unlisted investments, at cost | **–** | – | **717,523** | 673,879 |
| Share of net assets | **7,569,781** | 2,382,547 | **–** | – |
| Goodwill | **1,630,205** | 1,444,367 | **–** | – |
| Due from associates | **144,914** | 62,948 | **21,784** | 15,419 |
| Due to associates | **(89,426)** | (95,905) | **(105,818)** | (129,410) |
| | **9,255,474** | 3,793,957 | **796,966** | 723,365 |
| Market value of listed shares | | | **185,136** | 124,032 |

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

As at 31 December 2006, certain number of listed shares in an associate of the Group with an aggregate market value of approximately RMB7,695 million (2005: Nil) were pledged to secure certain bank loans of the Group (note 34(b)).

## 20. INTERESTS IN ASSOCIATES (Continued)

As at 31 December 2006, the Group was in the process of completing the registration of its equity interests in certain associates with an aggregate investment cost of approximately RMB96 million (2005: RMB101 million) transferred from Air China International Corporation upon the incorporation of the Company. The Directors of the Company are of the view that the aforesaid matter did not have any significant impact on the Group's ownership in those equity interests and hence the Group's financial position as at 31 December 2006.

Particulars of the associates as at 31 December 2006 are as follows:

| Company name | Place of incorporation/ registration and operations | Nominal value of registered/ issued share capital | Percentage of equity interests attributable to the Group | Principal activities |
|---|---|---|---|---|
| Cathay* (國泰航空有限公司) | Hong Kong | HK$787,139,514 | 17.5 | Airline operator |
| Shenzhen Airlines Co., Ltd. (深圳航空有限責任公司) | PRC/ Mainland China | RMB300,000,000 | 25 | Airline operator |
| Shandong Aviation Group Corporation ("Shandong Aviation") (山東航空集團有限公司) | PRC/ Mainland China | RMB580,000,000 | 48 | Investment holding |
| Shandong Airlines Co., Ltd. ("Shandong Airlines") (山東航空股份有限公司) | PRC/ Mainland China | RMB400,000,000 | 22.8 | Airline operator |
| Sichuan SNECMA Aeroengine Maintenance Co., Ltd. ("SNECMA") (四川斯奈克瑪航空發動機維修有限公司) | PRC/ Mainland China | US$31,900,000 | 43.6 | Provision of maintenance and repair services for aircraft engines |
| Chengdu Falcon Aircraft Engineering Service Co., Ltd. (成都富凱飛機工程服務有限公司) | PRC/ Mainland China | RMB16,474,293 | 35.6 | Provision of maintenance and repair services for aircraft engines |
| Yunnan Airport Aircraft Maintenance Services Co., Ltd. (雲南空港飛機維修服務公司) | PRC/ Mainland China | RMB10,000,000 | 40 | Provision of maintenance and repair services |
| Macau Aircraft Repair and Conversion Company Limited# (澳門飛機維修工程有限公司) | Macau | MOP100,000 | 17.3 | Provision of aircraft repair and conversion services |
| Jardine Airport Services Limited# (怡中航空服務有限公司) | Hong Kong | HK$10,000 | 34.5 | Provision of airport ground handling services |

## 20. INTERESTS IN ASSOCIATES (Continued)

| Company name | Place of incorporation/ registration and operations | Nominal value of registered/ issued share capital | Percentage of equity interests attributable to the Group | Principal activities |
|---|---|---|---|---|
| Menzies Macau Airport Services Limited# (明捷澳門機場服務有限公司) | Macau | MOP10,000,000 | 23.2 | Provision of airport ground handling services |
| Guangzhou Baiyun International Airport Ground Handling Service Company Limited (廣州白雲國際機場地勤服務有限公司) | PRC/ Mainland China | RMB100,000,000 | 21 | Provision of airport ground handling services |
| Sanya World Trade Development Company Limited***## (三亞世貿發展有限公司) | PRC/ Mainland China | RMB5,000,000 | 40 | Provision of airport ground handling services |
| CAAC Data Communications Co., Ltd. (民航數據通信有限責任公司) | PRC/ Mainland China | RMB10,800,000 | 23.2 | Provision of aviation data communication services |
| CAAC Cares Chongqing Co., Ltd. (重慶民航凱亞信息技術有限公司) | PRC/ Mainland China | RMB9,800,000 | 24.5 | Provision of airline-related information system services |
| Chengdu CAAC Southwest Cares Co., Ltd.## (成都民航西南凱亞有限責任公司) | PRC/ Mainland China | RMB2,000,000 | 35 | Provision of airline-related information system services |
| Tradeport Hong Kong Limited# (香港商貿港有限公司) | Hong Kong | HK$400 | 17.3 | Development and operation of a logistics centre |
| LSG Lufthansa Service Hong Kong Limited ("LSGHK")# (德國漢莎航空膳食服務(香港)有限公司) | Hong Kong | HK$501 | 13.9 | Provision of airline catering services |
| China National Aviation Finance Co., Ltd. ("CNAF")** (中國航空集團財務有限責任公司) | PRC/ Mainland China | RMB505,269,500 | 23.5 | Provision of financial services |

* 17.5% of the Group's equity interest in Cathay is held indirectly through two subsidiaries of the Company.

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

*** This associate became dormant during the current year and was in the process of deregistration as at 31 December 2006.

\# The shareholding interests of these associates are held indirectly through subsidiaries of the Company.

\#\# The English names are direct translations of the Chinese names of these companies.

## 20. INTERESTS IN ASSOCIATES (Continued)

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

| | Group | |
|---|---|---|
| | **2006** | 2005 |
| | ***RMB'000*** | *RMB'000* |
| Aggregate of associates' financial position: | | |
| Total assets | **129,330,489** | 32,096,859 |
| Total liabilities | **(79,777,602)** | (25,497,576) |
| Aggregate of associates' results: | | |
| Revenue | **35,150,157** | 21,026,538 |
| Net profit | **2,102,744** | 745,230 |
| Share of profits and losses after tax of associates: | | |
| Cathay | **227,609** | – |
| Dragonair | **18,679** | 139,824 |
| Others | **271,212** | 85,106 |
| | **517,500** | 224,930 |

Movements of goodwill are as follows:

| | Group | |
|---|---|---|
| | **2006** | 2005 |
| | ***RMB'000*** | *RMB'000* |
| Goodwill at beginning of year | **1,444,367** | 1,404,966 |
| Adjustment to opening goodwill *(note 20(a))* | **–** | 40,445 |
| Additions *(note 20(b))* | **1,393,370** | – |
| Disposal *(note 20(c))* | **(1,205,390)** | – |
| Exchange realignment | **(2,142)** | (1,044) |
| Goodwill at end of year | **1,630,205** | 1,444,367 |

*Notes:*

(a) During 2005, Shandong Aviation and Shandong Airlines restated their retained earnings as at 31 December 2004 and as such the goodwill, being calculated as the excess of the cost of the business combination over the Group's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities of Shandong Aviation and Shandong Airlines arising on the acquisitions of shareholding interests in these two companies, were adjusted accordingly.

(b) The goodwill arising in the current year mainly relates to the acquisition of the 17.5% equity interest in Cathay.

(c) Goodwill arising from the acquisition of Dragonair in previous years was disposed of upon the sale of the Group's entire interest in Dragonair to Cathay during the year.

## 20. INTERESTS IN ASSOCIATES (Continued)

### Impairment testing of goodwill attributable to Cathay, Shandong Airlines and Shandong Aviation

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

The recoverable amount of Cathay, Shandong Airlines and Shandong Aviation has been determined based on a value in use calculation. To calculate this, cash flow projections are based on financial budgets approved by management covering a one-year period. The discount rate applied to the cash flow projections beyond the one-year period is 5.5% (2005: 5.0%). No growth has been projected beyond the one-year period.

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

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

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

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

## 21. LONG TERM RECEIVABLE FROM ULTIMATE HOLDING COMPANY

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

## 22. AVAILABLE-FOR-SALE INVESTMENTS

Available-for-sale investments consist of unlisted equity investments measured at cost.

## 23. DEFERRED TAX ASSETS

The movements in deferred tax assets during the year are as follows:

| | Group | | Company | |
|---|---|---|---|---|
| | **2006** | 2005 | **2006** | 2005 |
| | ***RMB'000*** | *RMB'000* | ***RMB'000*** | *RMB'000* |
| Balance at beginning of year | **498,371** | 776,084 | **391,000** | 658,000 |
| Charge for the year *(note 12)* | **51,851** | (277,713) | **104,000** | (267,000) |
| Balance at end of year | **550,222** | 498,371 | **495,000** | 391,000 |

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

| | Group | | Company | |
|---|---|---|---|---|
| | **2006** | 2005 | **2006** | 2005 |
| | ***RMB'000*** | *RMB'000* | ***RMB'000*** | *RMB'000* |
| Deferred income tax liabilities: | | | | |
| Accelerated depreciation for tax purposes | **(455,935)** | (447,186) | **(444,633)** | (456,000) |
| Other deferred income tax liabilities | **(58,000)** | (72,000) | **(58,000)** | (72,000) |
| Gross deferred income tax liabilities | **(513,935)** | (519,186) | **(502,633)** | (528,000) |
| Deferred income tax assets: | | | | |
| Additional tax deduction on revaluation surplus arising from the Restructuring | **351,946** | 528,000 | **312,946** | 434,000 |
| Provisions and accruals | **507,309** | 341,070 | **495,687** | 329,000 |
| Losses available for offset against future taxable income | **15,902** | 10,487 | **–** | – |
| Other deferred income tax assets | **189,000** | 138,000 | **189,000** | 156,000 |
| Gross deferred income tax assets | **1,064,157** | 1,017,557 | **997,633** | 919,000 |
| Net deferred income tax assets | **550,222** | 498,371 | **495,000** | 391,000 |

There was no material unprovided deferred income tax during the year (2005: Nil).

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

## 24. INVENTORIES

An analysis of the inventories as at the balance sheet date is as follows:

| | Group | | Company | |
|---|---|---|---|---|
| | **2006** | 2005 | **2006** | 2005 |
| | ***RMB'000*** | *RMB'000* | ***RMB'000*** | *RMB'000* |
| Flight equipment spare parts | **894,678** | 745,411 | **612,457** | 516,320 |
| Work in progress | **88,419** | 72,664 | **1,499** | 3,586 |
| Catering supplies | **32,169** | 33,240 | **26,932** | 21,547 |
| | **1,015,266** | 851,315 | **640,888** | 541,453 |

## 25. ACCOUNTS RECEIVABLE

The Group normally allows a credit period ranging from 30 to 90 days to its sales agents and other customers. An aged analysis of the accounts receivable as at the balance sheet date, net of provision for doubtful debts, is as follows:

| | Group | | Company | |
|---|---|---|---|---|
| | **2006** | 2005 | **2006** | 2005 |
| | ***RMB'000*** | *RMB'000* | ***RMB'000*** | *RMB'000* |
| Within 30 days | **2,169,345** | 1,770,628 | **1,718,214** | 1,511,371 |
| 31 to 60 days | **361,524** | 458,454 | **377,219** | 503,590 |
| 61 to 90 days | **129,790** | 177,587 | **194,719** | 245,168 |
| Over 90 days | **174,568** | 357,806 | **81,715** | 257,255 |
| | **2,835,227** | 2,764,475 | **2,371,867** | 2,517,384 |

Included in the accounts receivable as at the balance sheet date is the following amount due from a joint venture:

| | Group | | Company | |
|---|---|---|---|---|
| | **2006** | 2005 | **2006** | 2005 |
| | ***RMB'000*** | *RMB'000* | ***RMB'000*** | *RMB'000* |
| Joint venture | **332,811** | 451,965 | **679,206** | 922,378 |

## 26. PREPAYMENTS, DEPOSITS AND OTHER RECEIVABLES

An analysis of prepayments, deposits and other receivables as at the balance sheet date is as follows:

| | Group | | Company | |
|---|---|---|---|---|
| | **2006** | 2005 | **2006** | 2005 |
| | ***RMB'000*** | *RMB'000* | ***RMB'000*** | *RMB'000* |
| Advances and others | **620,323** | 457,568 | **457,736** | 379,258 |
| Manufacturers' credits on aircraft acquisition receivables | **109,296** | 62,930 | **48,235** | 62,930 |
| Prepaid aircraft operating lease rentals | **163,059** | 110,472 | **163,059** | 91,608 |
| Receivables from the sale of staff quarters | **2,269** | 4,333 | **–** | 4,333 |
| Miscellaneous deposits | **182,089** | 127,132 | **173,669** | 113,649 |
| | **1,077,036** | 762,435 | **842,699** | 651,778 |

## 27. DEPOSITS AND CASH AND CASH EQUIVALENTS

| | Group | | Company | |
|---|---|---|---|---|
| | **2006** | 2005 | **2006** | 2005 |
| | ***RMB'000*** | *RMB'000* | ***RMB'000*** | *RMB'000* |
| Cash and bank balances | **1,280,406** | 1,092,900 | **394,880** | 439,803 |
| Cash placed with CNAF | **200,242** | 67,567 | **129,516** | 37,570 |
| | **1,480,648** | 1,160,467 | **524,396** | 477,373 |
| Time deposits placed with banks | **3,890,037** | 958,573 | **2,478,176** | 141,677 |
| Time deposits placed with CNAF | **–** | 403,296 | **–** | 377,796 |
| | **3,890,037** | 1,361,869 | **2,478,176** | 519,473 |
| Less: Pledged deposits against: | | | | |
| Bank loans *(note 34(c))* | **78,195** | 81,598 | **78,195** | 81,598 |
| Aircraft operating leases and financial derivatives | **133,309** | 94,977 | **2,477** | 2,450 |
| Pledged deposits | **211,504** | 176,575 | **80,672** | 84,048 |
| Less: Non-pledged deposits with maturity of more than three months when acquired | **1,570,777** | 97,375 | **421,498** | 20,875 |
| Cash and cash equivalents | **3,588,404** | 2,248,386 | **2,500,402** | 891,923 |

As at the balance sheet date, the cash and cash equivalents of the Group denominated in RMB amounted to RMB3,043,395,230 (2005: RMB992,468,000). The RMB is not freely convertible into other currencies, however, under Mainland China's Foreign Exchange Control Regulations and Administration of Settlement, Sale and Payment of Foreign Exchange Regulations, the Group is permitted to exchange RMB for other currencies through banks authorised to conduct foreign exchange business.

Cash at banks earns interest at floating rates based on daily bank deposit rates. Time deposits are made for terms of up to one year depending on the immediate cash requirements of the Group and the Company, and earn interest at the respective time deposit rates. The carrying amounts of deposits and cash and cash equivalents approximate to their fair value.

## 28. BALANCE WITH ULTIMATE HOLDING COMPANY

The amount due from the Company's ultimate holding company mainly arose from transactions as set out in notes 21 and 48 to the financial statements. The amount is unsecured, interest-free and repayable within one year.

Subsequent to the balance sheet date, the ultimate holding company has settled an amount of RMB100 million with the Company.

## 29. BALANCES WITH RELATED COMPANIES

The balances with related companies are unsecured, interest-free and repayable within one year or no fixed terms of repayment.

## 30. ACCOUNTS PAYABLE

An aged analysis of the accounts payable as at the balance sheet date is as follows:

| | Group | | Company | |
|---|---|---|---|---|
| | **2006** | 2005 | **2006** | 2005 |
| | ***RMB'000*** | *RMB'000* | ***RMB'000*** | *RMB'000* |
| Within 30 days | **3,660,639** | 3,247,501 | **3,069,452** | 2,549,447 |
| 31 to 60 days | **869,108** | 603,010 | **579,156** | 468,948 |
| 61 to 90 days | **304,730** | 293,407 | **235,421** | 253,482 |
| Over 90 days | **386,584** | 457,446 | **272,249** | 394,251 |
| | **5,221,061** | 4,601,364 | **4,156,278** | 3,666,128 |

Included in the accounts payable as at the balance sheet date is the following amount due to joint ventures:

| | Group | | Company | |
|---|---|---|---|---|
| | **2006** | 2005 | **2006** | 2005 |
| | ***RMB'000*** | *RMB'000* | ***RMB'000*** | *RMB'000* |
| Joint ventures | **136,455** | 115,435 | **316,482** | 288,588 |

## 31. BILLS PAYABLE

An aged analysis of the bills payable as at the balance sheet date is as follows:

| | Group | | Company | |
|---|---|---|---|---|
| | **2006** | 2005 | **2006** | 2005 |
| | ***RMB'000*** | *RMB'000* | ***RMB'000*** | *RMB'000* |
| Within 30 days | **191,330** | – | **191,330** | – |
| Over 90 days | **460,015** | 327,937 | **419,215** | 327,937 |
| | **651,345** | 327,937 | **610,545** | 327,937 |

Included in the bills payable as at the balance sheet date is the following amount due to an associate:

| | Group and Company | |
|---|---|---|
| | **2006** | 2005 |
| | ***RMB'000*** | *RMB'000* |
| CNAF *(note 48)* | **95,733** | 103,426 |

## 32. OTHER PAYABLES AND ACCRUALS

An analysis of the other payables and accruals as at the balance sheet date is as follows:

| | Group | | Company | |
|---|---|---|---|---|
| | **2006** | 2005 | **2006** | 2005 |
| | ***RMB'000*** | *RMB'000* | ***RMB'000*** | *RMB'000* |
| Provision for staff housing benefits | **24,791** | 135,381 | **19,401** | 112,372 |
| Accrued salaries, wages and benefits | **870,743** | 894,052 | **706,847** | 732,240 |
| Interest payable | **332,281** | 308,152 | **321,630** | 298,330 |
| Custom duties and levies payable | **1,309,984** | 982,819 | **1,232,679** | 900,544 |
| Current portion of long term payables *(note 36)* | **86,945** | 100,218 | **86,945** | 100,218 |
| Current portion of deferred income *(note 37)* | **76,944** | 76,943 | **76,944** | 76,943 |
| Advances from customers | **306,893** | 259,965 | **212,353** | 163,608 |
| Accrued operating expenses | **749,202** | 1,038,995 | **674,267** | 909,260 |
| Others | **435,104** | 371,910 | **214,731** | 275,381 |
| | **4,192,887** | 4,168,435 | **3,545,797** | 3,568,896 |

## 33. OBLIGATIONS UNDER FINANCE LEASES

The Group and the Company have obligations under finance lease agreements expiring during the years from 2007 to 2016 (2005: 2006 to 2011) in respect of aircraft. An analysis of the future minimum lease payments under these finance leases as at the balance sheet date, together with the present value of the net minimum lease payments which are principally denominated in foreign currencies, are as follows:

| | Group and Company | | | |
|---|---|---|---|---|
| | **Minimum lease payments 2006** | **Present value of minimum lease payments 2006** | Minimum lease payments 2005 | Present value of minimum lease payments 2005 |
| | ***RMB'000*** | ***RMB'000*** | *RMB'000* | *RMB'000* |
| Amounts repayable: | | | | |
| Within one year | **2,964,933** | **2,354,905** | 2,306,587 | 1,954,873 |
| In the second year | **2,492,368** | **1,996,954** | 2,330,192 | 1,949,802 |
| In the third to fifth years, inclusive | **7,046,163** | **6,061,709** | 6,850,768 | 6,071,492 |
| Over five years | **3,619,853** | **3,189,192** | 79,157 | 57,377 |
| Total minimum finance lease payments | **16,123,317** | **13,602,760** | 11,566,704 | 10,033,544 |
| Less: Amounts representing finance charges | **(2,520,557)** | | (1,533,160) | |
| Present value of minimum lease payments | **13,602,760** | | 10,033,544 | |
| Less: Portion classified as current liabilities | **(2,354,905)** | | (1,954,873) | |
| Non-current portion | **11,247,855** | | 8,078,671 | |

## 33. OBLIGATIONS UNDER FINANCE LEASES (Continued)

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

As at 31 December 2006, there were 32 (2005: 21) aircraft under finance lease agreements. Under the terms of the leases, the Company has the option to purchase, at the end of or during the lease terms, certain aircraft at fair market value and others at either fair market value or at the price as stipulated in the finance lease agreements. The effective borrowing rates during the current year ranged from 1.64% to 9.84% (2005: 1.64% to 9.84%).

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

(a) mortgages over certain of the Group's and the Company's aircraft, which had an aggregate net book value of approximately RMB16,589 million as at 31 December 2006 (2005: RMB10,487 million) (note 16); and

(b) guarantees by certain commercial banks in an aggregate amount of approximately RMB9,386 million (2005: RMB12,044 million).

As at 31 December 2006, certain PRC state-owned banks have provided counter-guarantees in an aggregate amount of RMB1,910 million (2005: RMB2,521 million) in respect of the above-mentioned commercial bank guarantee arrangements.

## 34. BANK LOANS, OTHER LOANS AND CORPORATE BONDS

| | Group | | Company | |
|---|---|---|---|---|
| | **2006** | 2005 | **2006** | 2005 |
| | ***RMB'000*** | *RMB'000* | ***RMB'000*** | *RMB'000* |
| Bank loans: | | | | |
| Secured | **10,419,442** | 11,667,241 | **9,791,644** | 11,258,268 |
| Unsecured | **10,328,590** | 8,336,734 | **10,040,806** | 8,126,735 |
| | **20,748,032** | 20,003,975 | **19,832,450** | 19,385,003 |
| Other loans: | | | | |
| Secured | **34,944** | 50,560 | **34,944** | 50,560 |
| Unsecured | **58,022** | 169,514 | **–** | 140,351 |
| | **92,966** | 220,074 | **34,944** | 190,911 |
| Corporate bonds – unsecured | **3,000,000** | 3,000,000 | **3,000,000** | 3,000,000 |
| | **23,840,998** | 23,224,049 | **22,867,394** | 22,575,914 |
| Bank loans repayable: | | | | |
| Within one year | **11,067,021** | 10,217,210 | **10,723,086** | 9,973,050 |
| In the second year | **2,635,719** | 2,732,712 | **2,579,565** | 2,698,551 |
| In the third to fifth years, inclusive | **5,574,198** | 4,677,985 | **5,405,741** | 4,575,502 |
| Over five years | **1,471,094** | 2,376,068 | **1,124,058** | 2,137,900 |
| | **20,748,032** | 20,003,975 | **19,832,450** | 19,385,003 |
| Other loans repayable: | | | | |
| Within one year | **72,000** | 183,960 | **13,978** | 154,797 |
| In the second year | **13,978** | 14,446 | **13,978** | 14,446 |
| In the third to fifth years, inclusive | **6,988** | 21,668 | **6,988** | 21,668 |
| | **92,966** | 220,074 | **34,944** | 190,911 |
| Corporate bonds – over five years | **3,000,000** | 3,000,000 | **3,000,000** | 3,000,000 |
| Total bank loans, other loans and corporate bonds | **23,840,998** | 23,224,049 | **22,867,394** | 22,575,914 |
| Less: Portion classified as current liabilities | **(11,139,021)** | (10,401,170) | **(10,737,064)** | (10,127,847) |
| Non-current portion | **12,701,977** | 12,822,879 | **12,130,330** | 12,448,067 |

## 34. BANK LOANS, OTHER LOANS AND CORPORATE BONDS (Continued)

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

| Nature | Interest rate and final maturity | Group 2006 RMB'000 | Group 2005 RMB'000 | Company 2006 RMB'000 | Company 2005 RMB'000 |
|---|---|---|---|---|---|
| **RMB denominated loans and corporate bonds:** | | | | | |
| Loans for purchases of aircraft and related equipment | Floating interest rates ranging from 5.18% to 5.75% and 5.18% to 5.51% per annum as at 31 December 2006 and 2005, respectively, with maturities through to 2016 | **2,844,000** | 4,452,262 | **2,844,000** | 4,452,262 |
| Loans for working capital | Fixed interest rates ranging from 3.7% to 5.81% and 2.92% to 5.02% per annum as at 31 December 2006 and 2005, respectively, with maturities through to 2009 | **2,817,934** | 4,196,394 | **2,730,000** | 4,140,000 |
| Loans for working capital | Floating interest rate at 5.42% per annum as at 31 December 2006 with maturities through to 2009 | **335,230** | – | **335,230** | – |
| Corporate bonds for purchases of aircraft and related equipment | Fixed interest rate at 4.50% per annum as at 31 December 2006 and 2005, with maturity in September 2015 | **3,000,000** | 3,000,000 | **3,000,000** | 3,000,000 |
| | | **8,997,164** | 11,648,656 | **8,909,230** | 11,592,262 |
| **United States dollars denominated loans:** | | | | | |
| Loans for purchases of aircraft and related equipment | Fixed interest rates ranging from 5.40% to 8.33% per annum as at 31 December 2006 and 2005, with maturities through to 2012 | **4,519,846** | 5,837,073 | **4,519,846** | 5,837,073 |
| Loans for purchases of aircraft and related equipment | Floating interest rate at six months LIBOR + 0.4% to 0.7% and six months LIBOR + 0.4% per annum as at 31 December 2006 and 2005 with maturities through to 2018 | **2,629,310** | 1,514,147 | **2,001,510** | 1,105,174 |
| Loans for working capital | Floating interest rate at six months LIBOR +0.4% to 0.7% and LIBOR + 0.5% to 0.7% per annum as at 31 December 2006 and 2005, respectively, with maturities through to 2007 | **6,372,630** | 4,000,508 | **6,129,830** | 3,833,345 |
| | | **13,521,786** | 11,351,728 | **12,651,186** | 10,775,592 |

## 34. BANK LOANS, OTHER LOANS AND CORPORATE BONDS (Continued)

| Nature | Interest rate and final maturity | Group 2006 RMB'000 | Group 2005 RMB'000 | Company 2006 RMB'000 | Company 2005 RMB'000 |
|---|---|---|---|---|---|
| **Hong Kong dollars denominated loans:** | | | | | |
| Loans for working capital | Fixed interest rate at 4.60% per annum as at 31 December 2005 with maturities through to 2006 | **–** | 15,605 | **–** | – |
| Loans for working capital | Floating interest rate at three months HIBOR + 1.15% and six months LIBOR + 1% per annum as at 31 December 2006 and 2005, respectively, with maturities through to 2007 | **15,070** | 208,060 | **–** | 208,060 |
| Loans for capital investment | Floating interest rate at three months HIBOR + 0.45% per annum as at 31 December 2006 with maturities through to 2013 | **1,208,654** | – | **1,208,654** | – |
| | | **1,223,724** | 223,665 | **1,208,654** | 208,060 |
| **Euros denominated loans:** | | | | | |
| Loans for purchase of related equipment | Fixed interest rate at 4.38% per annum as at 31 December 2006 with maturities through to 2013 | **98,324** | – | **98,324** | – |
| | | **98,324** | – | **98,324** | – |
| | | **23,840,998** | 23,224,049 | **22,867,394** | 22,575,914 |
| Less: Loans falling due within one year and classified as current liabilities | | **(11,139,021)** | (10,401,170) | **(10,737,064)** | (10,127,847) |
| Non-current portion | | **12,701,977** | 12,822,879 | **12,130,330** | 12,448,067 |

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

The Group's and the Company's bank and other loans of approximately RMB13,454 million as at 31 December 2006 (2005: RMB14,718 million) were secured by:

(a) mortgages over certain of the Group's aircraft and buildings with an aggregate net book value of approximately RMB17,625 million as at 31 December 2006 (2005: RMB16,471 million) (note 16); and land use rights with an aggregate carrying amount of approximately RMB37 million as at 31 December 2006 (2005: Nil) (note 17);

(b) pledge of certain number of listed shares in an associate of the Group with an aggregate market value of approximately RMB7,695 million as at 31 December 2006 (2005: Nil) (note 20);

(c) pledge of certain of the Group's bank deposits amounting to approximately RMB78 million as at 31 December 2006 (2005: RMB82 million) (note 27);

## 34. BANK LOANS, OTHER LOANS AND CORPORATE BONDS (Continued)

(d) guarantees by certain commercial banks amounting to approximately RMB8,281 million (2005: RMB9,780 million).

As at 31 December 2006, certain PRC state-owned banks provided counter-guarantees in an aggregate amount of approximately RMB3,811 million (2005: RMB4,891 million) to one of the above-mentioned commercial banks.

## 35. PROVISION FOR MAJOR OVERHAULS

Details of the movements of provision for major overhauls in respect of aircraft and engines under operating leases for each of the two years ended 31 December 2006 and 2005 are as follows:

| | Group | | Company | |
|---|---|---|---|---|
| | **2006** | 2005 | **2006** | 2005 |
| | ***RMB'000*** | *RMB'000* | ***RMB'000*** | *RMB'000* |
| At beginning of year | **654,439** | 498,828 | **493,292** | 401,372 |
| Provision for the year | **654,572** | 415,513 | **521,032** | 271,550 |
| Utilised during the year | **(339,764)** | (259,902) | **(270,178)** | (179,630) |
| At end of year | **969,247** | 654,439 | **744,146** | 493,292 |
| Less: Portion classified as current liabilities | **(47,318)** | (18,721) | **(47,318)** | (18,721) |
| Non-current portion | **921,929** | 635,718 | **696,828** | 474,571 |

## 36. LONG TERM PAYABLES

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

| | Group | | Company | |
|---|---|---|---|---|
| | **2006** | 2005 | **2006** | 2005 |
| | ***RMB'000*** | *RMB'000* | ***RMB'000*** | *RMB'000* |
| Customs duties and value-added tax payable | **305,250** | 417,339 | **305,250** | 417,339 |
| Others | **34,286** | 35,759 | **–** | 258 |
| | **339,536** | 453,098 | **305,250** | 417,597 |
| Less: Portion classified as current liabilities *(note 32)* | **(86,945)** | (100,218) | **(86,945)** | (100,218) |
| Non-current portion | **252,591** | 352,880 | **218,305** | 317,379 |

## 37. DEFERRED INCOME

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

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

| | Group | | Company | |
|---|---|---|---|---|
| | **2006** | 2005 | **2006** | 2005 |
| | ***RMB'000*** | *RMB'000* | ***RMB'000*** | *RMB'000* |
| Deferred income: | | | | |
| At beginning of year and end of year | **1,462,667** | 1,462,667 | **1,462,667** | 1,462,667 |
| Accumulated income recognised as other operating revenue: | | | | |
| At beginning of year | **359,814** | 282,871 | **359,814** | 282,871 |
| Credit during the year *(note 5)* | **76,943** | 76,943 | **76,943** | 76,943 |
| At end of year | **436,757** | 359,814 | **436,757** | 359,814 |
| Net carrying amounts | **1,025,910** | 1,102,853 | **1,025,910** | 1,102,853 |
| Less: Portion classified as current liabilities *(note 32)* | **(76,944)** | (76,943) | **(76,944)** | (76,943) |
| Non-current portion | **948,966** | 1,025,910 | **948,966** | 1,025,910 |

## 38. SHARE CAPITAL

| | Number of shares 2006 | Nominal value 2006 RMB'000 | Number of shares 2005 | Nominal value 2005 RMB'000 |
|---|---|---|---|---|
| Registered, issued and fully paid: | | | | |
| State legal person shares of RMB1.00 each | **4,826,195,989** | **4,826,196** | 4,826,195,989 | 4,826,196 |
| Non-H foreign shares of RMB1.00 each | **1,380,482,920** | **1,380,483** | 1,380,482,920 | 1,380,483 |
| H shares of RMB1.00 each | **4,405,683,364** | **4,405,683** | 3,226,532,000 | 3,226,532 |
| A shares of RMB1.00 each | **1,639,000,000** | **1,639,000** | – | – |
| | **12,251,362,273** | **12,251,362** | 9,433,210,909 | 9,433,211 |

A summary of the movements in the Company's issued share capital for the year ended 31 December 2006 is as follows:

| | Number of shares 2006 | Nominal value 2006 RMB'000 |
|---|---|---|
| At beginning of year | **9,433,210,909** | **9,433,211** |
| Public offer of A shares *(note 38(a))* | **1,639,000,000** | **1,639,000** |
| Placement of H shares to Cathay *(note 38(b))* | **1,179,151,364** | **1,179,151** |
| | **12,251,362,273** | **12,251,362** |

*Notes:*

(a) On 18 August 2006, 1,639,000,000 A shares of the Company were issued at an offer price of RMB2.80 per share and listed on the Shanghai Stock Exchange. The net proceeds from the initial public offering of A shares, after deducting share issue expenses of approximately RMB76 million, amounted to approximately RMB4,513 million (out of which approximately RMB1,639 million and RMB2,878 million were credited to the Company's paid-up capital and capital reserve, respectively).

(b) On 8 June 2006, the Company, CNAC, CITIC Pacific and SPAC entered into a conditional agreement in relation to the restructuring of the shareholdings in Cathay and Dragonair. Pursuant to the terms of the agreement, 1,179,151,364 H shares of the Company were issued to Cathay at HK$3.45 per H share on 27 September 2006. The net proceeds from the issue of H shares to Cathay, after deducting share issue expenses of approximately RMB69 million, amounted to approximately RMB4,057 million (out of which approximately RMB1,179 million and RMB2,874 million were credited to the Company's paid-up capital and capital reserve, respectively).

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

## 39. TREASURY SHARES

As at 31 December 2006, the Group owned a 17.5% equity interest in Cathay, which in turn owned a 17.34% equity interest in the Company. Accordingly, the 17.5% of Cathay's shareholding in the Company should be recorded in the Group's consolidated financial statements as treasury shares through deduction from equity.

## 40. RESERVES

### Group

The amounts of the Group's reserves and the movements therein for each of the two years ended 31 December 2006 are presented in the consolidated statement of changes in equity.

### Company

| | Capital reserve *RMB'000* | Reserve funds *RMB'000* | Retained earnings *RMB'000* | Total *RMB'000* |
|---|---|---|---|---|
| As at I January 2005 | 4,422,757 | 51,908 | 834,958 | 5,309,623 |
| Profit for the year | – | – | 2,113,350 | 2,113,350 |
| Proposed final 2005 dividend *(note 14(a))* | | | (224,793) | (224,793) |
| Transfer to reserve funds *(note 14(b))* | – | 252,908 | (252,908) | – |
| Issue of new shares upon exercise of over-allotment options | 830,414 | – | – | 830,414 |
| Share issue expenses | (40,910) | – | – | (40,910) |
| As at 31 December 2005 and 1 January 2006 | 5,212,261 | 304,816 | 2,470,607 | 7,987,684 |
| Profit for the year | – | – | 1,265,074 | 1,265,074 |
| Proposed final 2006 dividend *(note 14(a))* | – | – | (602,767) | (602,767) |
| Transfer to reserve funds *(note 14(b))* | – | 402,206 | (402,206) | – |
| Issue of new shares *(note 38(a) and (b))* | 5,897,294 | – | – | 5,897,294 |
| Share issue expenses *(note 38(a) and (b))* | (145,097) | – | – | (145,097) |
| As at 31 December 2006 | 10,964,458 | 707,022 | 2,730,708 | 14,402,188 |

## 41. LONG TERM COMPENSATION PLAN

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

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

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

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

As at 31 December 2006 and 31 December 2005, no SARs had been issued under the Plan.

## 42. DISTRIBUTABLE RESERVES

As at 31 December 2006, in accordance with the PRC Company Law, an amount of approximately RMB14,292 million (2005: RMB8,505 million) standing to the credit of the Company's capital reserve account, and an amount of approximately RMB707 million (2005: RMB305 million) standing to the credit of the Company's reserve funds, as determined in accordance with PRC Accounting Standards and Regulations, were available for distribution by way of a future capitalisation issue. In addition, the Company had retained earnings of approximately RMB4,193 million (2005: RMB1,641 million), as determined in accordance with PRC Accounting Standards and Regulations and being the lesser amount of the retained earnings determined in accordance with PRC Accounting Standards and Regulations and IFRSs, available for distribution as dividend.

## 43. MAJOR NON-CASH TRANSACTIONS

During the year, the Group had the following non-cash transactions:

(a) During the year, the Group entered into finance lease arrangements in respect of property, plant and equipment with a total capital value at the inception of the leases of approximately RMB6,017 million (2005: Nil).

(b) On 28 September 2006, the Group completed the sale of its entire interest in Dragonair to Cathay. The transaction was partially settled by 288,596,335 shares issued by Cathay at a price of HK$13.5 per share and partially settled by cash of approximately HK$433 million (equivalent to approximately RMB439 million) (note 1).

## 44. CONTINGENT LIABILITIES

As at 31 December 2006, the Group had the following contingent liabilities:

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

(b) On 15 April 2002, Flight CA129 crashed on approach to Gimhae International Airport, South Korea. There were 129 fatalities including 121 passengers and 8 crew members aboard the crashed aircraft. An investigation was conducted by the Chinese and the Korean civil aviation authorities, but the investigation has yet to be finished at the date of approval of these financial statements. Certain injured passengers and families of the deceased passengers and crew members have commenced proceedings in Korean courts seeking damages against Air China International Corporation, the predecessor of the Company. The Group cannot predict the timing of the courts' judgements or the possible outcome of the lawsuits nor any possible appeal actions. Up to 31 December 2006, the Company, Air China International Corporation and the Company's insurer had paid an aggregate amount of approximately RMB218 million in respect of passenger liability and other auxiliary costs. Included in the RMB218 million is an amount of approximately RMB199 million borne by the Company's insurer. As part of the above-mentioned restructuring, CNAHC has agreed to indemnify the Group for any liabilities relating to the crash of Flight CA129, excluding the compensation already paid up to 30 September 2004 (being the date of incorporation of the Company). The Directors of the Company believe that there will not be any material adverse impact on the Group's financial position.

## 44. CONTINGENT LIABILITIES (Continued)

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

| | Group | | Company | |
|---|---|---|---|---|
| | **2006** | 2005 | **2006** | 2005 |
| | ***RMB'000*** | *RMB'000* | ***RMB'000*** | *RMB'000* |
| Joint ventures | **32,250** | 91,000 | **–** | – |
| Associates | **143,199** | 149,109 | **123,105** | 128,303 |
| | **175,449** | 240,109 | **123,105** | 128,303 |

## 45. COMMITMENTS

### (a) Capital commitments

The Group and the Company had the following amounts of contractual commitments for the acquisition and construction of plant, property and equipment as at the balance sheet date:

| | Group | | Company | |
|---|---|---|---|---|
| | **2006** | 2005 | **2006** | 2005 |
| | ***RMB'000*** | *RMB'000* | ***RMB'000*** | *RMB'000* |
| Contracted, but not provided for: | | | | |
| Aircraft and flight equipment | **39,663,862** | 31,696,796 | **39,594,216** | 31,403,107 |
| Buildings | **950,817** | 835,902 | **563,112** | 664,614 |
| Others | **44,886** | 22,339 | **44,886** | 22,339 |
| | **40,659,565** | 32,555,037 | **40,202,214** | 32,090,060 |
| Authorised, but not contracted for: | | | | |
| Aircraft and flight equipment | **–** | 3,973,095 | **–** | 3,564,126 |
| Buildings | **2,183,678** | 1,920,079 | **2,180,090** | 1,920,079 |
| Others | **100,673** | 65,608 | **–** | – |
| Total capital commitments | **42,943,916** | 38,513,819 | **42,382,304** | 37,574,265 |

## 45. COMMITMENTS (Continued)

### (b) Investment commitments

The Group and the Company had the following amounts of investment commitments as at the balance sheet date:

| | Group | | Company | |
|---|---|---|---|---|
| | **2006** | 2005 | **2006** | 2005 |
| | ***RMB'000*** | *RMB'000* | ***RMB'000*** | *RMB'000* |
| Contracted, but not provided for: | | | | |
| Joint venture | **–** | – | **239,114** | 358,341 |
| Associate | **59,277** | 102,922 | **59,277** | 102,922 |
| Minority shareholders of CNAC | **3,122,420** | – | **3,122,420** | – |
| Total investment commitments | **3,181,697** | 102,922 | **3,420,811** | 461,263 |

On 21 June 2006, the Company and CNAC jointly announced that, subject to the satisfaction of certain conditions, the Company would privatise CNAC by way of a scheme of arrangement under Section 166 of the Companies Ordinance (the "Scheme"). Subject to and conditional upon the Scheme becoming effective, the Company would:

(i) purchase from the minority shareholders of CNAC an aggregate of 1,048,052,000 shares in CNAC for cancellation at a price of HK$2.8 per share or at an aggregate amount of approximately HK$2,935 million (equivalent to approximately RMB2,948 million); and

(ii) purchase an aggregate of 104,378,000 outstanding share options granted under the share option scheme of CNAC for cancellation at a price of HK$1.66 for each option or at an aggregate amount of approximately HK$173 million (equivalent to approximately RMB174 million).

Subsequent to the balance sheet date, on 24 January 2007, the Scheme became effective and the listing of CNAC on the Stock Exchange was then officially withdrawn thereafter (note 49(a)).

### (c) Operating lease commitments

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

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

| | Group | | Company | |
|---|---|---|---|---|
| | **2006** | 2005 | **2006** | 2005 |
| | ***RMB'000*** | *RMB'000* | ***RMB'000*** | *RMB'000* |
| Within one year | **2,301,491** | 1,507,057 | **1,716,993** | 760,230 |
| In the second to fifth years, inclusive | **6,276,717** | 2,862,349 | **4,813,863** | 1,657,353 |
| Over five years | **3,126,336** | 1,066,083 | **2,575,453** | 644,741 |
| | **11,704,544** | 5,435,489 | **9,106,309** | 3,062,324 |

## 46. FINANCIAL INSTRUMENTS

### (a) Fair value

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

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

### (b) Interest rate risk

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

**Year ended 31 December 2006**

*Fixed rate*

| | Within one year *RMB'000* | In the second year *RMB'000* | In the third to fifth years, inclusive *RMB'000* | Over five years *RMB'000* | Total *RMB'000* |
|---|---|---|---|---|---|
| Obligations under finance leases | 1,889,312 | 1,508,428 | 4,439,695 | – | 7,837,435 |
| Bank loans, other loans and corporate bonds | 3,272,260 | 1,000,997 | 2,948,271 | 3,214,576 | 10,436,104 |
| Bills payable | 651,345 | – | – | – | 651,345 |

*Floating rate*

| | Within one year *RMB'000* | In the second year *RMB'000* | In the third to fifth years, inclusive *RMB'000* | Over five years *RMB'000* | Total *RMB'000* |
|---|---|---|---|---|---|
| Obligations under finance leases | 465,593 | 488,526 | 1,622,014 | 3,189,192 | 5,765,325 |
| Bank loans and other loans | 7,866,761 | 1,648,699 | 2,632,916 | 1,256,518 | 13,404,894 |
| Cash at banks and time deposits | 5,370,685 | – | – | – | 5,370,685 |

## 46. FINANCIAL INSTRUMENTS (Continued)

### (b) Interest rate risk (Continued)

Year ended 31 December 2005

*Fixed rate*

| | Within one year *RMB'000* | In the second year *RMB'000* | In the third to fifth years, inclusive *RMB'000* | Over five years *RMB'000* | Total *RMB'000* |
|---|---|---|---|---|---|
| Obligations under finance leases | 1,625,907 | 1,949,802 | 6,071,492 | 57,377 | 9,704,578 |
| Bank loans, other loans and corporate bonds | 4,877,843 | 1,502,072 | 2,856,723 | 3,812,434 | 13,049,072 |
| Bills payable | 327,937 | – | – | – | 327,937 |

*Floating rate*

| | Within one year *RMB'000* | In the second year *RMB'000* | In the third to fifth years, inclusive *RMB'000* | Over five years *RMB'000* | Total *RMB'000* |
|---|---|---|---|---|---|
| Obligations under finance leases | 328,966 | – | – | – | 328,966 |
| Bank loans and other loans | 5,523,327 | 1,245,086 | 1,842,931 | 1,563,633 | 10,174,977 |
| Cash at banks and time deposits | 2,522,336 | – | – | – | 2,522,336 |

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

## 47. FINANCIAL RISK MANAGEMENT OBJECTIVES AND POLICIES

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

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

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

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

## 47. FINANCIAL RISK MANAGEMENT OBJECTIVES AND POLICIES (Continued)

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

### (a) Business risk

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

### (b) Liquidity risk

The Group's net current liabilities amounted to approximately RMB15,251 million as at 31 December 2006 (2005: RMB16,006 million). The Group recorded a net cash inflow from operating activities of approximately RMB6,212 million for the year ended 31 December 2006 (2005: RMB6,048 million). For the same period, the Group had a net cash outflow from investing activities of approximately RMB12,148 million (2005: RMB12,500 million). The Group also recorded a net cash inflow from financing activities of approximately RMB7,309 million and an outflow from financing activities of approximately RMB766 million for the years ended 31 December 2006 and 2005, respectively. The Group has recorded an increase in cash and cash equivalents of approximately RMB1,340 million and a decrease in cash and cash equivalents of approximately RMB7,165 million for the years ended 31 December 2006 and 2005, respectively.

Starting from 2007, the liquidity of the Group is primarily dependent on its ability to maintain adequate cash inflows from operations to meet its debt obligations as they fall due, and its ability to obtain external financing to meet its committed future capital expenditure. With regard to its future capital commitments and other financing requirements, the Company has already obtained several banking facilities with several PRC banks of up to an amount of RMB66,090 million as at 31 December 2006, of which an amount of approximately RMB29,002 million was utilised.

The Directors of the Company have carried out a detailed review of the cash flow forecast of the Group for the year ending 31 December 2007. Based on such forecast, the Directors have determined that adequate liquidity exists to finance the working capital and capital expenditure requirements of the Group during 2007. In preparing the cash flow forecast, the Directors have considered historical cash requirements of the Group as well as other key factors, including the availability of the above-mentioned loans financing which may impact the operations of the Group prior to the end of 2007. The Directors are of the opinion that the assumptions and sensitivities which are included in the cash flow forecast are reasonable. However, these are subject to inherent limitations and uncertainties and some or all of these assumptions may not be realised.

### (c) Jet fuel price risk

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

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

## 47. FINANCIAL RISK MANAGEMENT OBJECTIVES AND POLICIES (Continued)

### (c) Jet fuel price risk (Continued)

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

| | **Group** | | Group | |
|---|---|---|---|---|
| | **2006** | **2006** | 2005 | 2005 |
| | **Assets** | **Liabilities** | Assets | Liabilities |
| | ***RMB'000*** | ***RMB'000*** | *RMB'000* | *RMB'000* |
| Swaps, collars and forward contracts | **99,935** | **(242,108)** | 127,659 | (1,791) |

| | **Company** | | Company | |
|---|---|---|---|---|
| | **2006** | **2006** | 2005 | 2005 |
| | **Assets** | **Liabilities** | Assets | Liabilities |
| | ***RMB'000*** | ***RMB'000*** | *RMB'000* | *RMB'000* |
| Swaps, collars and forward contracts | **98,026** | **(242,108)** | 115,220 | (1,791) |

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

### (d) Foreign currency risk

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

### (e) Interest rate risk

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

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

## 47. FINANCIAL RISK MANAGEMENT OBJECTIVES AND POLICIES (Continued)

### (f) Credit risk

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

A significant portion of the Group's air tickets are sold by agents participating in the Billing and Settlements Plan ("BSP"), a clearing system between airlines and sales agents organised by the International Air Transportation Association. The balance due from BSP agents amounted to approximately RMB647 million as at 31 December 2006 (2005: RMB529 million).

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

## 48. RELATED PARTY TRANSACTIONS

The Group is part of a larger group of companies under CNAHC and has extensive transactions and relationships with members of CNAHC. Related parties refer to entities of which CNAHC is a shareholder and is able to exercise control or joint control. The transactions were made at prices and terms mutually agreed between the parties. The Directors of the Company are of the opinion that the transactions with related parties (see below) during the year were conducted in the usual course of business.

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

| | | **Group** | |
|---|---|---|---|
| | | **2006** | 2005 |
| | | ***RMB'000*** | *RMB'000* |
| (a) | Included in air traffic revenue | | |
| | Sale of air tickets: | | |
| | CNAHC Group | **3,192** | 9,836 |
| | Associates | **3,040** | 1,463 |
| | | **6,232** | 11,299 |
| | Sale of cargo space: | | |
| | CNAHC Group | **209,747** | 200,273 |
| | Government charter flights: | | |
| | CNAHC | **479,132** | 407,048 |

## 48. RELATED PARTY TRANSACTIONS (Continued)

| | Group | |
|---|---|---|
| | **2006** | 2005 |
| | ***RMB'000*** | *RMB'000* |
| (b) Included in other operating revenue | | |
| Aircraft engineering income: | | |
| Associates | **25,853** | 11,563 |
| Ground services income: | | |
| CNAHC Group | **1,700** | 1,061 |
| Joint ventures | **2,463** | 23,417 |
| Associates | **56,313** | 34,401 |
| | **60,476** | 58,879 |
| Bellyhold income: | | |
| Joint venture | **1,518,925** | 1,496,302 |
| Others: | | |
| CNAHC Group | **24,196** | 22,432 |
| Joint ventures | **9,483** | 33,406 |
| Associates | **36,653** | 35,568 |
| | **70,332** | 91,406 |
| (c) Included in finance revenue and finance costs | | |
| Interest income: | | |
| Associate | **9,220** | 2,363 |
| Interest expense: | | |
| Associate | **21,002** | 14,532 |

## 48. RELATED PARTY TRANSACTIONS (Continued)

| | Group 2006 RMB'000 | 2005 RMB'000 |
|---|---|---|
| (d) Included in operating expenses | | |
| Airport ground services, take-off, landing and depot expenses: | | |
| CNAHC Group | **105,255** | 92,836 |
| Associates | **210,160** | 248,128 |
| | **315,415** | 340,964 |
| Air catering charges: | | |
| CNAHC Group | **50,177** | 49,695 |
| Joint ventures | **126,024** | 115,116 |
| Associates | **29,472** | 7,496 |
| | **205,673** | 172,307 |
| Repair and maintenance costs: | | |
| Joint ventures | **376,598** | 363,181 |
| Associates | **155,960** | 125,717 |
| | **532,558** | 488,898 |
| Sale commission expenses: | | |
| CNAHC Group | **4,715** | 7,571 |
| Associates | **6,963** | 6,119 |
| | **11,678** | 13,690 |
| Management fees: | | |
| CNAHC Group | **10,623** | 10,096 |
| Aircraft leasing fees: | | |
| Associate | **529,893** | 201,388 |
| Others: | | |
| Joint ventures | **469** | – |
| CNAHC Group | **102,165** | 79,197 |
| Associates | **24,389** | 7,517 |
| | **127,023** | 86,714 |

## 48. RELATED PARTY TRANSACTIONS (Continued)

| | Group 2006 RMB'000 | Group 2005 RMB'000 | Company 2006 RMB'000 | Company 2005 RMB'000 |
|---|---|---|---|---|
| (e) Deposits, loans and bills payable: | | | | |
| Deposits placed with an associate | **200,242** | 470,863 | **129,516** | 415,366 |
| Loans from an associate | **76,461** | 203,016 | **34,944** | 190,910 |
| Bills payable to an associate | **95,733** | 103,426 | **95,733** | 103,426 |
| (f) Outstanding balance with related parties: | | | | |
| Long term receivable from ultimate holding company | **431,813** | 531,813 | **431,813** | 531,813 |
| Due from related companies | **14,378** | 38,039 | **21** | 12,993 |
| Due from associates | **144,914** | 62,948 | **21,784** | 15,419 |
| Due to associates | **(89,426)** | (95,905) | **(105,818)** | (129,410) |
| Due from a joint venture | **332,811** | 451,965 | **679,206** | 922,378 |
| Due to related companies | **(39,989)** | (174,151) | **(18,913)** | (141,093) |
| Due to joint ventures | **(136,455)** | (115,435) | **(316,482)** | (288,588) |
| Due from ultimate holding company | **289,933** | 474,216 | **304,933** | 474,216 |
| Due from subsidiaries | **–** | – | **55,080** | 11,519 |
| Due to subsidiaries | **–** | – | **(499,087)** | (588,623) |

The long term receivable from CNAHC is unsecured, interest-free and is not repayable within one year from the balance sheet date. Except for the long term receivable from CNAHC, the outstanding balances with other related parties are unsecured, interest-free and repayable within one year or have no fixed terms of repayment.

| | Group 2006 RMB'000 | Group 2005 RMB'000 |
|---|---|---|
| (g) Compensation of key management personnel of the Group: | | |
| Short term employee benefits | **8,577** | 5,501 |
| Post-employment benefits | **187** | 142 |
| | **8,764** | 5,643 |

Further details of the remuneration of the Directors and Supervisors are included in note 10 to the financial statements.

| | Group 2006 RMB'000 | Group 2005 RMB'000 |
|---|---|---|
| (h) Disposal of a long term investment to CNAHC Group | **–** | 20,737 |

## 48. RELATED PARTY TRANSACTIONS (Continued)

(i) On 25 August 2004, CNACG entered into two licences agreements with CNAC pursuant to which CNACG has agreed to grant licences to CNAC, free of royalty, for the rights to use certain trademarks in Hong Kong and Macau, respectively, so long as CNAC is a direct or indirect subsidiary of CNAHC. No royalty charge was levied in respect for the use of these trademarks during each of the two years ended 31 December 2006.

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

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

## 49. EVENTS AFTER THE BALANCE SHEET DATE

(a) On 24 January 2007, the Company privatised CNAC under a scheme of arrangement under Section 166 of the Companies Ordinance (the "Scheme") and:

  (i) purchased from the minority shareholders of CNAC an aggregate of 1,048,052,000 shares in CNAC for cancellation at a price of HK$2.8 per share or at an aggregate amount of approximately HK$2,935 million;

  (ii) purchased an aggregate of 66,252,000 outstanding share options granted under the share option scheme of CNAC for cancellation at a price of HK$1.66 for each option or at an aggregate amount of approximately HK$110 million with the remaining 38,126,000 share options granted under the share option scheme of CNAC forfeited by the respective option holders.

  The Scheme became effective on the same date and the listing of CNAC on the Stock Exchange was then officially withdrawn accordingly.

(b) On 26 February 2007, the Federal Judiciary of the United States filed a civil summon against the Company and Air China Cargo claiming that they, together with a number of other airlines, have violated certain anti-trust regulations in respect of their air cargo operations in the United States and the European Union. The status of the proceedings is still in the preliminary stage and therefore the Directors of the Company and Air China Cargo are of the view that it is not possible to estimate the eventual outcome of the claim with reasonable certainty at this stage. Also, the Directors of the Company and Air China Cargo are of the view that there would be valid defense against this claim and considered that no provision for this claim was needed accordingly.

## 49. EVENTS AFTER THE BALANCE SHEET DATE (Continued)

(c) During the 5th Session of the 10th National People's Congress, which was concluded on 16 March 2007, the PRC Corporate Income Tax Law (the "New Corporate Income Tax Law") was approved and will become effective on 1 January 2008. The New Corporate Income Tax Law introduces a wide range of changes which include, but are not limited to, the unification of the income tax rate for domestic-invested and foreign-invested enterprises at 25%. Since the detailed implementation and administrative rules and regulations have not yet been announced, the financial impact of the New Corporate Income Tax Law to the Group cannot be reasonably estimated at this stage.

## 50. APPROVAL OF THE FINANCIAL STATEMENTS

The financial statements were approved and authorised for issue by the Board of Directors on 19 March 2007.