## 1. CORPORATE INFORMATION

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

## 2.1 BASIS OF PREPARATION

These financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRSs"). They are prepared on a historical cost basis. They are presented in Renminbi ("RMB") and all values are rounded to the nearest thousand except when otherwise indicated.

### Basis of consolidation

The consolidated financial statements comprise the financial statements of the Company and its subsidiaries (the "Group") for the year ended 31 December 2006. The financial statements of the subsidiaries are prepared for the same reporting year as the Company, using consistent accounting policies. All intra-group balances, transactions, income and expenses and profits and losses resulting from intra-group transactions that are recognised in assets, are eliminated in full. Subsidiaries are fully consolidated from the date of acquisition, being the date on which the Group obtains control, and continue to be consolidated until the day that such control ceases.

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

## 2.2 IMPACT OF NEW AND REVISED IFRSs

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

- IAS 39 *Financial Instruments: Recognition and Measurement* ("IAS 39") — *Amendment for financial guarantee contracts (issued in August 2005)* which amended the scope of IAS 39 to require financial guarantee contracts issued that are not considered to be insurance contracts to be recognised initially at fair value and to be remeasured at the higher of the amount determined in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with IAS 18 *Revenue*; and

## 2.2 IMPACT OF NEW AND REVISED IFRSs *(continued)*

- IFRIC 4 *Determining whether an Arrangement contains a Lease* which provides further guidance in determining whether arrangements contain a lease to which lease accounting must be applied.

The adoption of these revised standard and new interpretation did not have any material impact on the financial statements of the Group and the Company.

## 2.3 IMPACT OF ISSUED BUT NOT YET EFFECTIVE STANDARDS

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

| | | **Effective date** *(Note)* |
|---|---|---|
| IAS 1 Amendment | Capital Disclosures | 1 January 2007 |
| IAS 23 Amendment | Borrowing Costs | 1 January 2009 |
| IFRS 7 | Financial Instruments: Disclosures | 1 January 2007 |
| IFRS 8 | Operating Segments | 1 January 2009 |
| IFRIC 7 | Applying the Restatement Approach under IAS 29 Financial Reporting in Hyperinflationary Economies | 1 March 2006 |
| IFRIC 8 | Scope of IFRS 2 | 1 May 2006 |
| IFRIC 9 | Reassessment of Embedded Derivatives | 1 June 2006 |
| IFRIC 10 | Interim Financial Reporting and Impairment | 1 November 2006 |
| IFRIC 11 | IFRS 2 — Group and Treasury Share Transactions | 1 March 2007 |
| IFRIC 12 | Service Concession Arrangements | 1 January 2008 |

*Note:* Effective dates of these standards or interpretations refer to the financial years beginning on or after the date noted.

The IAS 1 Amendment will affect the disclosures about qualitative information about the Group's objective, policies and processes 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.

IFRS 7 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.

## 2.3 IMPACT OF ISSUED BUT NOT YET EFFECTIVE STANDARDS *(continued)*

IFRS 8 requires the disclosure of information about the operating segments of the Group, the products and services provided by the segments, the geographical areas in which the Group operates, and revenues from the Group's major customers. This standard will supersede IAS 14 *Segment Reporting*.

IFRIC 10 requires that any impairment loss recognised for the Group's available-for-sale equity investment in an interim period is prohibited to be reversed in subsequent interim periods.

The Group is in the process of determining whether these new and revised standards and interpretations will have any material impact on the financial statements of the Group. So far, it has concluded that the adoption of the IAS1 Amendment, IFRS 7 and IFRS 8 may result in new or amended disclosures.

## 2.4 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### Subsidiaries

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

### Associates

An associate is an entity in which the Group has significant influence and which is neither a subsidiary nor a jointly controlled entity. The Group's interests in associates are accounted for under the equity method of accounting. Under the equity method, the investments in associates are carried in the balance sheet at cost plus post-acquisition changes in the Group's share of net assets of the associates. After application of the equity method, the Group determines whether it is necessary to recognise any additional impairment loss with respect to the Group's net investment in the associates. The consolidated income statement reflects the Group's share of the results of the operations of the associates. When there has been a change recognised directly in the equity of the associates, the Group recognises its share of any changes and discloses this, when applicable, in the consolidated statement of changes in equity. Profits and losses resulting from transactions between the Group and the associate are eliminated to the extent of the interest in the associate.

The reporting dates of the associates and the Group are identical and the associates' accounting policies conform to those used by the Group for like transactions and events in similar circumstances.

## 2.4 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

### Joint venture

The Group has an interest in a joint venture which is a jointly controlled entity. A joint venture is a contractual arrangement whereby two or more parties undertake an economic activity that is subject to joint control, and 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 interest in the joint venture using proportionate consolidation. The Group combines its share of each of the assets, liabilities, income and expenses of the joint venture with the similar items, line by line, in its consolidated financial statements. The financial statements of the joint venture are prepared for the same reporting year as the Group, using consistent accounting policies.

When the Group contributes or sells assets to the joint venture, 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 venture, the Group does not recognise its share of the profits of the joint venture from the transaction until it resells the assets to an independent party. The joint venture is proportionately consolidated until the date on which the Group ceases to have joint control over the joint venture.

### Goodwill

Goodwill on acquisition is initially measured at cost being the excess of the cost of the business combination over the acquirer's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities. Following initial recognition, goodwill is measured at cost less any accumulated impairment losses. Goodwill is reviewed for impairment, annually or more frequently if events or changes in circumstances indicate that the carrying value may be impaired.

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.

## 2.4 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

### Goodwill *(continued)*

Where goodwill forms part of a cash-generating unit and part of the operation within that unit is disposed of, the goodwill associated with the operation disposed of is included in the carrying amount of the operation when determining the gain or loss on disposal of the operation. Goodwill disposed of in this circumstance is measured on the basis of the relative values of the operation disposed of and the portion of the cash-generating unit retained.

Impairment losses recognised in relation to goodwill is not reversed in a subsequent period.

### Property, plant and equipment and depreciation

Property, plant and equipment, other than construction in progress, are stated at cost, excluding the costs of day to day servicing, less accumulated depreciation and accumulated impairment in value. The cost of self-constructed assets includes the cost of materials, direct labour and an appropriate proportion of production overheads. Such cost also includes the cost of replacing part of the plant and equipment when that cost is incurred, if the recognition criteria are met.

Depreciation is calculated on a 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 estimated useful lives of property, plant and equipment are as follows:

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

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.

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

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

## 2.4 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

### Construction in progress

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

### Intangible assets (other than goodwill)

Intangible assets acquired separately are measured on initial recognition at cost. The cost of intangible assets acquired in a business combination is the fair value as at the date of acquisition. Following initial recognition, intangible assets are carried at cost less any accumulated amortisation and any accumulated impairment losses. Internally generated intangible assets, excluding capitalised development costs, are not capitalised and expenditure is reflected in the consolidated income statement in the year in which the expenditure is incurred.

The useful lives of intangible assets are assessed to be either finite or indefinite.Intangible assets with finite lives are amortised over the useful economic life and assessed for impairment whenever there is an indication that the intangible asset may be impaired. The amortisation period and the amortisation method for an intangible asset with a finite useful life are reviewed at least at each balance sheet date.

Intangible assets with indefinite useful lives are tested for impairment annually either individually or at the cash generating unit level. Such intangible assets are not amortised. The useful life of an intangible asset with an indefinite life is reviewed annually to determine whether indefinite life assessment continues to be supportable. If not, the change in the useful life assessment from indefinite to finite is accounted for on a prospective basis.

*Patents and licences*

Purchased patents and licences are stated at cost less any impairment losses and are amortised on the straight-line basis over their estimated useful lives of 10 years.

*Research and development costs*

Research costs are expensed as incurred. An intangible asset arising from development expenditure on an individual project is recognised only when the Group can demonstrate the technical feasibility of completing the intangible asset so that it will be available for use or sale, its intention to complete and its ability to use or sell the asset, how the asset will generate future economic benefits, the availability of resources to complete the project and the ability to measure reliably the expenditure during the development.

## 2.4 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

### Intangible assets (other than goodwill) *(continued)*

*Research and development costs (continued)*

During the period of development, the asset is tested for impairment annually. Following the initial recognition of the development expenditure, the cost model is applied requiring the asset to be carried at cost less any accumulated amortisation and accumulated impairment losses. Amortisation of the asset begins when the development is complete and the asset is available for use. It is amortised over the period of expected future sales. During the period of which the asset is not yet in use, it is tested for impairment annually.

*Computer software*

Acquired computer software licenses are capitalised on the basis of the costs incurred to acquire and bring to use the specific software. These costs are amortised over their estimated useful lives of 3 to 10 years.

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

The Group assesses at each reporting date whether there is any indication that an asset may be impaired. If any such indication exists, or when annual impairment testing for an asset is required, the Group makes an estimate of the asset's recoverable amount. An asset's recoverable amount is the higher of an asset's or cash-generating unit's fair value less costs to sell and its value in use and is determined for an individual asset, unless the asset does not generate cash inflows that are largely independent of those from other assets or groups of assets, in which case, the recoverable amount is determined for the cash-generating unit to which the asset belongs. Where the carrying amount of an asset exceeds its recoverable amount, the asset is considered impaired and is written down to its recoverable amount.

In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset.

An assessment is made at each reporting date as to whether there is any indication that previously recognised impairment losses may no longer exist or may have decreased. If such indication exists, the recoverable amount is estimated. A previously recognised impairment loss is reversed only if there has been a change in the estimates used to determine the asset'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 consolidated income statement in the period in which it arises.

## 2.4 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

### Inventories

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

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

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

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

### Cash and cash equivalents

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

### Investments and other financial assets

Financial assets in the scope of IAS 39 are classified as financial assets at fair value through profit or loss, loans and receivables, held-to-maturity investments, and available-for-sale investments, as appropriate. When financial assets are recognised initially, they are measured at fair value, plus, in the case of investments not at fair value through profit or loss, directly attributable transaction costs. The Group determines the classification of its financial assets after initial recognition and, where allowed and appropriate, re-evaluates this designation at each financial year-end.

All regular way purchases and sales of financial assets are recognised on the trade date, 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.

## 2.4 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

### Investments and other financial assets *(continued)*

*Loans and receivables*

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market.

After initial measurement, loans and receivables are subsequently carried at amortised cost using the effective interest method less any allowance for impairment. 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 consolidated income statement when the loans and receivables are derecognised or impaired, as well as through the amortisation process.

*Available-for-sale investments*

The Group only holds available-for-sale investments which are non-trading investments in unlisted equity securities intended to be held on a long term basis. After initial recognition, available-for-sale investments are measured at fair value with gains or losses being recognised as a separate component of equity until the investment is derecognised or until the investment is determined to be impaired at which time the cumulative gain or loss previously reported in equity is included in the consolidated income statement.

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; and a discounted cash flow analysis.

## 2.4 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

### Impairment of financial assets

The Group assesses at each balance sheet date whether there is any objective evidence that a financial asset or a group of financial assets is impaired.

*Assets carried at amortised cost*

If there is objective evidence that an impairment loss on loans and receivables 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 consolidated income statement.

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 consolidated 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 trade receivables, 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.

## 2.4 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

### Impairment of financial assets *(continued)*

*Assets carried at amortised cost(continued)*

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 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 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 consolidated income statement, is transferred from equity to the consolidated income statement. Impairment losses on equity instruments classified as available for sale are not reversed through the consolidated income statement.

### Derecognition of 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 rights 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.

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.

## 2.4 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

### Derecognition of financial assets *(continued)*

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 in the case of a written put option (including a cash-settled option or similar provision) on an asset measured at fair value, where 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

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

Financial liabilities, including trade and bills payables, other payables, other loans, long term payables and interest-bearing bank loans, are initially stated at fair value of the consideration received 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 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 *Provisions, Contingent Liabilities and Contingent Assets*; and (ii) the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with IAS 18 *Revenue*.

### Derecognition of 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.

## 2.4 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

### Provisions

Provisions are recognised when the Group has a present obligation (legal or constructive) as a result of a past event, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and a reliable estimate can be made of the amount of the obligation.

Where the Group expects some or all of a provision to be reimbursed, the reimbursement is recognised as a separate asset but only when the reimbursement is virtually certain. The expense relating to any provision is presented in the consolidated income statement net of any reimbursement. If the effect of the time value of money is material, provisions are discounted using a current pre-tax rate that reflects, where appropriate, the risks specific to the liability. Where discounting is used, the increase in the provision due to the passage of time is recognised as a finance cost.

### Income tax

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

*Current income tax*

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

*Deferred income tax*

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

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

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

## 2.4 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

**Income tax** *(continued)*

*Deferred income tax (continued)*

Deferred income tax assets are recognised for all deductible temporary differences, carry-forward of unused tax credits and unused tax losses, to the extent that it is probable that taxable profit will be available against which the deductible temporary differences, 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 differences arises from the initial recognition of an asset or liability in a transaction that is not a business combination and, at the time of the transaction, affects neither the accounting profit nor taxable profit or loss; and

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

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

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

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

## 2.4 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

### Revenue recognition

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

*Sale of goods*

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

*Interest income*

Revenue is recognised as interest accrues using the effective interest method that is the rate that exactly discounts estimated future cash receipts through the expected life of the financial instruments to the net carrying amount of the financial asset.

*Dividends*

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

### Government grants

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

### Borrowing costs

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

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

## 2.4 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 at inception date of whether the fulfilment of the arrangement is dependent on the use of a specific asset or assets or the arrangement conveys a right to use the asset. A reassessment is made after inception of the lease only if one of the following applies:

- there is a change in contractual terms, other than a renewal or extension of the arrangement;
- there is a change in the determination of whether fulfilment is dependant on a specified asset;
- there is a substantial change to the asset; or
- a renewal option is exercised or extension granted, unless the term of the renewal or extension was initially included in the lease term.

Where a reassessment is made, lease accounting shall commence or cease from the date when the change in circumstances gave rise to the reassessment (except that for the last scenario, and at the date of renewal or extension period).

*Operating leases*

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

*Land use rights*

Land use rights are initially stated at cost and subsequently recognised as an expense in the consolidated income statement on a straight-line basis over the lease terms of 20 to 50 years.

## 2.4 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

### Foreign currency translation

Each entity in the Group determines its functional currency based on the assessment of its specific facts and circumstances. The Company chooses Renminbi ("RMB") as the presentation currency for the financial statements of the Group and the Company. Transactions in foreign currencies are initially recorded at the functional currency rate ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are retranslated at the functional currency rate of exchange ruling at the balance sheet date. All differences are taken to the consolidated income statement. Non-monetary items that are measured in terms of historical cost in a foreign currency are translated using the exchange rate as at the date of the initial transaction. Non-monetary items measured at fair value in a foreign currency are translated using the exchange rates at the date when the fair value was determined.

As at the reporting date, the assets and liabilities of companies whose functional currency differs from the presentation currency are translated into the presentation currency of the Group at the rate of exchange ruling at the balance sheet date and their income statements are translated at the weighted average exchange rates for the reporting period. The exchange differences arising on the retranslation are taken directly to a separate component of equity. On disposal of a foreign entity, the deferred cumulative amount recognised in equity relating to that particular foreign operation is recognised in the income statement.

### Employee benefits

*Retirement benefits*

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

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

## 2.4 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

### Employee benefits *(continued)*

*Share-based payment transactions*

The Company operates a share option scheme for the purpose of providing incentives and rewards to eligible participants who contribute to the success of the Group's operations. Employees (including independent non-executive directors and senior executives) of the Group receive remuneration in the form of share-based payment transactions, whereby employees render services as consideration for equity instruments ("equity settled transactions").

The cost of equity-settled transactions with employees is measured by reference to the fair value at the date on which they are granted. The fair value is determined using a binomial model, further details of which are given in note 35 to the financial statements. In valuing equity-settled transactions, no account is taken of any performance conditions, other than conditions linked to the price of the shares of the Company ("market conditions"), if applicable.

The cost of equity-settled transactions is recognised, together with a corresponding increase in equity, over the period in which the performance and/or service conditions are fulfilled, ending on the date on which the relevant employees become fully entitled to the award (the "vesting date"). The cumulative expense recognised for equity-settled transactions at each reporting date until the vesting date reflects the extent to which the vesting period has expired and the Group's best estimate of the number of equity instruments that will ultimately vest. The charge or credit to the income statement for the period represents the movement in cumulative expense recognised as at the beginning and end of that period.

No expense is recognised for awards that do not ultimately vest, except for awards where vesting is conditional upon a market condition, which are treated as vesting irrespective of whether or not the market condition is satisfied, provided that all other performance conditions are satisfied.

Where the terms of an equity-settled award are modified, the minimum expense recognised is the expense if the terms had not been modified. An additional expense is recognised for any modification, which increases the total fair value of the share-based payment arrangement, or is otherwise beneficial to the employee as measured at the date of modification.

## 2.4 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

### Employee benefits *(continued)*

*Share-based payment transactions (continued)*

Where an equity-settled award is cancelled, it is treated as if it had vested on the date of cancellation, and any expense not yet recognised for the award is recognised immediately. However, if a new award is substituted for the cancelled award, and designated as a replacement award on the date that it is granted, the cancelled and new awards are treated as if they were a modification of the original award, as described in the previous paragraph.

The dilutive effect of outstanding options is reflected as additional share dilution in the computation of earnings per share (further details are given in note 10).

### Dividends

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

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

## 2.5 SIGNIFICANT ACCOUNTING JUDGEMENTS AND 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 financial year, are discussed below.

*Impairment of goodwill*

The Group determines whether goodwill is impaired at least on an annual basis. This requires an estimation of the value in use of the cash-generating units to which the goodwill is allocated. Estimating the value in use requires the Group to make an estimate of the expected future cash flows from the cash-generating unit and also to choose a suitable discount rate in order to calculate the present value of those cash flows. Details of goodwill are given in note 19 to the financial statements.

## 2.5 SIGNIFICANT ACCOUNTING JUDGEMENTS AND ESTIMATES *(continued)*

**Estimation uncertainty** *(continued)*

*Deferred tax assets*

Deferred tax assets are recognised for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary differences 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, which affects the probability of utilisation and the tax rate to be used in the calculations. Details of deferred tax assets are contained in note 8 to the financial statements.

## 3. SEGMENT INFORMATION

The Group comprises the following business segments:

- liquid milk products segment — manufacture and distribution of ultra-high temperature milk ("UHT milk"), milk beverages and yogurt;
- ice cream products segment — manufacture and distribution of ice cream; and
- other dairy products segment — manufacture and distribution of milk powder.

As the Group mainly operates and generates its revenue and results in the PRC, no geographical segment analysis is presented.

## 3. SEGMENT INFORMATION *(continued)*

The following tables present the revenue, results and certain asset and liability information for the Group's business segments for the year ended 31 December 2006:

| | **2006** **RMB'000** | 2005 RMB'000 |
|---|---|---|
| Segment revenue: | | |
| Liquid milk | **14,260,929** | 9,314,688 |
| Ice cream | **1,818,042** | 1,295,861 |
| Other dairy products | **167,397** | 214,401 |
| | **16,246,368** | 10,824,950 |
| Segment results: | | |
| Liquid milk | **970,207** | 637,292 |
| Ice cream | **119,610** | 80,492 |
| Other dairy products | **24,394** | (623) |
| | **1,114,211** | 717,161 |
| Unallocated corporate expenses | **(133,021)** | (65,673) |
| Profit from operating activities | **981,190** | 651,488 |
| Interest income | **15,827** | 12,898 |
| Finance costs | **(63,081)** | (43,956) |
| Share of profits and losses of associates | **8,384** | (3,295) |
| Profit before tax | **942,320** | 617,135 |
| Income tax expense | **(76,032)** | (61,612) |
| Profit for the year | **866,288** | 555,523 |

## 3. SEGMENT INFORMATION *(continued)*

| | 2006<br>RMB'000 | 2005<br>RMB'000 |
|---|---|---|
| Segment assets: | | |
| Liquid milk | **6,049,910** | 4,274,241 |
| Ice cream | **1,029,309** | 886,902 |
| Other dairy products | **118,804** | 169,559 |
| Unallocated corporate assets | **1,668,720** | 1,226,247 |
| Eliminations | **(1,103,065)** | (469,844) |
| Total assets | **7,736,678** | 6,087,105 |
| Segment liabilities: | | |
| Liquid milk | **3,809,625** | 2,547,286 |
| Ice cream | **471,854** | 386,960 |
| Other dairy products | **33,655** | 67,239 |
| Unallocated corporate liabilities | **918,929** | 788,385 |
| Eliminations | **(1,103,065)** | (469,844) |
| Total liabilities | **4,130,998** | 3,320,026 |
| Capital expenditure: | | |
| Liquid milk | **1,300,644** | 739,821 |
| Ice cream | **86,804** | 246,915 |
| Other dairy products | **7,216** | 20,823 |
| Others | **77,761** | 38,294 |
| | **1,472,425** | 1,045,853 |
| Depreciation and amortisation: | | |
| Liquid milk | **312,529** | 210,296 |
| Ice cream | **73,419** | 51,972 |
| Other dairy products | **5,927** | 5,713 |
| Others | **14,671** | 10,292 |
| | **406,546** | 278,273 |
| Other non-cash expenses/(income): | | |
| Liquid milk | **3,304** | (764) |
| Ice cream | **(187)** | 219 |
| Other dairy products | **1,489** | 2,795 |
| Others | **27** | (95) |
| | **4,633** | 2,155 |

## 4. REVENUE, OTHER INCOME AND GAINS

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

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

| | Notes | 2006 RMB'000 | 2005 RMB'000 |
|---|---|---|---|
| Revenue | | **16,246,368** | 10,824,950 |
| Other income and gains: | | | |
| Government grants | (a) | **22,438** | 10,426 |
| Trademark fees | | **1,368** | 1,896 |
| Amortisation of deferred income | (b) | **4,605** | 4,145 |
| Foreign exchange gains, net | | **16,217** | 5,733 |
| Dilution gain arising from an investment in a jointly controlled entity | (c) | **25,000** | — |
| Gain on disposal of an investment in an associate | | **2,167** | — |
| Others | | **4,664** | 2,767 |
| | | **76,459** | 24,967 |
| | | **16,322,827** | 10,849,917 |

*Notes:*

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

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

(c) During the year, the Group made a capital contribution to a jointly controlled entity by the injection of self-developed intangible assets based on the fair value of such assets. The gain represented the difference between the fair value and the book value of the injected assets attributable to the share of the joint venture partners.

## 5. PROFIT BEFORE TAX

The Group's profit before tax is arrived at after charging/(crediting):

| | **2006** **RMB'000** | 2005 RMB'000 |
|---|---|---|
| Cost of inventories sold | **12,524,597** | 8,411,745 |
| Employee benefits expense (excluding directors' remuneration as disclosed in note 6) | | |
| — Wages, salaries and bonuses | **619,649** | 380,277 |
| — Retirement benefit contributions | **51,098** | 10,050 |
| — Share-based payment expense (note 35) | **3,108** | — |
| | **673,855** | 390,327 |
| Depreciation of property, plant and equipment | **403,485** | 276,964 |
| Amortisation of land use rights | **1,707** | 1,309 |
| Amortisation of intangible assets | **1,354** | — |
| Research and development costs | **5,506** | 6,291 |
| Provision for/(write-back of provision for) trade receivables | **3,478** | (194) |
| Write-down of inventories to net realisable value | **1,155** | 2,349 |
| Minimum lease payments under operating leases on buildings and certain production equipment | **32,910** | 8,788 |
| Display space leasing fees | **87,827** | 60,886 |
| Loss on disposal of items of property, plant and equipment | **1,075** | 3,243 |
| Auditors' remuneration | **2,816** | 2,270 |

## 6. DIRECTORS' AND SENIOR EXECUTIVES' EMOLUMENTS

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

| | **2006**<br>**RMB'000** | 2005<br>RMB'000 |
|---|---|---|
| Fees | **270** | 165 |
| Other emoluments | | |
| — basic salaries, housing benefits, other allowances and benefits in kind | **4,576** | 3,503 |
| — retirement benefits contributions | **42** | 20 |
| | **4,888** | 3,688 |

| | Notes | **Fees**<br>RMB'000 | **Basic salaries, housing benefits, other allowances and benefits in kind**<br>RMB'000 | **Retirement benefits contributions**<br>RMB'000 | **Total remuneration**<br>RMB'000 |
|---|---|---|---|---|---|
| **2006** | | | | | |
| **Executive directors** | | | | | |
| **— Mr. Niu Gensheng** | | **30** | **988** | **14** | **1,032** |
| **— Ms. Lu Jun** | (a) | **30** | **798** | **—** | **828** |
| **— Mr. Yang Wenjun** | | **30** | **1,770** | **14** | **1,814** |
| **— Mr. Sun Yubin** | | **30** | **1,020** | **14** | **1,064** |
| **Non-executive directors** | | | | | |
| **— Mr. Jiao Shuge** | (b) | **—** | **—** | **—** | **—** |
| **— Mr. Liu Haifeng, David** | (b) | **—** | **—** | **—** | **—** |
| **— Ms. Jin Yujuan, Lily** | (b) | **—** | **—** | **—** | **—** |
| **— Mr. Julian Juul Wolhardt** | (b) | **—** | **—** | **—** | **—** |
| **Independent non-executive directors** | | | | | |
| **— Mr. Wang Huaibao** | | **50** | **—** | **—** | **50** |
| **— Mr. Zhang Julin** | | **50** | **—** | **—** | **50** |
| **— Mr. Li Jianxin** | | **50** | **—** | **—** | **50** |
| | | **270** | **4,576** | **42** | **4,888** |

## 6. DIRECTORS' AND SENIOR EXECUTIVES' EMOLUMENTS *(continued)*

| | Fees RMB'000 | Basic salaries, housing benefits, other allowances and benefits in kind RMB'000 | Retirement benefits contributions RMB'000 | Total remuneration RMB'000 |
|---|---|---|---|---|
| 2005 | | | | |
| Executive directors | | | | |
| — Mr. Niu Gensheng | 18 | 858 | 5 | 881 |
| — Ms. Lu Jun | 18 | 685 | 5 | 708 |
| — Mr. Yang Wenjun | 18 | 1,050 | 5 | 1,073 |
| — Mr. Sun Yubin | 18 | 910 | 5 | 933 |
| Non-executive directors | | | | |
| — Mr. Jiao Shuge | — | — | — | — |
| — Mr. Liu Haifeng, David | — | — | — | — |
| — Ms. Jin Yujuan, Lily | — | — | — | — |
| Independent non-executive directors | | | | |
| — Mr. Wang Huaibao | 31 | — | — | 31 |
| — Mr. Zhang Julin | 31 | — | — | 31 |
| — Mr. Li Jianxin | 31 | — | — | 31 |
| | 165 | 3,503 | 20 | 3,688 |

(a) Ms. Lu Jun was re-designated as a non-executive director subsequent to the year end.

(b) Mr. Liu Haifeng, David and Ms. Jin Yujuan, Lily, who resigned in January and March 2006 respectively, agreed to waive their entitlements to directors' fees totalling RMB12,500 (2005: RMB36,000). The remaining two (2005: one) non-executive directors agreed to waive their entitlements to directors' fees totalling RMB96,000 (2005: RMB18,000) for the year. Other than the aforementioned, there was no arrangement under which a director waived or agreed to waive any remuneration during the year.

## 6. DIRECTORS' AND SENIOR EXECUTIVES' EMOLUMENTS *(continued)*

Two (2005: Three) of the five highest paid individuals were directors whose emoluments have been shown above. Details of emoluments paid to the remaining three (2005: two) non-director, highest paid senior executives for the year were as follows:

| | **2006** | 2005 |
|---|---|---|
| | **RMB'000** | RMB'000 |
| Basic salaries, housing benefits, other allowances and benefits in kind | **3,095** | 1,604 |
| Discretionary bonuses | **151** | 208 |
| Employee share option benefits | **90** | — |
| Retirement benefits scheme contributions | **40** | 25 |
| | **3,376** | 1,837 |

The number of non-director, highest paid employees whose remuneration fell within the following bands is as follows:

| | **Number of employees** | |
|---|---|---|
| | **2006** | 2005 |
| Nil to HK$1,000,000 | **—** | 2 |
| HK$1,000,001 to HK$1,500,000 | **3** | — |
| | **3** | 2 |

Out of the above amount, approximately RMB1,140,000 (2005: RMB889,000) and RMB1,127,000 (2005: not applicable) were paid or payable to Mr. Yao Tongshan and Mr. Bai Ying respectively.

During the year, share options were granted to two non-director, highest paid employees in respect of their services to the Group, further details of which are included in the disclosures in note 35 to the financial statements. The fair value of such options, which has been recognised in the consolidated income statement over the vesting period, was determined as at the date of grant and the amount recognised in the financial statements for the current year is included in the above non-director, highest paid employees' remuneration disclosures.

## 7. FINANCE COSTS

| | 2006 RMB'000 | 2005 RMB'000 |
|---|---|---|
| Interest on bank loans wholly repayable within five years | **48,474** | 40,826 |
| Interest on long term payables | **14,855** | 5,415 |
| Less: amounts capitalised | **(248)** | (2,285) |
| | **63,081** | 43,956 |

The amounts capitalised are the borrowing costs related to funds borrowed specifically for the purpose of obtaining qualifying assets. The interest rate on such capitalised borrowings during the year was 5.67% (2005: varied from 2.88% to 5.76%) per annum.

## 8. INCOME TAX EXPENSE

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

Under the PRC income tax law, except for certain preferential treatment available to eighteen (2005: fourteen) of the Group's subsidiaries, the entities within the Group are subject to CIT at a rate of 33% on the taxable income as reported in their statutory accounts which are prepared in accordance with the PRC accounting standards and financial regulations.

## 8. INCOME TAX EXPENSE *(continued)*

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

| | Notes | **2006**<br>**RMB'000** | 2005<br>RMB'000 |
|---|---|---|---|
| Profit before tax | | **942,320** | 617,135 |
| At PRC CIT rate of 33% | | **310,966** | 203,655 |
| Non-(taxable)/deductible items and others, net | | **(4,234)** | 22,685 |
| Effect on tax exemptions | (a) | **(230,700)** | (164,728) |
| At the effective income tax rate of 8.1% (2005: 10.0%) | | **76,032** | 61,612 |

*Notes:*

(a) Eighteen (2005: fourteen) subsidiaries were subject to tax concessions in 2006. The total taxable profit of the subsidiaries that are subject to tax concessions amounted to approximately RMB699,090,000 (2005: RMB499,176,000) in aggregate. Out of the eighteen subsidiaries, fifteen (2005: seven) subsidiaries were granted tax concessions by the state tax bureau in accordance with the "Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises" under which these subsidiaries would be exempted from CIT for the first two profitable years and subject to 50% of the applicable tax rate for the following three profitable years. Two (2005: seven) subsidiaries were granted tax concessions by the local tax bureau in accordance with the policy of "The Notice of Income Tax Exemption for the Country's Key Enterprises in Agricultural Industries" of the tax authorities. The remaining one (2005: nil) was granted a three-year tax exemption by the local tax bureau in accordance with the state tax bureau's policy to aid the new companies established in remote and destitute areas.

(b) The share of tax attributable to associates amounting to approximately RMB4,790,000 (2005: RMB1,687,000) is included in the share of profits and losses of associates on the face of the consolidated income statement.

## 8. INCOME TAX EXPENSE *(continued)*

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

| | Group | |
|---|---|---|
| | **2006** | 2005 |
| | **RMB'000** | RMB'000 |
| Tax losses arising in the PRC | **2,174** | 14,377 |
| Tax credit related to purchases of domestic equipment | **27,481** | — |
| Temporary differences | **141,707** | 66,068 |
| | **171,362** | 80,445 |

The temporary differences associated with investments in subsidiaries, associates and a jointly controlled entity, for which deferred tax liability has not been recognised aggregated to approximately RMB438,037,000 (2005: RMB182,023,000).

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

Except for the amount disclosed above, the Group and the Company did not have any material unrecognised deferred tax liabilities or deferred tax assets at 31 December 2006.

## 9. DIVIDENDS

| | Notes | 2006 RMB'000 | 2005 RMB'000 |
|---|---|---|---|
| *Declared and paid during the year* | | | |
| Equity dividends on ordinary shares | | **93,873** | 80,053 |
| *Proposed for approval at AGM* | | | |
| Equity dividends on ordinary shares: | | | |
| Proposed final — RMB0.1094 (2005: RMB0.0686) per ordinary share | (a) | **149,718** | 93,873 |

*Note:*

(a) The proposed total dividend is calculated based on approximately 1,368,416,000 (2005: 1,368,416,000) existing shares in issue. The proposed final dividend for the year is subject to the approval of the Company's shareholders at the forthcoming Annual General Meeting ("AGM"). Such dividend is not recognised as a liability in the consolidated financial statements as at 31 December 2006 but will be reflected as an appropriation of retained earnings for the year ending 31 December 2007.

## 10. EARNINGS PER SHARE

Basic earnings per share is calculated by dividing the profit for the year attributable to ordinary equity holders of the Company by the weighted average number of ordinary shares outstanding during the year.

The share options outstanding had an antidilutive effect on the calculation of diluted earnings per share for the year ended 31 December 2006. The diluted earnings per share for the year ended 31 December 2005 was calculated by dividing the profit for that year attributable to ordinary equity holders of the Company by the weighted average number of ordinary shares outstanding during that year, being the weighted average number of ordinary shares outstanding during that year, adjusted for the effects of dilutive potential ordinary shares outstanding during that year.

## 10. EARNINGS PER SHARE *(continued)*

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

| | **2006** **Number of shares** **'000** | 2005 Number of shares '000 |
|---|---|---|
| Weighted average number of ordinary shares for the purpose of the basic earnings per share calculation | **1,368,416** | 1,251,129 |
| Effect of dilution: | | |
| Conversion of convertible instrument | **—** | 117,287 |
| Weighted average number of ordinary shares for the purpose of the diluted earnings per share calculation | **1,368,416** | 1,368,416 |

## 11. PROPERTY, PLANT AND EQUIPMENT

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

| | Buildings and structures RMB'000 | Plant and machinery RMB'000 | Office equipment RMB'000 | Motor vehicles RMB'000 | Total RMB'000 |
|---|---|---|---|---|---|
| At 1 January 2006, net of accumulated depreciation | 1,012,716 | 2,040,890 | 55,680 | 31,147 | 3,140,433 |
| Additions | 40,278 | 421,414 | 27,252 | 4,872 | 493,816 |
| Capital injection from minority share holders (note 34(b)) | 37,397 | 35,422 | 1,255 | — | 74,074 |
| Transfers from construction in progress (note 12) | 181,058 | 727,709 | 4,214 | — | 912,981 |
| Disposals | (60) | (8,751) | (202) | (1,294) | (10,307) |
| Investment to a jointly controlled entity (note (c)) | (20,115) | — | — | — | (20,115) |
| Sales to a jointly controlled entity (note (c)) | (8,035) | (18,777) | (302) | — | (27,114) |
| Depreciation charged for the year | (55,543) | (317,954) | (19,679) | (10,309) | (403,485) |
| At 31 December 2006, net of accumulated depreciation | 1,187,696 | 2,879,953 | 68,218 | 24,416 | 4,160,283 |
| At 1 January 2006 | | | | | |
| Cost | 1,091,858 | 2,457,703 | 84,409 | 51,955 | 3,685,925 |
| Accumulated depreciation | (79,142) | (416,813) | (28,729) | (20,808) | (545,492) |
| Net carrying amount | 1,012,716 | 2,040,890 | 55,680 | 31,147 | 3,140,433 |
| At 31 December 2006 | | | | | |
| Cost | 1,319,536 | 3,599,339 | 115,884 | 54,932 | 5,089,691 |
| Accumulated depreciation | (131,840) | (719,386) | (47,666) | (30,516) | (929,408) |
| Net carrying amount | 1,187,696 | 2,879,953 | 68,218 | 24,416 | 4,160,283 |

## 11. PROPERTY, PLANT AND EQUIPMENT *(continued)*

| | Buildings and structures RMB'000 | Plant and machinery RMB'000 | Office equipment RMB'000 | Motor vehicles RMB'000 | Total RMB'000 |
|---|---|---|---|---|---|
| At 1 January 2005, net of accumulated depreciation | 775,481 | 1,351,753 | 62,374 | 37,920 | 2,227,528 |
| Additions | — | 340,989 | 6,061 | 3,287 | 350,337 |
| Transfers from construction in progress (note 12) | 286,735 | 557,206 | 3,434 | — | 847,375 |
| Disposals | (5,104) | (2,449) | (83) | (207) | (7,843) |
| Depreciation charged for the year | (44,396) | (206,609) | (16,106) | (9,853) | (276,964) |
| At 31 December 2005, net of accumulated depreciation | 1,012,716 | 2,040,890 | 55,680 | 31,147 | 3,140,433 |
| At 1 January 2005 | | | | | |
| Cost | 810,337 | 1,563,042 | 78,432 | 49,174 | 2,500,985 |
| Accumulated depreciation | (34,856) | (211,289) | (16,058) | (11,254) | (273,457) |
| Net carrying amount | 775,481 | 1,351,753 | 62,374 | 37,920 | 2,227,528 |
| At 31 December 2005 | | | | | |
| Cost | 1,091,858 | 2,457,703 | 84,409 | 51,955 | 3,685,925 |
| Accumulated depreciation | (79,142) | (416,813) | (28,729) | (20,808) | (545,492) |
| Net carrying amount | 1,012,716 | 2,040,890 | 55,680 | 31,147 | 3,140,433 |

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

(b) Certain property, plant and equipment of the Group with a net book value of approximately RMB609,929,000 (2005: RMB467,667,000) have been pledged to secure the long term payables of the Group, details of which are set out in note 30 to the financial statements.

(c) During the year, the Group injected capital to a jointly controlled entity in the form of property, plant and equipment with a carrying amount of RMB40,230,000 and sold property, plant and equipment with a carrying amount of RMB54,228,000 to that entity. The amounts disclosed in the above table represented 50% of the transaction amounts, which were the interest attributable to the joint venture partners (notes 34 and 39).

## 11. PROPERTY, PLANT AND EQUIPMENT *(continued)*

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

| | Company | |
|---|---|---|
| | **2006** | 2005 |
| | **RMB'000** | RMB'000 |
| At 1 January, net of accumulated depreciation | **88** | 105 |
| Additions | **2** | 6 |
| Depreciation charged for the year | **(23)** | (23) |
| Disposal | **(2)** | — |
| At 31 December, net of accumulated depreciation | **65** | 88 |
| At 1 January | | |
| Cost | **121** | 115 |
| Accumulated depreciation | **(33)** | (10) |
| Net carrying amount | **88** | 105 |
| At 31 December | | |
| Cost | **121** | 121 |
| Accumulated depreciation | **(56)** | (33) |
| Net carrying amount | **65** | 88 |

## 12. CONSTRUCTION IN PROGRESS

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

| | Group | |
|---|---|---|
| | **2006** | 2005 |
| | **RMB'000** | RMB'000 |
| Carrying amount at beginning of the year | **235,373** | 292,013 |
| Additions during the year | **1,026,013** | 790,735 |
| Transfers to property, plant and equipment (note 11) | **(912,981)** | (847,375) |
| Carrying amount at end of the year | **348,405** | 235,373 |

## 13. OTHER INTANGIBLE ASSETS

Movements of the Group's intangible assets are as follows:

| | **Patents and licences RMB'000** | **Computer software RMB'000** | **Total RMB'000** |
|---|---|---|---|
| **Cost at 1 January 2006, net of accumulated amortisation** | **—** | **—** | **—** |
| **Additions** | **—** | **7,558** | **7,558** |
| **Contribution from a minority shareholder (note 34(a))** | **7,000** | **—** | **7,000** |
| **Amortisation provided during the year** | **(233)** | **(1,121)** | **(1,354)** |
| **At 31 December 2006** | **6,767** | **6,437** | **13,204** |
| **At 31 December 2006** | | | |
| **Cost** | **7,000** | **7,558** | **14,558** |
| **Accumulated amortisation** | **(233)** | **(1,121)** | **(1,354)** |
| **Net carrying amount** | **6,767** | **6,437** | **13,204** |

There were no other intangible assets as at 1 January 2005 and at 31 December 2005.

## 14. LAND USE RIGHTS

| | Group 2006 RMB'000 | 2005 RMB'000 |
|---|---|---|
| Carrying amount at beginning of the year | **67,871** | 34,062 |
| Recognised during the year | **64,842** | 35,118 |
| Amortised during the year | **(1,707)** | (1,309) |
| Carrying amount at end of the year | **131,006** | 67,871 |
| Current portion included in prepayments, deposits and other receivables under current assets (note 23) | **2,620** | 1,948 |
| Non-current portion | **128,386** | 65,923 |
| | **131,006** | 67,871 |

## 15. INTERESTS IN SUBSIDIARIES

| | Company 2006 RMB'000 | 2005 RMB'000 |
|---|---|---|
| Unlisted shares, at cost | **851,806** | 689,210 |
| Loan to a subsidiary | **972,419** | 972,419 |
| | **1,824,225** | 1,661,629 |

The loan to a subsidiary included in the interests in subsidiaries above is unsecured, interest-free and has no fixed terms of repayment. The carrying amount of the loan to a subsidiary approximates to its fair value.

During the year, the Company acquired certain interests in six subsidiaries from Inner Mongolia Mengniu Dairy (Group) Company Limited ("Inner Mongolia Mengniu") and Inner Mongolia Mengniu Founding Industry Management Co., Ltd. for long term investment purposes. The consideration for these acquisitions was determined based on the valuation by external valuers.

## 15. INTERESTS IN SUBSIDIARIES *(continued)*

Details of the Company's subsidiaries at 31 December 2006 are set out below:

| Name | Date of incorporation/ establishment* | Issued share capital | Percentage of equity interest attributable to the Company | | Principal activities |
|---|---|---|---|---|---|
| | | | Direct | Indirect | |
| China Dairy Holdings (i) | 5 June 2002 | US$214 | 100% | — | Investment holding |
| China Dairy (Mauritius) Limited (i) | 15 June 2002 | US$100 | — | 100% | Investment holding |
| Inner Mongolia Mengniu Dairy (Group) Company Limited (iii) (內蒙古蒙牛乳業(集團)股份有限公司) | 18 August 1999 | RMB267,429,488 | — | 84.32% | Manufacture and sale of dairy products |
| Beijing Mengniu Dairy Co., Ltd. (i) (ii) (北京蒙牛乳制品有限責任公司) | 4 July 2000 | RMB500,000 | — | 43.85% | Package and sale of dairy products |
| Inner Mongolia Mengniu Founding Industry Management Co., Ltd. (i) (ii) (內蒙古蒙牛方鼎產業管理有限責任公司) | 9 February 2002 | RMB45,000,000 | — | 84.32% | Investment holding |
| Mengniu Dairy (Wulanhaote) Co., Ltd. (i) (iii) (蒙牛乳業(烏蘭浩特)有限責任公司) | 18 June 2002 | RMB30,000,000 | — | 84.32% | Manufacture and sale of dairy products |
| Inner Mongolia Mengniu Dairy Keerqin Co., Ltd. (i) (iii) (內蒙古蒙牛乳業科爾沁有限責任公司) | 19 June 2002 | RMB20,000,000 | — | 84.32% | Manufacture and sale of dairy products |

## 15. INTERESTS IN SUBSIDIARIES *(continued)*

Details of the Company's subsidiaries at 31 December 2006 are set out below: *(continued)*

| Name | Date of incorporation/ establishment* | Issued share capital | Percentage of equity interest attributable to the Company Direct | Percentage of equity interest attributable to the Company Indirect | Principal activities |
|---|---|---|---|---|---|
| Mengniu Dairy (Dangyang) Co., Ltd. (i) (iii) (蒙牛乳業(當陽)有限責任公司) | 7 November 2002 | RMB42,000,000 | — | 84.32% | Manufacture and sale of dairy products |
| Mengniu Dairy (Beijing) Co., Ltd. (i) (iii) (蒙牛乳業(北京)有限責任公司) | 11 November 2002 | RMB60,000,000 | 26.70% | 61.81% | Manufacture and sale of dairy products |
| Jinhua Mengniu Dairy Co., Ltd. (i) (ii) (金華蒙牛乳業有限公司) | 19 February 2003 | RMB500,000 | — | 43.00% | Manufacture and sale of dairy products |
| Mengniu Dairy (Shenyang) Co., Ltd. (i) (iii) (蒙牛乳業(沈陽)有限責任公司) | 4 December 2003 | RMB100,000,000 | 26.05% | 62.37% | Manufacture and sale of dairy products |
| Beijing Mengniu Hongda Dairy Co., Ltd. (i) (ii) (北京蒙牛宏達乳制品有限責任公司) | 12 September 2002 | RMB10,000,000 | — | 43.85% | Package and sale of dairy products |
| Inner Mongolia Mengniu Dairy Baotou Co., Ltd. (i) (iii) (內蒙古蒙牛乳業包頭有限責任公司) | 9 January 2003 | RMB30,000,000 | 26.40% | 62.06% | Manufacture and sale of dairy products |
| Mengniu Dairy (Dengkou Bayan Gaole) Co., Ltd. (i) (iii) (蒙牛乳業(磴口巴彥高勒)有限責任公司) | 13 July 2003 | RMB40,000,000 | — | 84.32% | Manufacture and sale of dairy products |

## 15. INTERESTS IN SUBSIDIARIES *(continued)*

Details of the Company's subsidiaries at 31 December 2006 are set out below: *(continued)*

| Name | Date of incorporation/ establishment* | Issued share capital | Percentage of equity interest attributable to the Company Direct | Percentage of equity interest attributable to the Company Indirect | Principal activities |
|---|---|---|---|---|---|
| Inner Mongolia Mengniu Dairy (Group) Shanxi Dairy Co., Ltd. (i) (ii) (內蒙古蒙牛乳業(集團)山西乳業有限公司) | 14 July 2003 | RMB10,000,000 | — | 75.89% | Manufacture and sale of dairy products |
| Mengniu Dairy (Jiaozuo) Co., Ltd. (i) (iii) (蒙牛乳業(焦作)有限公司) | 6 November 2003 | RMB110,000,000 | — | 84.32% | Manufacture and sale of dairy products |
| Mengniu Dairy Taian Co., Ltd. (i) (iii) (蒙牛乳業泰安有限責任公司) | 18 November 2003 | RMB110,000,000 | 26.03% | 62.37% | Manufacture and sale of dairy products |
| Mengniu Dairy (Luannan) Co., Ltd. (i) (iii) (蒙牛乳業(灤南)有限責任公司) | 31 March 2004 | RMB56,000,000 | 26.06% | 62.34% | Manufacture and sale of dairy products |
| Mengniu Dairy (Tangshan) Co., Ltd. (i) (iii) (蒙牛乳業(唐山)有限責任公司) | 31 March 2004 | RMB70,000,000 | 26.05% | 62.35% | Manufacture and sale of dairy products |
| Mengniu Dairy (Maanshan) Co., Ltd. (i) (iii) (蒙牛乳業(馬鞍山)有限責任公司) | 4 February 2005 | RMB155,000,000 | — | 84.32% | Manufacture and sale of dairy products |
| Mengniu (Wuhan) Frealth Dairy Co., Ltd. (i) (iii) (蒙牛(武漢)友芝友乳業有限公司) | 6 January 2006 | RMB120,000,000 | — | 43.85% | Manufacture and sale of dairy products |

## 15. INTERESTS IN SUBSIDIARIES *(continued)*

Details of the Company's subsidiaries at 31 December 2006 are set out below: *(continued)*

| Name | Date of incorporation/ establishment* | Issued share capital | Percentage of equity interest attributable to the Company | | Principal activities |
|---|---|---|---|---|---|
| | | | Direct | Indirect | |
| Inner Mongolia Mengniu Breeding Biotech Co., Ltd. (i) (ii) (內蒙古蒙牛繁育生物技術有限公司) | 31 July 2006 | RMB20,000,000 | — | 54.81% | Cultivation and sale of cattle embryos |
| Inner Mongolia Mengniu Hi-tech Dairy Co., Ltd. (i) (ii) (內蒙古蒙牛高科乳業有限公司) | 2 August 2006 | RMB150,000,000 | — | 84.32% | Manufacture and sale of dairy products |
| Mengniu Dairy (Tai Yuan) Co., Ltd. (i) (ii) (蒙牛乳業(太原)有限公司) | 13 April 2006 | RMB50,000,000 | — | 84.32% | Manufacture and sale of dairy products |
| Mengniu Dairy (Shangzhi) Co., Ltd. (i) (ii) (蒙牛乳業(尚志)有限責任公司) | 10 June 2005 | RMB50,000,000 | — | 84.32% | Manufacture and sale of dairy products |
| Mengniu Dairy (Chabei) Co., Ltd. (i) (ii) (蒙牛乳業(察北)有限公司) | 15 June 2005 | RMB30,000,000 | — | 65.77% | Manufacture and sale of dairy products |
| Mengniu Dairy (Baoji) Co., Ltd. (i) (iii) (蒙牛乳業(寶雞)有限公司) | 1 November 2005 | RMB60,000,000 | — | 84.32% | Manufacture and sale of dairy products |

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

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

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

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

## 16. INTERESTS IN ASSOCIATES

| | Group 2006 RMB'000 | 2005 RMB'000 |
|---|---|---|
| Share of net assets | **40,371** | 18,700 |

Details of the Group's associates at 31 December 2006 are set out below:

| Name | Particulars of issued shares held | Place of incorporation/ registration and operations | Percentage of equity interest attributable to the Group (indirect) 2006 | 2005 | Principal activities |
|---|---|---|---|---|---|
| Xinjiang Tianxue Food Co., Ltd. (i) (新疆天雪食品有限公司) | Registered capital | The PRC | 21% | 21% | Trading of dairy products |
| Inner Mongolia Meng Niu AustAsia Model Dairy Farm Company Limited (i) (內蒙古蒙牛澳亞示范牧場有限責任公司) | Registered capital | The PRC | 25% | 25% | Production of raw milk, planting of pastures and processing of milk |
| Fuzhou Mengxin Trading Co., Ltd. (i) (福州蒙鑫貿易有限公司) | Registered capital | The PRC | 39% | 38% | Trading of dairy products |
| Shijiazhuang Mengniu Ice Cream Sales Co., Ltd. (i) (石家庄蒙牛冰淇淋銷售有限公司) | Registered capital | The PRC | 34% | 33% | Trading of dairy products |
| Tianjin Mengniu Ice Cream Sales Co., Ltd. (i) (天津蒙牛冰淇淋銷售有限責任公司) | Registered capital | The PRC | 34% | 33% | Trading of dairy products |
| Guangzhou Mengniu Dairy Trading Co., Ltd. (i) (廣州市蒙牛乳業貿易有限公司) | Registered capital | The PRC | 34% | 33% | Trading of dairy products |

## 16. INTERESTS IN ASSOCIATES *(continued)*

Details of the Group's associates at 31 December 2006 are set out below: *(continued)*

| Name | Particulars of issued shares held | Place of incorporation/ registration and operations | Percentage of equity interest attributable to the Group (indirect) 2006 | 2005 | Principal activities |
|---|---|---|---|---|---|
| Wuhan Mengniu Dairy Co., Ltd. (i) (武漢蒙牛乳業有限公司) | Registered capital | The PRC | 24% | 31% | Trading of dairy products |
| Guilin Mengniu Dairy Sales Co., Ltd. (i) (桂林蒙牛乳業銷售有限公司) | Registered capital | The PRC | 34% | 33% | Trading of dairy products |
| Tianjin Mengniu Dairy Sales Co., Ltd. (i) (天津市蒙牛乳業銷售有限公司) | Registered capital | The PRC | 34% | 33% | Trading of dairy products |
| Wenzhou Mengniu Dairy Co., Ltd. (i) (溫州蒙牛乳業有限公司) | Registered capital | The PRC | 34% | 33% | Trading of dairy products |
| Heilongjiang Mengniu Dairy Sales Co., Ltd. (formerly known as Harbin Mengniu Dairy Co., Ltd.)(i) (黑龍江蒙牛乳業銷售有限公司 (原名為哈爾濱蒙牛乳業有限公司)) | Registered capital | The PRC | 38% | 38% | Trading of dairy products |
| Chengdu Mengniu Dairy Sales Co., Ltd (i) (成都蒙牛乳業銷售有限責任公司) | Registered capital | The PRC | 34% | 33% | Trading of dairy products |
| Nanjing Mengniu Dairy Sales Co., Ltd. (i) (南京蒙牛乳業銷售有限公司) | Registered capital | The PRC | 38% | 38% | Trading of dairy products |
| Shenyang Mengniu Dairy Co., Ltd. (i) (ii) (瀋陽蒙牛乳業有限公司) | Registered capital | The PRC | 17% | 17% | Trading of dairy products |
| Jinan Mengniu Dairy Co., Ltd. (i) (濟南蒙牛乳業有限公司) | Registered capital | The PRC | 38% | 38% | Trading of dairy products |

## 16. INTERESTS IN ASSOCIATES *(continued)*

Details of the Group's associates at 31 December 2006 are set out below: *(continued)*

| Name | Particulars of issued shares held | Place of incorporation/ registration and operations | Percentage of equity interest attributable to the Group (indirect) 2006 | 2005 | Principal activities |
|---|---|---|---|---|---|
| Taiyuan Mengniu Dairy Co., Ltd. (i) (太原市蒙牛乳業有限公司) | Registered capital | The PRC | 33% | 34% | Trading of dairy products |
| Nanchang Mengniu Dairy Sales Co., Ltd. (i) (南昌蒙牛乳業銷售有限責任公司) | Registered capital | The PRC | 38% | 38% | Trading of dairy products |
| Chongqing Mengniu Dairy Sales Co., Ltd. (i) (重慶市蒙牛乳業銷售有限公司) | Registered capital | The PRC | 38% | 38% | Trading of dairy products |
| Hefei Mengniu Dairy Sales Co., Ltd. (i) (合肥市蒙牛乳業銷售有限公司) | Registered capital | The PRC | 38% | 38% | Trading of dairy products |
| Shijiazhuang Jinmengyuan Trading Co., Ltd. (i) (石家庄金蒙源貿易有限責任公司) | Registered capital | The PRC | 38% | 38% | Trading of dairy products |
| Beijing Mengniu Technical Development Co., Ltd. (i) (ii) (北京蒙牛科技發展有限公司) | Registered capital | The PRC | 17% | 17% | Technical development |
| Wulumuqi Mengniu Dairy Sales Co., Ltd. (i) (烏魯木齊蒙牛乳業銷售有限公司) | Registered capital | The PRC | 34% | — | Trading of dairy products |
| Kunming Deluxe Commercial Trading Co., Ltd. (i) (昆明特侖蘇商貿有限公司) | Registered capital | The PRC | 38% | — | Trading of dairy products |

## 16. INTERESTS IN ASSOCIATES *(continued)*

Details of the Group's associates at 31 December 2006 are set out below: *(continued)*

| Name | Particulars of issued shares held | Place of incorporation/ registration and operations | Percentage of equity interest attributable to the Group (indirect) 2006 | 2005 | Principal activities |
|---|---|---|---|---|---|
| Changsha Mengniu Dairy Co., Ltd. (i) (長沙市蒙牛乳業有限責任公司) | Registered capital | The PRC | 34% | — | Trading of dairy products |
| Xi'an Mengniu Dairy Sales Co., Ltd. (i) (西安蒙牛乳業銷售有限公司) | Registered capital | The PRC | 39% | — | Trading of dairy products |
| Changchun Mengniu Dairy Sales Co., Ltd. (i) (長春蒙牛乳品銷售有限公司) | Registered capital | The PRC | 38% | — | Trading of dairy products |
| Xuzhou Mengniu Dairy Sales Co., Ltd. (i) (徐州蒙牛乳業銷售有限公司) | Registered capital | The PRC | 34% | — | Trading of dairy products |
| Foshan Mengniu Dairy Sales Co., Ltd. (i) (佛山市蒙牛乳業銷售有限公司) | Registered capital | The PRC | 38% | — | Trading of dairy products |
| Guiyang Mengniu Dairy Trading Co., Ltd. (i) (貴陽蒙牛乳業貿易有限公司) | Registered capital | The PRC | 38% | — | Trading of dairy products |
| Shengyang Mengniu Dairy Sales Co., Ltd. (i) (ii) (瀋陽蒙牛乳業銷售有限公司) | Registered capital | The PRC | 17% | — | Trading of dairy products |
| Xiangfan Mengniu Dairy Sales Co., Ltd. (i) (襄樊市蒙牛乳業銷售有限公司) | Registered capital | The PRC | 34% | — | Trading of dairy products |

## 16. INTERESTS IN ASSOCIATES *(continued)*

Details of the Group's associates at 31 December 2006 are set out below: *(continued)*

| Name | Particulars of issued shares held | Place of incorporation/ registration and operations | Percentage of equity interest attributable to the Group (indirect) 2006 | 2005 | Principal activities |
|---|---|---|---|---|---|
| Hangzhou Mengniu Dairy Trading Co., Ltd. (i) (杭州蒙牛貿易有限公司) | Registered capital | The PRC | 38% | — | Trading of dairy products |
| Suzhou Mengniu Dairy Sales Co., Ltd. (i) (蘇州蒙牛乳制品銷售有限公司) | Registered capital | The PRC | 38% | — | Trading of dairy products |
| Guangzhou Mengniu Dairy Sales Co., Ltd. (i) (廣州市蒙牛乳業銷售有限公司) | Registered capital | The PRC | 26% | — | Trading of dairy products |
| Shanghai Mengniu Food Sales Co., Ltd. (i) (上海蒙牛食品銷售有限公司) | Registered capital | The PRC | 38% | 38% | Trading of dairy products |

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

(ii) Since more than 20% of the equity interest of the associate was held by Inner Mongolia Mengniu, in which the Company held 84.32% equity interest, the Company had significant influence over the associate even with less than 20% of equity interest held indirectly as at the balance sheet date.

## 16. INTERESTS IN ASSOCIATES *(continued)*

The following table illustrates the summarised financial information of the Group's associates extracted from their unaudited management accounts:

| | **2006** | 2005 |
|---|---|---|
| | **RMB'000** | RMB'000 |
| Share of the associates' assets and liabilities: | | |
| Current assets | **125,335** | 77,901 |
| Non-current assets | **72,816** | 61,134 |
| Current liabilities | **(117,443)** | (97,064) |
| Non-current liabilities | **(40,337)** | (23,271) |
| Net assets | **40,371** | 18,700 |
| Share of the associates' revenues and profits and losses: | | |
| Revenues | **1,075,167** | 610,063 |
| Profits and losses | **8,384** | (3,295) |

## 17. INTEREST IN A JOINTLY CONTROLLED ENTITY

In August 2006, the following jointly controlled entity was established:

| Name | Particulars of issued shares held | Place of establishment and operations | Percentage of equity interests attributable to the Group (indirect) 2006 | 2005 | Principal activities |
|---|---|---|---|---|---|
| Mengniu Arla (Inner Mongolia) Dairy Products Co. Ltd. (i) (內蒙古蒙牛阿拉乳制品有限責任公司) | Registered capital | The PRC | 42.16% | — | Manufacture and sale of other dairy products |

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

## 17. INTEREST IN A JOINTLY CONTROLLED ENTITY *(continued)*

The share of the assets, liabilities, income and expenses of the jointly controlled entity at 31 December 2006 and for the year then ended, which are included in the consolidated financial statements, are as follows:

| | 2006 RMB'000 |
|---|---|
| Share of the assets and liabilities: | |
| Current assets | 40,077 |
| Non-current assets | 78,700 |
| Current liabilities | (33,645) |
| Net assets | 85,132 |
| Share of the revenue and loss: | |
| Revenue | 49,178 |
| Cost of sales and operating expenses | (54,098) |
| Loss | (4,920) |

## 18. AVAILABLE-FOR-SALE INVESTMENTS

| | Group | |
|---|---|---|
| | 2006 RMB'000 | 2005 RMB'000 |
| Unlisted equity investments, at cost | 15,316 | 8,029 |

## 19. GOODWILL

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

— liquid milk products CGU;

— ice cream products CGU; and

— other dairy products CGU.

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

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

— the new product launch and new market expansion have been successful in the past;

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

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

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

| | **Discount rate** | | **Growth rate** | |
|---|---|---|---|---|
| | **2006** | **2005** | **2006** | **2005** |
| Liquid milk products CGU | 12.9% | 12.2% | 8.0% | 8.3% |
| Ice cream products CGU | 12.9% | 12.2% | 5.0% | 8.3% |
| Other dairy products CGU | 12.9% | 12.2% | 6.0% | 8.3% |

## 19. GOODWILL *(continued)*

The carrying amounts of goodwill of approximately RMB 115,549,000 at 31 December 2006 and 2005 allocated to the liquid milk products CGU, ice cream products CGU and other dairy products CGU were approximately RMB83,839,000, RMB23,865,000 and RMB 7,845,000, respectively.

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

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

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

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

## 20. INVENTORIES

| | Group | |
|---|---|---|
| | **2006** | 2005 |
| | **RMB'000** | RMB'000 |
| Raw materials | **520,050** | 488,937 |
| Finished goods | **551,410** | 292,064 |
| | **1,071,460** | 781,001 |

## 21. BILLS RECEIVABLE

An ageing analysis of the bills receivable as at the balance sheet date, based on the invoice date, is as follows:

| | Group | |
|---|---|---|
| | **2006** | 2005 |
| | **RMB'000** | RMB'000 |
| Within 3 months | **125,140** | 81,167 |
| 4 to 6 months | **2,953** | 361 |
| | **128,093** | 81,528 |

As at 31 December 2006, the bills receivable amounting to approximately RMB119,400,000 (2005: RMB80,590,000) were factored with recourse to financial institutions. The corresponding amounts were recorded as short term bank loans (note 28).

## 22. TRADE RECEIVABLES

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

An ageing analysis of the trade receivables of the Group, net of provision for doubtful debts, is as follows:

| | Group | |
|---|---|---|
| | **2006** | 2005 |
| | **RMB'000** | RMB'000 |
| Within 3 months | **163,944** | 160,485 |
| 4 to 6 months | **20,453** | 7,580 |
| 7 to 12 months | **2,104** | 6,592 |
| Over 1 year | **475** | — |
| | **186,976** | 174,657 |

The amounts due from associates of approximately RMB66,459,000 (2005: RMB30,748,000) and an amount due from a jointly controlled entity of approximately RMB1,973,000 (2005: nil) are included in the above balance. These balances are unsecured, non-interest-bearing and are repayable on credit terms similar to those offered to other major customers of the Group.

## 23. PREPAYMENTS, DEPOSITS AND OTHER RECEIVABLES

| | Group | |
|---|---|---|
| | **2006** | 2005 |
| | **RMB'000** | RMB'000 |
| Deposits | **4,810** | 3,047 |
| Prepayments | **154,690** | 144,076 |
| Land use rights — current portion (note 14) | **2,620** | 1,948 |
| Other receivables | **18,386** | 15,404 |
| | **180,506** | 164,475 |

## 24. CASH AND CASH EQUIVALENTS AND PLEDGED DEPOSITS

| | Group | |
|---|---|---|
| | **2006** | 2005 |
| | **RMB'000** | RMB'000 |
| Cash and bank balances | **1,180,058** | 1,247,764 |
| Pledged deposits | **45,071** | 53,673 |
| Time deposits with original maturity of more than three months | **150,000** | — |
| | **1,375,129** | 1,301,437 |
| Less: Deposits pledged for banking facilities (note 26) | **(45,071)** | (53,673) |
| Cash and cash equivalents | **1,330,058** | 1,247,764 |

| | Company | |
|---|---|---|
| | **2006** | 2005 |
| | **RMB'000** | RMB'000 |
| Cash and bank balances | **11,403** | 2,624 |

The Group's cash and cash equivalents comprise cash at banks and in hand. Cash at banks earns interest at floating rates based on daily bank deposit rates. Cash and bank balances amounting to RMB1,358,807,000 (2005: RMB1,285,418,000) were denominated in Renminbi, which is not freely convertible in the international foreign exchange market and its exchange rate is determined by the People's Bank of China.

## 25. TRADE PAYABLES

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

| | **Group** | |
|---|---|---|
| | **2006** | 2005 |
| | **RMB'000** | RMB'000 |
| Within 3 months | **971,494** | 770,373 |
| 4 to 6 months | **51,696** | 94,884 |
| 7 to 12 months | **5,623** | 15,438 |
| Over 1 year | **5,886** | 6,638 |
| | **1,034,699** | 887,333 |

An amount due to an associate of approximately RMB4,872,000 (2005: RMB3,224,000) is included in the above balance. The balances are unsecured, non-interest-bearing and repayable on demand.

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

## 26. BILLS PAYABLE

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

| | **Group** | |
|---|---|---|
| | **2006** | 2005 |
| | **RMB'000** | RMB'000 |
| Within 3 months | **221,527** | 125,645 |
| 4 to 6 months | **102,209** | 104,027 |
| | **323,736** | 229,672 |

Except for an aggregate balance of approximately RMB152,902,000 (2005: RMB148,877,000) secured by the pledge of certain of the Group's deposits amounting to RMB36,438,000 (2005: RMB36,475,000) (note 24), bills payables are unsecured.

## 27. ACCRUALS AND OTHER PAYABLES

| | Group | |
|---|---|---|
| | **2006** | 2005 |
| | **RMB'000** | RMB'000 |
| Advances from customers | **274,141** | 227,484 |
| Salary and welfare payables | **132,596** | 79,699 |
| Current portion of long term payables (note 30) | **201,423** | 146,766 |
| Other payables | **771,305** | 498,195 |
| Other accruals | **60,338** | 24,430 |
| | **1,439,803** | 976,574 |

The amounts due to associates of approximately RMB52,206,000 (2005: RMB32,374,000) are included in the above balance. The balances are unsecured, non-interest-bearing and are repayable on demand.

## 28. INTEREST-BEARING BANK LOANS

| | | Group | | | |
|---|---|---|---|---|---|
| | | **2006** | | 2005 | |
| | **Maturity** | **Fixed rate** | **Floating rate** | Fixed rate | Floating rate |
| | | **RMB'000** | **RMB'000** | RMB'000 | RMB'000 |
| Short term bank loans, secured | 2007 | **119,400** | **—** | 80,590 | — |
| Short term bank loans, unsecured | 2007 | **72,000** | **42,622** | 155,000 | 130,000 |
| Long term bank loans, unsecured | 2008-2009 | **—** | **641,136** | 75,000 | 370,702 |
| | | **191,400** | **683,758** | 310,590 | 500,702 |

| | | Company | | | |
|---|---|---|---|---|---|
| | | **2006** | | 2005 | |
| | **Maturity** | **Fixed rate** | **Floating rate** | Fixed rate | Floating rate |
| | | **RMB'000** | **RMB'000** | RMB'000 | RMB'000 |
| Short term bank loans, unsecured | 2007 | **—** | **6,622** | — | — |
| Long term bank loans, unsecured | 2008-2009 | **—** | **157,432** | — | — |
| | | **—** | **164,054** | — | — |

## 28. INTEREST-BEARING BANK LOANS *(continued)*

At 31 December 2006, short term bank loans of approximately RMB119,400,000 (2005: RMB80,590,000) were secured by certain bills receivable of the Group (note 21).

During the year, the annual interest rates of the short term bank loans and the long term bank loans varied from 3.00% to 5.814% and from 3.00% to 6.65% (2005: varied from 3.00% to 5.58% and from 2.88% to 5.76%), respectively. As at 31 December 2006, except for a long term bank loan of US$33,000,000 equivalent to approximately RMB257,759,000 (2005: US$10,000,000) denominating in United States dollars, all the Group's interest-bearing bank loans were denominated in RMB.

The repayment schedule of the bank loans is as follows:

| | Group | |
|---|---|---|
| | **2006** | 2005 |
| | **RMB'000** | RMB'000 |
| Within 1 year | **234,022** | 365,590 |
| 1 — 2 years | **399,630** | 190,000 |
| 2 — 5 years | **241,506** | 255,702 |
| Total interest-bearing bank loans | **875,158** | 811,292 |
| Less: Amount due within 1 year included in current liabilities | **(234,022)** | (365,590) |
| | **641,136** | 445,702 |

| | Company | |
|---|---|---|
| | **2006** | 2005 |
| | **RMB'000** | RMB'000 |
| Within 1 year | **6,622** | — |
| 1 — 2 years | **69,970** | — |
| 2 — 5 years | **87,462** | — |
| Total interest-bearing bank loans | **164,054** | — |
| Less: Amount due within 1 year included in current liabilities | **(6,622)** | — |
| | **157,432** | — |

## 29. OTHER LOANS

| | Group | |
|---|---|---|
| | **2006** | 2005 |
| | **RMB'000** | RMB'000 |
| Short term | **31,000** | 23,600 |
| Long term | **—** | 11,481 |
| | **31,000** | 35,081 |

The repayment schedule of the other loans is as follows:

| | **2006** | 2005 |
|---|---|---|
| | **RMB'000** | RMB'000 |
| Within 1 year | **31,000** | 23,600 |
| 1 — 2 years | **—** | 11,481 |
| | **31,000** | 35,081 |

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

## 30. LONG TERM PAYABLES

The Group's long term payables represent the amortised costs of the outstanding instalment payable for the purchase of production equipment. The effective interest rate used for the amortisation is the prevailing market interest rate. The balances are repayable as follows:

| | Group | |
|---|---|---|
| | **2006** | 2005 |
| | **RMB'000** | RMB'000 |
| Within 1 year | **201,423** | 146,766 |
| 1 — 2 years | **122,889** | 165,881 |
| 2 — 5 years | **164,862** | 145,640 |
| Over 5 years | **4,359** | — |
| Total long term payables | **493,533** | 458,287 |
| Less: Amount due within 1 year included in current liabilities (note 27) | **(201,423)** | (146,766) |
| | **292,110** | 311,521 |

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

## 31. DEFERRED INCOME

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

| | Group | |
|---|---|---|
| | **2006** | 2005 |
| | **RMB'000** | RMB'000 |
| At beginning of the year | **60,081** | 64,226 |
| Received during the year | **72,912** | — |
| Amortisation during the year | **(4,605)** | (4,145) |
| At end of the year | **128,388** | 60,081 |
| Current portion | **7,889** | 4,145 |
| Non-current portion | **120,499** | 55,936 |
| | **128,388** | 60,081 |

## 32. SHARE CAPITAL

| | Note | **2006** **RMB'000** | 2005 RMB'000 |
|---|---|---|---|
| *Authorised:* | | | |
| 3,000,000,000 ordinary shares of HK$0.1 each | | **319,235** | 319,235 |

| | | **Number of ordinary shares '000** | RMB'000 |
|---|---|---|---|
| *Issued and fully paid:* | | | |
| At 1 January 2005 | | **1,110,525** | 118,138 |
| Shares issued upon conversion of convertible instrument | (a) | **257,891** | 27,435 |
| At 1 January and 31 December 2006 | | **1,368,416** | 145,573 |

*Note:*

(a) On 16 June 2005, convertible instrument of approximately US$24,664,000 (equivalent to approximately RMB204,636,000) was converted into approximately 257,891,000 ordinary shares of HK$0.10 each, giving rise to a share premium of approximately RMB177,201,000, being the excess of the value of the convertible instrument of RMB204,636,000 over the par value of the new shares issued of RMB27,435,000 (note 33).

## 33. RESERVES

### (A) Group

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

| | Share premium RMB'000 | Contributed surplus RMB'000 Note (a) | Statutory reserves RMB'000 Note (b) | Currency translation differences RMB'000 | Share option reserve RMB'000 Note 35 | Total RMB'000 |
|---|---|---|---|---|---|---|
| At 1 January 2005 | 950,380 | 214,677 | 149,962 | (1,969) | — | 1,313,050 |
| Shares issued upon conversion of convertible instrument (note 32(a)) | 177,201 | — | — | — | — | 177,201 |
| Transfer to statutory reserves | — | — | 136,137 | — | — | 136,137 |
| Dividends paid to equity holders of the Company | — | (10,000) | — | — | — | (10,000) |
| Currency translation differences | — | — | — | (647) | — | (647) |
| **At 1 January 2006** | **1,127,581** | **204,677** | **286,099** | **(2,616)** | **—** | **1,615,741** |
| **Transfer to statutory reserves** | **—** | **—** | **208,964** | **—** | **—** | **208,964** |
| **Currency translation differences** | **—** | **—** | **—** | **4,313** | **—** | **4,313** |
| **Additional equity contributed by a minority shareholder** | **—** | **27,343** | **—** | **—** | **—** | **27,343** |
| **Equity-settled share option arrangements** | **—** | **—** | **—** | **—** | **3,108** | **3,108** |
| **At 31 December 2006** | **1,127,581** | **232,020** | **495,063** | **1,697** | **3,108** | **1,859,469** |

## 33. RESERVES *(continued)*

### (B) Company

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

| | Share premium RMB'000 | Contributed surplus RMB'000 Note (a) | Currency translation differences RMB'000 | Retained earnings RMB'000 | Share option reserve RMB'000 Note 35 | Total RMB'000 |
|---|---|---|---|---|---|---|
| At 1 January 2005 | 950,380 | 397,574 | — | 1,263 | — | 1,349,217 |
| Profit for the year (note (d)) | — | — | — | 69,880 | — | 69,880 |
| Dividends paid | — | (10,000) | — | (70,053) | — | (80,053) |
| Shares issued upon conversion of convertible instrument (note 32(a)) | 177,201 | — | — | — | — | 177,201 |
| Currency translation differences | — | — | (199) | — | — | (199) |
| **At 1 January 2006** | **1,127,581** | **387,574** | **(199)** | **1,090** | **—** | **1,516,046** |
| **Profit for the year (note (d))** | **—** | **—** | **—** | **144,277** | **—** | **144,277** |
| **Dividends paid** | **—** | **—** | **—** | **(93,873)** | **—** | **(93,873)** |
| **Currency translation differences** | **—** | **—** | **3,563** | **—** | **—** | **3,563** |
| **Equity-settled share option arrangements** | **—** | **—** | **—** | **—** | **3,108** | **3,108** |
| **At 31 December 2006** | **1,127,581** | **387,574** | **3,364** | **51,494** | **3,108** | **1,573,121** |

## 33. RESERVES *(continued)*

### (B) Company *(continued)*

*Notes:*

**(a) Contributed surplus**

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

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

During the year, a minority shareholder injected additional capital to a subsidiary of the Group. The excess of the amount of capital injected by the minority shareholder over its additional interest in the subsidiary's net assets attributable to the Company's equity holders was recorded as contributed surplus of the Group.

**(b) Statutory reserves**

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

**(c) Distributable reserves**

Under the Companies Law (2001 Second Revision) of the Cayman Islands, the share premium and contributed surplus of the Company are distributable to shareholders, provided that immediately following the distribution of the dividend, the Company is able to pay off its debts as and when they fall due in the ordinary course of business. As at 31 December 2006, the Company's reserves available for distribution to shareholders amounted to approximately RMB1,566,649,000 (2005: RMB1,516,046,000).

**(d)** The profit attributable to equity holders of the Company for the year ended 31 December 2006 dealt with in the financial statements of the Company was RMB144,277,000 (2005: RMB69,880,000), including the dividend income from subsidiaries amounting to approximately RMB152,408,000 (2005: RMB80,053,000).

## 34. NON-CASH TRANSACTIONS

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

(a) A minority shareholder injected capital amounting to RMB7,000,000 to a subsidiary in the form of intangible assets (note 13).

(b) Minority shareholders contributed RMB74,074,000 to two subsidiaries of the Group in the form of property, plant and equipment (note 11).

(c) The Group purchased property, plant and equipment by means of long term payables amounting to approximately RMB217,313,000 (2005: RMB197,903,000).

(d) The Group injected capital to a jointly controlled entity in the form of property, plant and equipment of carrying amount of RMB40,230,000 (note 11(c)). The Group made further capital contribution of approximately RMB50,000,000 to the jointly controlled entity in the form of injection of self-developed intangible assets (note 4(c)) .

## 35. SHARE-BASED PAYMENT PLAN

The Company operates a share option scheme (the "Scheme") for the purpose of providing incentives and rewards to eligible participants who contribute to the success of the Group's operations. Eligible participants of the Scheme include the Company's directors, including independent non-executive directors, other employees of the Group, suppliers of goods or services to the Group, customers and any person or entity that provides research, development or technological support to the Group. The Scheme became effective on 28 June 2005 and, unless otherwise cancelled or amended, will remain in force for 10 years from that date.

The maximum number of shares in respect of share options currently permitted to be granted under the Scheme is an amount equivalent, upon their exercise, to 10% of the total number of shares of the Company in issue as at 28 June 2005, which is approximately 136,842,000 shares. The maximum number of shares issuable under share options to each eligible participant in the Scheme within any 12-month period is limited to 1% of the total shares of the Company in issue at any time. Any further grant of share options in excess of these limits is subject to shareholders' approval in a general meeting.

## 35. SHARE-BASED PAYMENT PLAN *(continued)*

Share options granted to a director, chief executive or substantial shareholder of the Company, or to any of their associates, are subject to approval in advance by the independent non-executive directors. In addition, any share options granted to a substantial shareholder or an independent non-executive director of the Company, or to any of their associates, in excess of 0.1% of the shares of the Company in issue at any time or with an aggregate value (based on the closing price of the Company's shares at the date of grant) in excess of HK$5,000,000, within any 12-month period, are subject to shareholders' approval in advance in a general meeting.

The offer of a grant of share options may be accepted within 20 business days from the date of offer, upon payment of a consideration of HK$1 in total by the grantee. The exercise period of the share options granted is determinable by the directors, and commences after a certain vesting period and ends on a date which is not later than six years from the date of offer of the share options or the expiry date of the Scheme, if earlier.

The exercise price of share options is determinable by the directors, but may not be less than the highest of (i) The Stock Exchange of Hong Kong Limited (the "Stock Exchange") closing price of the Company's shares on the offer date of the share options; (ii) the average Stock Exchange closing price of the Company's shares for the five business days immediately preceding the offer date; and (iii) the nominal value of the shares.

Share options do not confer rights on the holders to dividends or to vote at shareholders' meetings.

On 26 October 2006, the Group granted 6,803,000 options to employees (excluding directors) at an exercise price of HK$13.4 per share (the average closing share price for the five business days immediately preceding the grant date). Options will be vested as four equal batches with 25% of the options vesting on the first, second, third and forth anniversary from the grant date and accordingly, grantees have to remain in service for a period of four years from the date of grant. In addition, the options will only be vested if and when the pre-set performance targets of the Group, the division and the grantee are achieved. Unless all of these targets are met, the share options will lapse. All of the options granted were outstanding at 31 December 2006.

The average fair value of the options is estimated to be RMB4.85 at the grant date, using a binomial model, taking into account the terms and conditions upon which the instruments were granted. The contractual life of each option granted is six years. There are no cash settlement alternatives. All of the options granted were unvested and outstanding as at the balance sheet date. The Group recognised an expense of RMB3,108,000 during the year ended 31 December 2006.

## 35. SHARE-BASED PAYMENT PLAN *(continued)*

The following table lists the inputs to the model for the year ended 31 December 2006:

| | |
|---|---|
| Dividend yield (%) | 1.0 |
| Expected volatility (%) | 38 |
| Risk-free interest rate (%) | 3.9 |
| Expected life of option (years) | 5-5.5 |
| Spot price (HK$) | 13.38 |
| Exercise price (HK$) | 13.40 |

In light of lack of historical exercise record, the expected life of the options is based on the results of empirical studies performed in the United States and is not necessarily indicative of exercise patterns that may occur. The expected volatility reflects the assumption that the historical volatility is indicative of future trends, which may also not necessarily be the actual outcome. The spot price is the closing price of the Company's shares at the grant date. The exercise price is the average closing share price for the five business days immediately preceding the grant date.

## 36. COMMITMENTS

### (a) Capital commitments

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

| | Group | |
|---|---|---|
| | **2006** | 2005 |
| | **RMB'000** | RMB'000 |
| Contracted, but not provided for | **613,660** | 343,232 |

Included in the above amount, the commitments of approximately RMB55,675,000 (2005: nil) were in relation to the Group's share of a jointly controlled entity's own capital commitments.

Subsequent to the balance sheet date, the board of directors approved the capital expenditure (not contracted for) amounting to approximately RMB1,190,000,000 (2005: RMB1,226,768,000), out of which approximately RMB155,000,000 (2005: nil) was related to the Group's interest in a jointly controlled entity.

## 36. COMMITMENTS *(continued)*

### (b) Operating lease commitments

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

| | Group | |
|---|---|---|
| | **2006** | 2005 |
| | **RMB'000** | RMB'000 |
| Within one year | **9,333** | 4,841 |
| In the second to fifth years, inclusive | **21,014** | 17,165 |
| | **30,347** | 22,006 |

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

## 37. CONTINGENT LIABILITIES

The Group is contingently liable in respect of loan guarantees granted to certain banks in favour of certain suppliers of raw milk (the "Suppliers"). The amount of guarantees granted as at 31 December 2006 amounted to RMB153,976,000 (2005: RMB140,976,000). The guarantees are solely given by the Group, but the guarantees are counter-guaranteed by the Suppliers who are independent third parties. Securities under these counter-guarantees included property, dairy cattle and other assets owned by the Suppliers.

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

## 38. FAIR VALUES OF FINANCIAL INSTRUMENTS

The carrying amounts of the Group's financial assets and liabilities (which are classified as current assets and liabilities) approximated to their fair values at 31 December 2006 because of the short maturity of these instruments.

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

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

## 39. RELATED PARTY TRANSACTIONS

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

| | | | Group | |
|---|---|---|---|---|
| | | | **2006** | 2005 |
| | | Notes | **RMB'000** | RMB'000 |
| (a) | Sales of liquid milk products to associates | (i) | **2,293,796** | 1,234,058 |
| (b) | Sales of ice cream products to associates | (i) | **120,350** | 97,704 |
| (c) | Sales of other dairy products to associates | (i) | **661** | — |
| (d) | Purchase of raw materials from an associate | (i) | **(64,139)** | (17,475) |
| (e) | Sale of raw materials to a jointly controlled entity | (ii) | **48,969** | — |
| (f) | Purchase of other dairy products from a jointly controlled entity | (i) | **(1,517)** | — |
| (g) | Purchase of ice cream products from an associate | (i) | **(22,610)** | — |
| (h) | Sale of property, plant and equipment to a jointly controlled entity | (iii) | **58,776** | — |
| (i) | Transfer of receivables to a jointly controlled entity | (iv) | **41,104** | — |
| (j) | Transfer of payables to a jointly control entity | (iv) | **(2,337)** | — |

*Notes:*

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

(ii) Such transactions were conducted at cost, which approximated to the prevailing market price of the materials.

(iii) The sales price was determined by reference to the valuation performed by an external valuer.

(iv) The cash consideration was determined based on the carrying amounts of the assets and liabilities transferred on the transaction date.

(v) The above transactions did not constitute connected transactions as defined in the Listing Rules.

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

## 40. FINANCIAL RISK MANAGEMENT OBJECTIVES AND POLICIES

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

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

### i) Interest rate risk

The Group's income and operating cash flows are substantially independent of changes in market interest rates and the Group has no significant interest-bearing assets, other than cash at banks. The Group's exposure to the risk of changes in market interest rates relates primarily to the Group's borrowings with floating interest rates. The Group closely monitors its interest rate risk by performing periodic reviews and evaluations of its debt portfolio and gearing ratio. The interest rates and terms of repayment of the bank loans of the Group are disclosed in note 28 to the financial statements. In the opinion of the directors, the Group has no significant interest rate risk and has not used any interest rate swaps to hedge its exposure to interest rate risk.

### ii) Foreign currency risk

The Group's businesses are principally located in the PRC and substantially all transactions are conducted in RMB, except for the purchases of machinery and equipment and sales of dairy products to Hong Kong and Macau. As at 31 December 2006, substantially all of the Group's assets and liabilities were denominated in RMB except that the cash and cash equivalents of approximately RMB2,619,000 (2005: RMB3,894,000) and RMB13,703,000 (2005: RMB12,125,000) were denominated in United States dollars and Hong Kong dollars, respectively, and that interest-bearing bank loans of approximately RMB257,759,000 (2005: RMB80,702,000) and long term payables of approximately RMB363,588,000 (2005: RMB139,059,000) were denominated in United States dollars. The fluctuation of the exchange rates of RMB against foreign currencies could affect the Group's results of operations. However, in the opinion of the directors, the foreign currency risk exposure is under management's control.

## 40. FINANCIAL RISK MANAGEMENT OBJECTIVES AND POLICIES *(continued)*

### iii) Credit risk

The cash and cash equivalents, as well as the pledged deposits, of the Group are mainly deposited with state-owned commercial banks in the PRC.

The majority of the Group's sales are conducted on a cash basis. The Group has implemented policies to ensure that sales of products are made to distributors, who wish to trade on credit terms, with an appropriate credit history which is subject to periodic reviews. Receivable balances are monitored on an ongoing basis and the Group's exposure to bad debts is not significant.

The credit risk of the Group's other financial assets, which comprise prepayments, deposits and other receivables and available-for-sale investments, arises from default of the counterparty, with a maximum exposure equal to the carrying amounts of these assets.

In addition, the Group's guarantees of the bank loans borrowed by certain suppliers of raw milk amounting to RMB153,976,000 (2005: RMB140,976,000) (note 37) represent the Group's other exposure to credit risk. RMB149,976,000 (2005: RMB140,976,000) of the above guarantees are cross-guaranteed and secured by assets owned by these suppliers.

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

### iv) Commodity price risk

The Group's exposure to price risk is insignificant.

### v) Liquidity risk

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

## 41. SUBSEQUENT EVENTS

On 18 December 2006, each of Inner Mongolia Mengniu, Mengniu Dairy (Beijing) Co., Ltd. and Mengniu Dairy (Maanshan) Co., Ltd., subsidiaries of the Company, entered into a joint venture contract with an independent third party to set up equity joint ventures in the PRC to produce, market, distribute and sell yogurt and related products. Details were disclosed in the Company's announcement dated 18 December 2006. As of the date of the report, the application for the establishment of the joint ventures was in the process.

On 3 April 2007, Inner Mongolia Mengniu entered into an agreement to acquire the 48% interest in Mengniu (Wuhan) Frealth Dairy Co., Ltd. ("Mengniu Wuhan") from the minority shareholder of Mengniu Wuhan at a consideration of RMB134,400,000. After the acquisition, Mengniu Wuhan will then become a wholly-owned subsidiary of Inner Mongolia Mengniu. Details were disclosed in the Company's announcement dated 4 April 2007.

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.

Apart from the above, no significant events took place subsequent to 31 December 2006.

## 42. COMPARATIVE AMOUNTS

Certain comparative amounts have been reclassified to conform with current year's presentation.

## 43. APPROVAL OF THE FINANCIAL STATEMENTS

The financial statements were approved and authorised for issue by the board of directors on 12 April 2007.