REPORT OF THE BOARD OF DIRECTORS

The Board of Directors is pleased to present its report together with the audited financial statements of the Company and the Group for the year ended 31 December 2006.

BUSINESS OF THE GROUP

The Group is principally engaged in the design, development, production, distribution and installation of a broad range of advanced telecommunications equipment, including wireless communications systems, wireline switch and access equipment, optical and data communications equipment, handsets, and telecommunications software systems and services.

FINANCIAL RESULTS

Please refer to p. 100 and p. 174 this annual report for the results of the Group for the year ended 31 December 2006 prepared in accordance with PRC GAAP and HKFRSs.

FINANCIAL SUMMARY

Set out on page 17 of this annual report are the results and financial position summary of the Group for the three financial years ended 31 December 2006 prepared in accordance with the PRC GAAP.

Set out on page 19 to page 20 of this annual report are the results and financial position summary of the Group for the five financial years ended 31 December 2006 prepared in accordance with HKFRSs, which have been extracted from the accountants' report of the Group for the three fiscal years ended 31 December 2003 contained in the prospectus dated 29 November 2004 issued by the Company in connection with its initial public offering of H shares and financial statements of the Group for the years ended 31 December 2004, 2005 and 2006 prepared in accordance with HKFRSs.

BUSINESS REVIEW

(I) Business review for 2006

Overview of the PRC telecommunications industry in 2006

China's telecommunications industry maintained steady growth during 2006. According to the statistics from the Ministry of Information Industry, revenue for the telecommunications sector in China grew by 11.7% to RMB648.4 billion and capital expenditure grew by 7.5% to RMB218.7 billion, as compared to the same period last year. Driven by the mobile and data businesses, the telecommunications sector enjoyed sound overall growth. Carriers increased their investments in transmission setup to expedite network rollouts as would be required in the coming 3G era. On the other hand, expenditure on CDMA and PHS, the Group's traditional leading products in the domestic market, continued to decline significantly. TD-SCDMA assumed growing importance in China's telecommunications industry as the government enhanced policy directives over proprietary intellectual property rights, although tangible investments in TD-SCDMA had yet to occur in large scale.

Overview of the global telecommunications industry in 2006

Growth in the global telecommunications sector slowed down to consolidate in 2006 following significant gains in 2004 and 2005. According to the statistics from Gartner, revenue of the global telecommunications market was worth US$1,663.3 billion in 2006, in which the telecommunications equipment market accounted for US$334.2 billion. In 2007, the revenue of the telecommunications equipment market is expected to increase slightly to US$353.7 billion. An overview of the regional markets indicates that while Western Europe, North America and the Asia Pacific account for over three quarters of the telecommunications market, the momentum for future growth lies with emerging markets like the Middle East and Africa.

REPORT OF THE BOARD OF DIRECTORS

Operating results of the Group for 2006

Revenue from the Group's principal operations based on the financial statements prepared in accordance with PRC GAAP amounted to RMB23.032 billion, representing a year-on-year growth of 6.7%. Net profit amounted to RMB807 million, representing a year-on-year decrease of 32.4%.

Revenue from the Group's principal operations based on the financial statements prepared in accordance with Hong Kong Financial Reporting Standards amounted to RMB23.032 billion, representing a year-on-year growth of 6.7%. Net profit amounted to RMB767 million, representing a year-on-year decrease of 40.4%.

By markets:

The domestic market

In 2006, the Group registered RMB12.802 billion in revenue from its domestic principal operations, a decline of 7.7% compared to the previous year. In the PRC market, there were opportunities as well as challenges for the Group in 2006. The Group encountered significant decline of investment in its traditional CDMA and PHS products and stabilised sales in the domestic market by expanding its market share in GSM and other products. Meanwhile, the Group vigorously implemented the State policy of proprietary innovation and positioned itself favourably for the future 3G market in China in close cooperation with the carriers.

The international market

In 2006, the Group's revenue from its international principal operations grew by 32.8% to RMB10.230 billion and accounted for 44.4% of its total revenue from principal operations, which was 8.7 percentage points higher compared the previous year, as it continued full-scale execution of its strategy of internationalization. Regionally, major breakthroughs were achieved in the market for multinational carriers in the Asia Pacific region, as a result of our strategy to focus on mainstream multinational carriers. Strong sales growth was registered in North Africa while groundbreaking sales were being made in Europe and North America.

By products:

Wireless communications products

The Group is able to begin mass production of 3G products in all three modes, namely TD-SCDMA, WCDMA and CDMA2000, for commercial application. In 2006, the Group engaged in TD-SCDMA trial network tests in Xiamen and Qingdao, in collaboration with China Mobile and China Netcom, respectively. The results have been encouraging and positive relationships have been built with the carriers. Research and development efforts relating to the serialization of WCDMA base stations progressed smoothly. Breakthroughs were achieved for high-efficiency power amplifier and core technologies of baseband in 2006. While maintaining our low-cost advantage, we have surpassed some of our competitors in terms of performance and speed of our products, which delivered outstanding results in the HSDPA tests conducted by China Mobile and China Telecom Research Institute.

Our GSM products enjoyed strong growth in 2006, having been short-listed by multinational carrier projects in South Asia and Eastern Europe while gaining access to the Indian market. The international sales of our CDMA products were also underpinned by substantial growth as inroads were being made in North America.

REPORT OF THE BOARD OF DIRECTORS

Switch and access products

Carriers' investments in traditional switch and access products continued to decline in 2006. The Group responded by increasing its market share in traditional products and driving its fixed line intelligence solutions in tandem with changing approaches of the carriers.

Data and optical communications and products

The Group provides a variety of data communications equipment such as NGN, DSL systems, routers, routing switches and wireless access data products. The DC1 IDD network built by the Group on behalf of China Telecom passed the final phase of inspection and acceptance. In the optical communications sector, multi-purpose transmission equipment adaptable to backbone networks, convergence levels and access level were launched. We also started research and development on the ASON version during the year. All in all, there was significant progress over the previous year in terms of regional coverage and network levels.

Handsets

The Group made inroads towards market diversification for its handset products with balanced development between the global and the domestic markets, in contrast to being confined to sale of PHS and CDMA handsets in the domestic market prior to 2005.

On the domestic front, our A12 GSM handset model was selected as one of China Mobile's customised handsets, laying solid foundations for further collaborations with China Mobile. Our CDMA handsets maintained a strong share of the PRC market. Our U310 TD handset received the first approval for trial network access by TD handsets, while U350 was introduced to the market as the first TD+GSM dual mode handset in the world. Internationally, the growth in the sales of CDMA handsets was most notable.

Miscellaneous

In 2006, the Group completed the first mass production of its IPTV products. With increasing carrier investment in value-added services and the growth of the network management business, prospects look promising for this type of products and its related services.

(II) Discussion and analysis prepared under PRC GAAP

The financial data below are extracted from the Group's audited financial statements for the year ended 31 December 2006 prepared in accordance with PRC GAAP. The following discussion and analysis should be read in conjunction with the Group's financial statements audited by Ernst & Young Hua Ming Certified Public Accountants and the accompanying notes thereto.

REPORT OF THE BOARD OF DIRECTORS

1 ***Certain indicators by industry, product and geographic segments for the reporting period as compared to the previous year***

Breakdown of income		Revenue from principal operations (RMB in millions)	Cost of principal operations (RMB in millions)	Profit margin of principal operations (%)	Year-on-year increase/ decrease in revenue from principal operations	Year-on-year increase/ decrease in cost of principal operations	Year-on-year increase/ decrease in profit margin (basis point)
I.	**By industry**						
	Manufacturing of communications systems	23,031.7	15,171.8	33.6%	6.7%	8.8%	–1.3
	Total	23,031.7	15,171.8	33.6%	6.7%	8.8%	–1.3
II.	**By product**						
	Wireless communications systems	9,186.9	5,225.0	42.6%	2.9%	6.0%	–1.7
	Wireline switch and access systems	2,279.4	1,356.2	40.0%	–17.2%	9.3%	–14.5
	Optical and data communications systems	3,874.7	2,944.6	23.5%	15.6%	10.5%	3.5
	Handset	4,519.5	3,375.2	24.8%	4.3%	–5.6%	7.8
	Telecommunication software systems, services and other products	3,171.2	2,270.8	27.9%	43.7%	48.0%	–2.1
	Total	23,031.7	15,171.8	33.6%	6.7%	8.8%	–1.3
	Including: connected transactions	69.5	46.4	33.0%	4.7%	8.4%	–2.5
	Explanatory statement on the pricing principles, necessity and continuity of connection transactions.	Prices at which the Company conducted connected transactions with the connected parties were consistent with market prices. Sales to the connected parties by the Company represented mainly marketing of the Company's products by the connected parties as agents. Such transactions were of an ongoing nature.					
III.	**By region**						
	The PRC	12,801.8	8,553.9	32.7%	–7.7%	–8.7%	0.7
	Asia (excluding the PRC)	5,753.7	3,918.2	31.4%	25.9%	45.5%	–9.2
	Africa	2,563.2	1,501.3	40.9%	–9.6%	–8.8%	–0.6
	Other regions	1,913.0	1,198.4	36.9%	543.0%	393.8%	19.0
	Total	23,031.7	15,171.8	33.6%	6.7%	8.8%	–1.3

2 ***Certain indicators for major products accounting for 10% of revenue from principal operations or profit from principal operations***

Product segment	Revenue from principal operations (RMB in millions)	Cost of principal operations (RMB in millions)	Profit margin of principal operations (%)
Wireless communications	9,186.9	5,225.0	42.6%
Wireline switch and access	2,279.4	1,356.2	40.0%
Optical and data communications	3,874.7	2,944.6	23.5%
Handset	4,519.5	3,375.2	24.8%
Telecommunication software systems, services and other products	3,171.2	2,270.8	27.9%

REPORT OF THE BOARD OF DIRECTORS

3 *Breakdown of the Company's assets*

Unit: RMB in millions

Item	2006 Amount	2006 As a percentage of total assets	2005 Amount	2005 As a percentage of total assets	Increase/ decrease (%)
Total assets	**25,916.9**	**100.0%**	21,779.1	100.0%	19.0%
Amounts receivable	**7,360.7**	**28.4%**	4,994.4	22.9%	47.4%[1]
Total fixed assets	**3,061.5**	**11.8%**	2,506.9	11.5%	22.1%
Long-term equity investments	**100.7**	**0.4%**	85.5	0.4%	17.8%
Construction in progress	**469.6**	**1.8%**	126.7	0.6%	270.6%[2]
Short-term borrowings	**945.7**	**3.6%**	136.1	0.6%	594.9%[3]
Inventories	**2,761.0**	**10.7%**	2,519.5	11.6%	9.6%
Long-term borrowing	**1,679.2**	**6.5%**	767.8	3.5%	118.7%[4]

Note 1: The balance of amounts receivable (comprising bills receivable, amounts receivable and long-term amounts receivable) increased by 47.4%, year-on-year, as a result of deferred contract payments as part of the favourable credit terms granted by the Group to its customers.

Note 2: The balance of construction in progress increased by 270.6%, year-on-year, reflecting the Group's acquisition and construction of ZTE Industrial Park in Xili and R&D centres in Nanjing and Shanghai during the year.

Note 3: The balance of short-term borrowings increased by 594.9%, year-on-year, as a result of the increase in the Group USD Loans to meet working capital requirements.

Note 4: The balance of long-term borrowings increased by 118.7%, year-on-year, as the Group utilised long-term bank loans as additional working capital and project construction funds during the year.

4 *Breakdown of profit, expenses and income tax of the Company for the period*

Item	As a percentage of total profit 2006	As a percentage of total profit 2005	Increase/ decrease (%)
Profit margin from principal operations	**724.4%**	501.1%	223.31[1]
Profit margin from other operations	**6.5%**	1.1%	5.4
Expenses for the period	**690.9%**	429.4%	261.52[2]
Investment gains	**3.0%**	–4.0%	7.0
Subsidy income	**57.2%**	30.5%	26.7
Non-operating income and expenses, net	**–0.2%**	0.7%	–0.9

Note 1: Profit from principal operations as a percentage of total profit increased by 223.3 percentage points mainly as a result of increased expenses and reduced total profit for the period.

Note 2: Expenses as a percentage of total profit for the period increased by 261.5 percentage points mainly as a result of increased R&D investment in customised products for overseas strategic markets and advanced technologies such as 3G, WIMAX and IMS.

REPORT OF THE BOARD OF DIRECTORS

Unit: RMB in millions

Item	2006	2005	Increase/ decrease (%)
Selling and distribution expenses	**3,140.1**	3,023.1	3.9%
General and administrative expenses	**4,010.2**	3,137.1	27.8%
Finance expenses	**239.6**	288.8	–17.0%
Income tax	**125.6**	158.5	–20.8%

5 *Breakdown of cash flow*

Unit: RMB in millions

Item	2006	2005	Increase/ decrease (%)
Net cash flow from operating activities	**–1,555.0**	177.3	–977.0%[1]
Net cash flow from investing activities	**–1,163.6**	–984.3	–18.2%
Net cash flow from financing activities	**1,465.8**	–1,195.5	222.6%[2]

Note 1: Net cash flow from operating activities decreased by 977.0%, year-on-year, mainly as a result of increased operating receivables for the Group during the year. Amounts receivable increased as contract payments were deferred as part of the favourable business terms offered by the Group to its customers. Meanwhile, cash-settled expenses increased following expanded operations, resulting in a wider margin between operating cash flow and net profit.

Note 2: Net cash flow from financing activities increased by 222.6%, year-on-year, mainly as a result of new loans drawn by the Group during the year for use as additional working capital and project construction funds.

6 *Business operations and results of principal subsidiaries*

Business operations of the Company's principal subsidiaries:

Name of company	Registered capital (RMB in millions)	Percentage of equity interest (%)	Scope of business	Total assets (in millions)	Net profit (in millions)	Revenue from principal operations (in millions)	Profit from principal operations (in millions)
ZTE Kangxun	50 million	90	Production of electronic products and related parts (excluding restricted items)	5,783.6	168.9	11,414.0	495.4
ZTE Software	50 million	98	Development, production and sale of telecommunications system drivers, software for service-based businesses and provision of related technical consultancy services	1,813.4	1,975.4	4,074.0	4,060.0

The Company does not hold any interest in any company in which the Company's share of its income accounted for more than 10% of the net profit of the Company.

For details of other subsidiaries and principal associates, please refer to Note IV to the financial statements prepared in accordance with PRC GAAP.

REPORT OF THE BOARD OF DIRECTORS

7 *Major suppliers and customers*

Purchases by the Group from its largest supplier amounted to RMB980 million in 2006, accounting for 7.1% of the total purchases of the Group for the year, while the purchases made from its five largest suppliers amounted to RMB2,762 million, accounting for 19.5% of the total purchases of the Group for the year. None of the Directors or Supervisors or their associates or any of the shareholders of the Company (other than Zhongxingxin) had any interest in any of the five largest suppliers of the Group (the above figures for the Group prepared in accordance with PRC GAAP were consistent with corresponding figures prepared in accordance with HKFRSs).

Sales by the Group in 2006 to its largest customer amounted to RMB4,708.6 million, accounting for 20.4% of the total sales of the Group for the year, while sales to its five largest customers amounted to RMB9,171.4 million, accounting for 39.8% of the total sales of the Group for the year. None of the Directors or Supervisors or their associates or any of the shareholders of the Company had any interest in any of the five largest customers of the Group (the above figures of the Group are consistent under PRC GAAP and HKFRSs).

8 *Investments*

(1) *Use of proceeds from the global issue of H shares*

In December 2004, the Company completed a global offering of 160,151,040 H shares (including H shares issued pursuant to the exercise of the over-allotment option) at an issue price of HKD22.00 per share, raising total proceeds of HKD3,523,322,880.00, equivalent to RMB3,734,722,252.80. After deduction of the underwriting fees and expenses relating to the global offering and reduction in shareholding of state-owned shares, the net proceeds of RMB3,542,177,725.94 were credited into the designated account of the Company on 9 December 2004 and 16 December 2004 respectively. Shenzhen Dahua Tiancheng Certified Public Accountants had examined and verified the net proceeds and issued a capital verification report (Shenhua (2005) Yanzi No.(003)).

The Group intended to use the above net proceeds for the following purposes:

- the Group intended to use approximately RMB2,125,306,635.56 from the above net proceeds for the expansion of the Group's overseas operations; and

- the Group intended to use approximately RMB1,416,871,090.38 from the above net proceeds for the research and development on new products and technologies of strategic importance.

REPORT OF THE BOARD OF DIRECTORS

As at the end of the reporting period, the net proceeds from the H share global offering of the Company was applied as follows:

For the year 2004, 2005 and 2006, application of proceeds amounted to RMB1,160,319,000, RMB2,137,048,000 and RMB244,811,000 respectively.

Unit: in RMB10,000

Total amount of proceeds	354,217.8	Total amount of proceeds utilised during the year	24,481.1
		Total amount of proceeds utilised on an accumulated basis	354,217.8

Projects committed	Amount of proceeds proposed to be injected	Any changes to project	Actual amount of proceeds utilised	Earnings generated	Whether project schedule has been met	Whether expected earnings has been attained
IP switching platforms for mobile communications	24,039	No	24,039	See below	Yes	Yes
Integrated mobile broadband service systems	22,525	No	22,525	See below	Yes	Yes
High speed packet mobile communication base station systems	23,820	No	23,820	See below	Yes	Yes
Intelligent wireless integrated access systems	12,890.1	No	12,890.1	See below	Yes	Yes
Core router	20,838	No	20,838	See below	Yes	Yes
NGN systems	20,118	No	20,118	See below	Yes	Yes
Automated optical switching network systems	17,457	No	17,457	See below	Yes	Yes
Sub-total	141,687.1	—	141,687.1	—	—	—
Overseas operations	212,530.7	—	212,530.7	See below	Yes	Yes
Total	354,217.8	—	354,217.8	—	—	—

Note: As at 31 December 2006, proceeds from the H share global offering of the Company in 2004 had been utilised in full.

Progress of projects utilising the proceeds from the H share global offering and revenue from these projects are set out as follows:

IP switching platforms for mobile communications

The IP switching platforms for mobile communications for NGN network, base station controllers and the IP switching platform supporting a variety of core networks based on 3G wireless standards were completed as scheduled, giving the Company a leading position in the industry. Mass production of IP switching platforms has commenced, generating earnings following commercial application by domestic mobile networks and in numerous countries around the world.

Integrated mobile broadband service system

Research and development of the integrated service platform for this project was completed and products in connection with services including network paging, network conferences, one-touch dialing, caller tunes, soft terminal communications, SMS and WAP were being extensively used in the networks of domestic carriers. Moreover, such products were also employed to provide value-added services to telecommunications carriers in countries including Columbia, Malaysia, the Philippines and Pakistan. In future, the integrated platform will be able to support services on PSTN, PHS, GSM, CDMA, 3G and NGN networks simultaneously. Given its competitive edge in technology, this project has significant business opportunities.

High-speed packet mobile communications base station systems

Riding on the mass commercial application of CDMA2000 EV-DO Rev.0, the project saw completion in the development of various advanced functions and the pre-emptive launch of the CDMA2000 EV-DO Rev.A system which promises superior performance. ZTE has now opened over 50 CDMA2000 1xEV-DO commercial or trial stations in more than 40 countries and regions, including the Philippines, Vietnam, Norway, Sri Lanka and Mongolia. ZTE became the focus of the industry after it had been officially awarded the world's first EVDO Rev.A commercial contract in May 2006. The world's first commercial application of Ap connector was conducted in Sri Lanka in June 2006 as the CDMA2000 ALLIP integrated solution was introduced with over 400,000 users. ZTE's EV-DO was introduced in Norway, the U.S. and other high-end markets in mid-2006.

REPORT OF THE BOARD OF DIRECTORS

Intelligent wireless integrated access systems

This project has been successfully launched following completion of product research and development. Meanwhile, research and development of next generation intelligent wireless integrated access system products equipped with expansion connectors to access 3G networks has also been completed. These intelligent wireless integrated access systems have the capacity to meet the demands of the international market and are compatible with the development of the next generation networks. As a result, we expect further business opportunities for such products.

Core routers

Product research and development has been completed for the project, which has passed the stringent testing procedures of China Telecom Research Institute. The high-end routers have been put to commercial application. Contracts have been awarded to construct core connections in the next-generation CNGI backbone networks for numerous carriers, including China Mobile and China Unicom, as well as to undertake trial projects of urban networks in various provinces for China Telecom's CN2. The IPV6 trial station with 10G connections set up in Kunming has passed the initial inspection and acceptance test of China Unicom to facilitate ZTE's growth in the data product market.

NGN systems

Following the launch of bulk-volume media gateway equipment and softswitch control equipment in 2005, the V2.0 version was completed and put to commercial application in 2006, while the launch of TG and AG had significantly enhanced the stability of the system. The NGN system is currently being applied in the long-distance softswitch commercial trial network of China Telecom and the Shanghai International Station project. The DC1 IDD network built by ZTE on behalf of China Telecom officially passed the final inspection and acceptance of China Telecom Group Company on 21 November 2006.

There were also extensive commercial applications of ZTE's soft switch products in the intelligence upgrade projects for fixed line convergence stations or NGN projects in Guangdong, Shanghai, Wuhan, Chongqing, Sichuan, Liaoning and Inner Mongolia. Market prospects are promising for the proprietary NGN systems of ZTE, which are fully capable of providing a rich variety of functions in massive scale to meet increasing demand from users.

Automated optical switching network systems

Research and development of automated optical switching network systems for commercial application has been completed and commercial trial stations have been set up in Inner Mongolia with marketing and functional enhancement initiatives underway. Automated optical switching network technologies prepare operators for future requirements in telecommunications as they facilitate the introduction of new businesses with ease, as well as enhancing operational management of optical networks. Prospects are promising as carriers are expected to deploy automated optical switching systems in the coming years, first in the backbone networks and then gradually extending to urban and regional networks.

Proceeds from the offering of shares applied in overseas operations contributed to the continuous growth of the Group's overseas revenue in recent years.

(2) *Major investments using funds other than the share issue proceeds*

In May 2006, ZTE (H.K.) Limited (''ZTE HK''), a wholly-owned subsidiary of the Company, and ZTE Software, a subsidiary of the Company, established Xi'an Zhongxing Software Company, Limited with a registered capital of RMB30 million. The principal scope of business of this company is: development, production and sale of telecommunications equipment, value-added services, network planning, terminal equipment, network management system, telecommunications system drivers, development, production and sales of hardware and software for service-based telecommunications businesses, development of other software, provision of related technical consultancy services and import/export businesses.

REPORT OF THE BOARD OF DIRECTORS

In June 2006, ZTE Energy (Cayman) Co., Limited (''ZTE Energy'') was incorporated in the Cayman Islands with an authorised capital of US$10 million and ZTE HK had a 100% shareholding in ZTE Energy. The company was principally engaged in research and development, production, sales and investment in the energy sector.

In July 2006, ZTE HK and ZTE Software established Shanghai Zhongxing Software Company, Limited, Nanjing Zhongxing Software Company, Limited and Chengdu Zhongxing Software Company, Limited, respectively, each with a registered capital of RMB50 million. The three new subsidiaries are principally engaged in the development, production and sale of telecommunications equipment, value-added services, network planning, terminal equipment, network management system, telecommunications system drivers, development, production and sales of hardware and software for service-based telecommunications businesses, development of other software and provision of related technical consultancy services. The Company held 98% interest in each of these three new subsidiaries through ZTE HK and ZTE Software.

In December 2006, China Communications Services Company Limited launched a global offering of H shares for listing on the main board of the Stock Exchange of Hong Kong, in which the Company subscribed for 17,674,000 H shares through ZTE HK at the global offer price of HK$2.2 per share for a total subscription amount of HK$38,883,000.

9 *There were no changes in the accounting estimates and tracking of accounting errors of the Group.*

10 *For the Special Notice on the Use of Funds of Listed Companies by the Controlling Shareholder and other Connected Parties issued by Ernst & Young Hua Ming, please refer to the announcement published by the Company on the website designated for information disclosure, on 19 April 2007.*

11 *The independent opinion of the Independent Directors on the use of funds by Connected Parties and the Company's accumulated and current guarantees for 2006 was as follows:*

(1) The transfer of funds between the Company and the controlling shareholder and other connected parties represent sales and purchases of goods in the ordinary course of business. Such transactions have been conducted based on fair market prices and were not adverse to the Company's interests. Neither the controlling shareholder of the Company nor its subsidiaries nor other connected parties have appropriated the Company's funds.

(2) In order to standardised the management of third-party guarantees, the Company has formulated the Administrative Measures on Third-party Guarantees, and set out provisions in the Articles of Association the examination and approval procedures in relation to third-party guarantees. Details of guarantees disclosed in the 2006 annual report are true and the Company has not committed any unlawful acts of guarantees or connected guarantees.

(3) As required by China Securities Regulatory Commission, the Independent Directors of the Company have reviewed the Company's transactions against the Notice Regulating Third-party Guarantees made by Listed Companies (Zheng Jian Fa[2005] No. 120) the Notice Regulating Several Issues of Fund Uses with Connected Persons and Third-party Guarantees for Listed Companies (Zheng Jian Fa[2003] No. 56) and are of the view that the Company has been in strict compliance with the relevant provisions under the Notice and have not found any matter which is in breach of the Notice.

REPORT OF THE BOARD OF DIRECTORS

12 *Day-to-day operation of the Board of Directors*

(1) *During 2006, the Board of Directors of the Company convened five meetings, the details of which are as follows:*

Session of the Board of Directors	Date of meeting	Mode of meeting	Date of announcing resolutions of meetings	Newspapers for publication of announcements
16th meeting of the third session	6 April 2006	On-site meeting	7 April 2006	China Securities Journal, Securities Times, Shanghai Securities News, The Standard and Hong Kong Economic Times
17th meeting of the third session	25 April 2006	Video conference	26 April 2006	
18th meeting of the third session	24 August 2006	On-site meeting	25 August 2006	
19th meeting of the third session	25 October 2006	On-site meeting	26 October 2006	
20th meeting of the third session	15 December 2006	Video conference	18 December 2006	

(2) *Board implementation of resolutions of the general meeting*

Pursuant to the relevant resolution passed at the 2005 annual general meeting, the Board of Directors of the Company implemented the 2005 profit distribution plan, according to which RMB2.5 for every 10 shares (including tax) or a total of RMB239,880,000 was paid in cash on the basis of the Company's total share capital of 959,521,650 shares as at 31 December 2005. Record date for dividend payment for A shares: 13 July 2006. Ex-dividend date: 14 July 2006. Record date for dividend payment for H shares: 12 May 2006. Dividend payment date: 14 July 2006.

13 *The 2006 profit distribution proposal*

The audited net profit of the Company for the year 2006 calculated in accordance with PRC GAAP amounted to RMB650,356,000. Profit available for distribution amounted to RMB3,766,426,000 after adding the undistributed profit of RMB3,116,070,000 carried forward at the beginning of the year.

The audited net profit of the Company for the year 2006 calculated in accordance with HKFRSs amounted to RMB831,130,000. Profit available for distribution amounted to RMB1,786,512,000 after adding the undistributed profit of RMB955,382,000 carried forward at the beginning of the year.

In accordance with the requirements of the Ministry of Finance of the People's Republic of China and the Articles of Association, profit available for distribution shall be the lower of profit available for distribution as calculated in accordance with PRC GAAP and that calculated in accordance with HKFRSs. Therefore the amount of profit available for distribution is RMB1,786,512,000. The 2006 profit distribution proposal recommended by the Board of Directors of the Company is as follows: RMB1.50 (including tax) for every 10 shares or a total of RMB143,928,000 in cash on the basis of the Company's total share capital of 959,521,650 shares as at 31 December 2006.

REPORT OF THE BOARD OF DIRECTORS

14 *Designated newspapers for information disclosure*

China Securities Journal, Securities Times and Shanghai Securities News have been designated as newspapers for information disclosure by the Company in China. The Standard (English) and Hong Kong Economic Times (Chinese) have been designated as newspapers for information disclosure by the Company in Hong Kong.

(III) Business Outlook and Risk Exposure in 2007

1. *Business outlook for 2007*

Modest growth is expected for the global telecommunications industry in 2007. The Group is set to capture sound business opportunities as the potential future 3G investment becomes clearer. On the other hand, competition will become more intense due to continuing industry consolidation. With the implementation of corporate strategies on differentiation, human resources and cost priority, the management is confident that the Group would be able to capture market opportunities amid increasing competition. Major objectives set for 2007 are as follows:

(1) to cope with market conditions and customer requirements by conducting market-driven research and development, realigning our organizational structure, enhancing overall capabilities of solutions and building customer-oriented capabilities and organization underpinned by integrated marketing and integrated commercial technologies;

(2) To adopt further customer differentiation, optimise the allocation of resources, improve the functional positioning of the overseas regional platforms and representative offices at various levels and to enhance global execution capabilities for leading strategies;

(3) To enhance training of critical staff;

(4) To resolve issues arising from customer dissatisfaction with deliveries and compartmentalized logistics management by developing logistics capabilities and organization oriented towards customers and driven by uniform sources of information;

(5) To better define the nature of engineering and after-sales services by developing a customer-oriented engineering and after-sales service team capable of uniform dispatching and speedy response to ensure that engineering and after-sales services will grow into a core business and a profit centre.

To achieve the above development objectives, the Group will strive to implement major capital expenditure plans by improving its operating efficiency and accelerating the turnover of funds. Meanwhile, we will meet additional funding requirements by resorting to various means of financing, including bank loans, in a reasonable and effective manner. To maintain its competitive edge and sustainable development, the Group intends to commit funds to the development of ZTE Industrial Park and the second phase of the R&D buildings in Shanghai and Nanjing. We will also carry out upgrades and replacements of fixed assets, IT equipment and software when necessary.

2. *Risk exposure*

(1) *Policy risks*

Investments in system equipment, especially in the case of China, are subject to macro-economic factors such as government policies.

REPORT OF THE BOARD OF DIRECTORS

(2) *International market risks*

The Group has now established a business presence in over 100 countries and regions. Such geographic coverage demands a high level of skills in business operation to cope with issues arising from differences in political and legal systems, taxation, market profiles and cultural traditions.

(3) *Foreign exchange risks*

The Group will continue to experience imbalances in foreign exchange payments with the growth of its international business. Meanwhile, there are long-term risks relating to competitiveness and foreign currency transaction as a result of the appreciation of RMB.

3. *Future changes in the accounting policies and accounting estimates of the Company following the implementation of new accounting standards and its impact on the financial conditions and operating results of the Company*

In accordance with Order No. 33 of the Ministry of Finance and requirements of the document Cai Kuai [2006] No. 3 (財會[2006]3號), the Company resolved to carry out full implementation of the revised "Enterprise Accounting Standards — Basic Standards" and 38 implementation rules, including "Enterprise Accounting Standard No. 1 — Inventory" and others, with effect from 1 January 2007, whereupon the "Enterprise Accounting System" and original "Enterprise Accounting Standards" shall cease to be implemented.

In accordance with "Enterprise Accounting Standard No. 38 — Initial Implementation of the Enterprise Accounting Standards," the Company shall classify, recognise and measure all new assets, liabilities and shareholders' equity in accordance with the provisions of the Enterprise Accounting Standards on the date of initial implementation. The effect of the adjustment on the date of initial implementation on the shareholders' equity at the beginning of 2007 was a decrease of RMB21,955,000 in shareholders' equity. Please refer to Appendix II of the Notes to the Financial Statements prepared under PRC GAAP, *Statement of reconciliation of differences between shareholders' equity prepared in accordance with the current and the new PRC accounting standards and the notes thereto.*

The impact of the implementation of new Enterprise Accounting Standards on the Company's financial report mainly included the following:

1. Research and development expenses incurred by the Company during the development stage may, subject to certain conditions, be recognised as intangible assets and amortised over the benefit period;

2. For sales contracts that effectively have a financing nature with deferred receipt of sales amounts, operating income shall be recognised at the fair value of the goods sold and finance gains arising from the contracts shall be recognised on a deferred basis;

3. Staff welfare expenses shall be recognised as remuneration payable to staff (staff welfare) based on the actual staff welfare expenses and the welfare schemes;

4. Share-based payments settled in equity (such as the Phase 1 Share Incentive Scheme of the Company) shall be recognised as current expenses at the fair value of the equity tools based of the number of options exercised;

5. Government subsidies shall be recognised when the conditions of grant are being fulfilled and such subsidies become receivable, rather than upon actual receipt. Expenses or asset depreciation related to government subsidies shall be directly charged to the current profit and loss when incurred; government subsidies used as compensation shall be concurrently recognised as non-operating income;

REPORT OF THE BOARD OF DIRECTORS

6. Changes in the fair value of financial assets or liabilities that are measured at fair value and whose changes are dealt with in profit and loss shall be directly taken into account in the current income statement and the balance sheet;

7. Derivative financial tools, hedging tools and their profit or loss shall be separately recognised in the financial report;

8. Real estate properties held for investment purposes shall be separately recognised in the financial report using cost model measurement, if such costs can be reliably measured;

9. Investments in subsidiaries shall be accounted for using the cost method and dividends payable by the subsidiaries to the parent shall not be recognised as investment gains until being declared, with no impact on the consolidated statement.

The implementation of the new Enterprise Accounting Standards, will further standardise the Company's accounting recognition, measurement and reporting, improve the quality of its financial information and narrow the differences between financial reports prepared under PRC accountings standards and Hong Kong Financial Reporting Standards.

(IV) Other Matters in the Report of the Directors

1. *Property, plant and equipment*

Details of changes in the property, plant and equipment of the Company and the Group for the year are set out in note 15 and note 16 to the financial statements prepared in accordance with HKFRSs.

2. *Bank loans and other borrowings*

Details of bank loans and other borrowings of the Company and the Group as at 31 December 2006 are set out in note 32 to the financial statements prepared in accordance with HKFRSs.

3. *Reserves*

Details of the reserves and changes in the reserves of the Company and the Group for the year are set out in note 40 to the financial statements prepared in accordance with HKFRSs.

4. *Pre-emptive rights*

There is no provision under the Company Law of the People's Republic of China or the Articles of Association regarding pre-emptive rights that requires the Company to offer new shares to its existing shareholders on a prorate basis.

5. *Purchase, sale or redemption of shares*

Neither the Company nor any of its subsidiaries has purchased, sold or redeemed any listed securities of the Company during the year.

6. *Share capital*

Details of the share capital of the Company during the year, together with the changes in the share capital and the reasons therefor, are set out in note 37 to the financial statements prepared in accordance with HKFRSs and on page 21 in this annual report.