

Report of the Board of Directors

1. Discussion and analysis on the operations of the Company during the reporting period.

(1) Business Review

The Company belongs to the electric power-generating equipment manufacturing industry and ranks as one of the biggest player among its counterparts in the PRC. The principal operations of the Company include hydro turbine generators, steam turbine generators, A.C. and D.C. electrical motors and controlling devices.

In 2002, all staff of the Company had been focused on achieving the objective of "satisfy the orders; gain the profits". Facing the most heavy and difficult mission for production and operation in the history of the Company, the Company had strengthened the corporate governance and supervision, put great efforts in expanding the market, enhanced technologies and equipments level, and had accomplished the aim of turning a record of loss to a record of profit on which basis the Company will be able to develop rapidly.

For the year ended 31 December 2002, in accordance with the PRC accounting standards, revenue from principal activities of the Company amounted to RMB920,905,000, representing an increase of 148.70%; net profit amounted to RMB20,011,000; earnings per share was RMB0.045; in accordance with accounting principles generally accepted in Hong Kong, profit after taxation attributable to shareholders was RMB34,740,000; earnings per share was RMB0.077.

In 2002, the Company produced 9 sets of hydro turbine generators with electric power generation capacity of 618MW; 18 sets of steam turbine generators with electric power generation capacity of 3628MW; 24 sets of modules of equipment installed at the Three Gorges Project; 80 sets of D.C. motors with electric power generation capacity of 176.585MW; 42 sets of A.C. motors with electric power generation capacity of 28.51MW.

During the year, the Company recorded orders worth of about RMB1.69 billion.

(2) Revenue from principal operations and cost from principal operations (prepared under the PRC accounting standards)

	Income from principal operations RMB'000	Percentage of income from principal operations (%)	Costs of principal operations RMB'000	Gross profit from principal operations RMB'000
Electric power generating equipment	779,712	84.67	614,992	164,720
Technology improvement services and others	141,193	15.33	83,047	58,146
Total	920,905	100	698,039	222,866



Report of the Board of Directors *(continued)*

(3) Operation and Result of substantial controlling companies

As at 31 December 2002

Name	Nature of Business	Main Business	Registered Capital	Interests held	Total asset	Net profit (loss)
DFEM Control Equipment Company Limited	Manufacturing	Design, manufacture and sale of control equipment in relation to generators and A.C. and D.C. motors	1,300	96.15%	7,971	27
DFEM Power Equipment Company Limited	Manufacturing	Design, manufacture and sale of large and medium A.C. and D.C. motors and small hydro-power motors	4,275	98.83%	11,817	(966)
DFEM Tooling and Moulding Company Limited	Manufacturing	Design, manufacture and sale of industrial tool and knife tool; process and sale of ordinary machinery and machinery accessories	1,460	99.32%	1,965	25
DFEM Equipment Engineering Company Limited	Manufacturing	Overhaul of electrical machinery technological transformation; design, manufacture and sale of complete set of electrical machinery control system; environmental protection equipment; design, manufacture installation and sale of special equipment etc.	1,350	97.04%	1,951	50

(4) Major suppliers and customers of the Company

As at 31 December 2002, purchases from the top five suppliers amounted to RMB139,990,000, representing 28.27% of the total purchases. Sales to the top five customers amounted to RMB472,751,000, representing 51% of the total sales.

During the year, directors, supervisors and other related persons or shareholders of the Company did not hold any interest in the aforesaid suppliers and customers.

(5) Financial position of the Company (under PRC GAAP)

1. Closing balance of total assets amounted to RMB2,764,956,000, increased by 6.74% as compared with RMB2,590,425,000 of the previous year. Such change is attributable to:
 - A. an increase of RMB550,612,000 in revenue from principal operations as compared with last year causing an increase of RMB106,005,000 in net accounts receivable;
 - B. a recovery of assets entrusted to Hai Tong Securities Limited (海通證券有限公司) causing a reduction of RMB33,287,000 in short-term investment;
 - C. Stallion Estate Company (黑馬物業) applied Hui Yuan Mansion (匯源大廈) to settle the loan of RMB44,000,000, Huaxin Dongli Investment Company (華信動力投資公司) applied Huaxin Mansion (華信大廈) to settle the loan of RMB4,200,000, causing a reduction in other receivables for the year and
 - D. a significant surge in asset value of the Company causing an increase of RMB166,352,000 or 42.94% in net inventories as compared with the previous year.

Report of the Board of Directors *(continued)*

2. Closing balance of current liabilities amounted to RMB1,448,322,000, increased by 16.92% as compared with RMB1,238,692,000 of the previous year. Such change is attributable to:
 - A. The accounts payable by the Company is RMB81,834,000 in 2002 with an increase of RMB10,683,000 as compared with the previous year;
 - B. The prepayment received from client for the year and an increase in deposit of progress payments by clients causing an increase of RMB250,820,000 or 151.16% as compared with the previous year;
3. Closing balance of long-term liabilities amounted to RMB408,724,000, decreased by 12.11% from RMB465,024,000 of the previous year due to repayment of bank loans.
4. During the reporting period, the gearing ratio of the Company was 67%, unchanged as compared with the previous year.
5. Closing balance of shareholders' fund amounted to RMB907,161,000, increased by 2.41% from RMB885,832,000 of the previous year due to realization of profits in the year.
6. Profit from principal operations was RMB220,145,000, increased by 559.11% as compared with RMB33,400,000 of the previous year. Such increase is mainly attributable to (i) the sharp rise of 148.70% in sales revenues as compared with that of 2001 and (ii) an increase of 15% in composite gross profit margin.
7. Net profit is RMB20,011,000, an increase of RMB281,360,000 as compared with that of the previous year, (net loss in the previous year is RMB261,349,000). Such increase is mainly attributable to:
 - A. an increase of RMB186,745,000 in profit from principal operations;
 - B. a net decrease of RMB9,462,000 in provision for bad debts arising from debt restructuring during the year; and
 - C. return of export tax amounting to RMB8,170,000 for the year.
8. During the reporting period, cash flows from operating activities per share amounted to RMB0.05, increased by RMB0.17 from RMB-0.12 of the previous year due to an increase in revenue from operating business.

(6) Difficulties and corresponding measures in operation

In view of onerous operating tasks in 2002, the Company implemented a series of determined and effective protection measures, work hard in solving the production difficulties involving heavy production line, assorted new products and the Three Gorges Project, promptly meeting orders, emphasizing on coordination and implementation of contracts, enhancing technologies, improving allocation of resources and organization of production, technological services, equipment maintenance, improving allocation and coordination of nodes, such as power supply and on-site management, rigorously controlling production and carrying reviews on a monthly basis. In order to make better use of external and internal resources, the Company performed outsourcing. As for crucial sets of turbines, the Company implemented "Three sets in operation; one set idle", which enhanced quality of services of the second and the third set, management and supervision, as well as enhanced the utility rate of crucial equipment and machinery in order to accomplish the production target of 2002.

2. Investment

(1) Use of proceeds

In accordance with the purpose stipulated in the Company's Prospectus for the issue of A Shares and H Shares, the proceeds of RMB752,548,000 from A Shares and H Shares listing has to be applied in the four projects which involve the technological renovation for improving the electric power generation capacity of hydro turbine generator sets. The use of proceeds up to 31 December 2002 is as follows:

Projects stipulated in the Company's Prospectus:

- (i) In respect of the technological renovation projects for improving electric power generation capacity of hydro turbine generator sets, the total planned investment was RMB670,000,000. During the reporting period, the actual investment amounted to RMB29,627,000. To date, the cumulative actual investment in this project amounted to RMB241,352,000. Through the implementation of the technological renovation, the electric power generation capacity and technology level of hydro and steam turbine generator sets of the Company have been enhanced.

Report of the Board of Directors *(continued)*

- (ii) In respect of the capital inputs in joint venture projects with foreign investors for the production of large-scale hydro turbine generator sets and steam turbine generators, the total planned investment was RMB160,000,000. On 6 March 2001 and 27 May 2002, the Company convened an extraordinary general meeting and an annual general meeting for 2001 respectively, approving the Company to change the use of RMB160,000,000, which was initially intended to be contributed to the joint venture projects with foreign entities regarding large-scale hydro turbine generators and large-scale steam turbine generators, to the use as working capital due to insufficiency thereto. Currently, the change of use for this proceeds has been put into effect.
- (iii) In respect of the additional capital, the total planned investment was RMB150,000,000. The actual investment amounted to RMB150,000,000. The investment had been completed.
- (iv) In respect of the repayment of the loans of the Seventh and Eighth Five-Year Plan, the total planned investment was RMB75,000,000. The actual investment amounted to RMB88,449,000. The investment had been completed.

As at 31 December 2002, the balance of proceeds amounted to approximately RMB112,747,000. The Company has deposited the balance of proceeds in domestic banks.

3. Development Trend of the Company in 2003

Following the implementation of the "State Western Region Development Strategy" and commencement of the "Electricity transmission from western China to eastern China" project, the market for electric power generators is expecting a prosperous development. The commencement of a series of electric power generation projects stimulates new opportunities for development.

The Company is one of the largest manufacturers of electric power generating equipment in the PRC. The new market environment requires even higher electric power generation capacity of the Company. In 2002, the Company accomplished an annual hydro and steam turbine electric power generation of an aggregate capacity of 4,500,000 KW, which is the best record in history. In 2003, the actual annual electric power generation of the Company will have capacity of 7,400,000 KW, which will create a new record in history. As a result, the Company aims at achieving the aggregate capacity of 10,000,000 KW by the end of 2004, reaching the world top-class in terms of electric power generation capacity in order to significantly enhance its competitiveness. Therefore, the year of 2003 is the crucial year for such objective.

As such, the Company will rely on scientific approach to effectively organize production, make use of every potential capability, invest to innovate and expand technologies, further enhancing technological performance, diversify scientifically in production and deliver goods on schedule. As for quality control, the Company shall pay attention to customers' needs, keep on improving quality, implement quality control cards system and establish famous brand. As for market expansion, with forward-looking strategies, the Company will seize the opportunity to meet the peak season for orders in 2003, work hard to take orders for the years ahead. As for scientific development, the Company shall focus on "Ahead of Schedule", enhancing technologies with innovation. As for management, the Company shall strictly define responsibilities and duties, emphasize managerial efficiency and further implement the provision for division of labour. As for cost control, the Company shall tightly control budget, maintain inventory at adequate level and efficiently utilize financial resources. As for enterprise culture, the Company shall improve workers' skills, and develop a knowledge-oriented enterprise.

4. Daily work of the Board of Directors

(1) Board meetings held and the resolution passed during the reporting period

The Board of Directors held ten meetings during the year to consider and pass the following:

1. The 19th meeting of the third Board of Directors was held on 23 January 2001 for considering and approving: the Company's 2002 administration guideline and objective; fixed assets investment plan for 2002; adjustment of the use of some proceeds; announcement of profit warning; application to China Merchants Bank for banking facilities amounting to RMB200 million; acceptance of resignations from the relevant directors.
2. The 20th meeting of the third Board of Directors was held on 28 February 2002 for considering and approving the acquisition of Deyang Dongfeng Electrical Machinery Manufacturing Co. Ltd. by DFEM Power System Company Limited (東方電機動力設備有限公司) by way of increase in its capital; increase from 20% to 40% in provision for bad debt arising from other receivables.
3. The 21st meeting of the third Board of Directors was held on 9 April 2002 for considering and approving the 2001 audited financial statements of the Company; the 2001 profit after taxation distribution plan of the Company and the 2002 profit distribution policy; the 2001 annual report and its summary; the holding of the 2001 annual general meeting; the appointment of auditors; the 2002 financial budget of the Company.

Report of the Board of Directors *(continued)*

4. The 22nd meeting of the third Board of Directors was held on 29 April 2002 for considering and approving the first quarterly report of the Company for 2002; the appointment of auditors.
5. The 23rd meeting of the third Board of Directors was held on 20 June 2002 for considering and approving the report on Self-inspection of Modern Corporate System on Listed Companies to China Securities Regulatory Commission and State Economic and Trade Commission; application to Bank of China for banking facilities amounting to RMB300 million.
6. The 24th meeting of the third Board of Directors was held on 16 August 2002 for considering and approving the unaudited interim report of the Company for 2002; the interim profit distribution plan of the Company for 2002; the interim financial report of the Company for 2002; application to Everbright Bank for banking facilities amounting to RMB50 million; the establishment of the new technological development complex.
7. The 25th meeting of the third Board of Directors was held on 30 October 2002 for considering and approving the third quarterly report of the Company for 2002; amendments to the Articles of Association of the Company; Rules of Procedures for Annual General Meeting of Dongfang Electrical Machinery Company Limited (東方電機股份有限公司股東大會議事規則), Rules of Procedures for the Board of Directors' Meeting of Dongfang Electrical Machinery Company Limited (東方電機股份有限公司董事會議事規則); the holding of an extraordinary general meeting; expansion of crucial equipment for enhancing capabilities of manufacturing hydro electric turbine generators; the establishment of ERP system in the Company.
8. The 26th meeting of the third Board of Directors was held on 28 November 2002 for considering and approving the nominations of Madam Ada Ying Kay Wong and Mr. Chen Zhangwu as independent directors of the 4th Board of Directors; the remunerations for members of the 4th Board of Directors and the 4th Supervisory Committee.
9. The 27th meeting of the third Board of Directors was held on 23 December 2002 for considering and approving that Stallion Estate Company (黑馬物業) applied Hui Yuan Mansion (匯源大廈) to settle the loan due to the Company.
10. The first meeting of the fourth Board of Directors was held on 23 December 2002 for considering and approving the election of Mr. Si Zefu as the Chairman of the Company; the election of Mr. Zhu Yuanchao as the Vice-Chairman of the Company; the appointment of Mr. Zhu Yuanchao as the General Manager of the Company; the appointments of Mr. Han Zhiqiao, Mr. Zhou Hongxi, Mr. Gong Dan, Mr. Zhang Tiande, Mr. He Jianhau, Mr. Gao Feng, Mr. Liu Hui as the Deputy General Manager of the Company; the appointment of Mr. Gong Dan as Secretary to the Board of Directors; the adjustment of the Strategic Committee and the composition of members of the Asset Management Committee; the establishment of the Audit and Review Committee.

The announcements of the above discloseable resolutions passed by the Board meetings were published on Shanghai Security Daily and China Security Post in the PRC, and Wen Wei Po and The Standard in Hong Kong on the following day after the holding of the relevant Board meetings.

- (2) **During the reporting period, directors of the Company strictly executed each resolutions passed at the Board meeting will seek the best interest for the Company and shareholders with sincerity, diligence and honesty.**

5. Profit distribution

No interim dividend was declared or paid during the year ended 31 December 2002. The Board recommends that no profit distribution shall be declared for the year and no capital reserve will be transferred to increase share capital. The above proposal is subject to the approval by the shareholders at the Annual General Meeting.

Report of the Board of Directors *(continued)*

6. Other matters

(1) Financial summary

The financial summary of the Group for the five years ended 31 December 2002 prepared under HK GAAP is set out on page 101 of this Annual Report.

(2) Net assets per share

Net assets per share of the Company determined under HK GAAP and under PRC GAAP are set out in the section headed "Major Accounting Data and Business Data" of this Annual Report.

(3) Fixed assets

Movements in fixed assets during the year are set out in note 13 and note 5 (9) to the financial statements prepared under HK GAAP and PRC GAAP respectively.

(4) Borrowings and interest capitalisation

Particulars of bank loans and other loans are set out in note 23 to the financial statements prepared under HK GAAP and note 14, 19 to the financial statements prepared under PRC GAAP. Interest capitalised by the Company during the year amounted to RMB2,248,000.

(5) Reserves

Movements in reserves during the year are set out in note 25 to the financial statements prepared under HK GAAP.

(6) Directors' and supervisors' interests in contracts

At the end of the year or at any time during the year, none of the directors or supervisors was materially interested directly or indirectly in any contract of significance of the Company except the service contracts mentioned below.

(7) Directors', supervisors' and senior management's interests in subscription for shares or debentures

At no time during the year was the Company a party to any arrangements to enable the directors, supervisors or senior management of the Company to acquire benefits by means of the acquisition of shares in or debentures of the Company or any other body corporate.

(8) Directors' and supervisors' service contracts

Each of the directors and supervisors has entered into a service agreement with the Company. Save as aforementioned, none of the directors has a service contract with the Company which is not determinable by the Company within one year without the payment of compensation (other than statutory compensation). Particulars of the directors' and supervisors' emoluments are set out in note 11 to the financial statements prepared under HK GAAP.

(9) Substantial shareholder's interests in contracts

On 25 February 1994, the Company entered into a service agreement with DFEW which was effective retrospectively from 1 January 1994 for a period of ten years for the provision of utility services. Pursuant to the service agreement, the Company agreed to provide public utilities, electronic office equipment, office space, communication services and the procurement of materials for DFEW. Under the same agreement, DFEW is responsible for, inter alia, the construction, maintenance and management of the staff quarters of the Company and the provision of services for environmental hygiene, procurement and management of office equipment, canteen services, security, staff welfare and management of retired employees, packaging and transportation of finished products and medical care etc.

Report of the Board of Directors *(continued)*

(10) Retirement plan

Particulars of the retirement plan of the Company are set out in the principal accounting policies (m) employee benefits in the notes to the financial statements prepared under HK GAAP.

(11) Purchase, sale or redemption of the Company's shares

No purchase, sale or redemption of the shares of the company was made by the Company or its subsidiaries during the year.

(12) Pre-emptive rights

There is no provision regarding pre-emptive rights in the Company's Articles of Association.

(13) The Code of Best Practice

The Company has complied throughout the year with the Code of Best Practice as set out in Appendix 14 of the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited.

(14) The Company currently has no employee medical insurance, nor detailed plans to do so.

(15) Since foreign currency operations of the Company are settled in USD and the exchange of RMB to USD is relatively stable, there are no significant risks to foreign exchange.

(16) During the reporting period, contingent liabilities of the Company are set out on note 29 to the financial statement prepared under accounting principles generally accepted in Hong Kong.

(17) During the reporting period, the Company did not pledge any assets.

(18) Announcement of annual results

The Chinese version of the 2002 Annual Results was published on 2 April 2002 in the Shanghai Security Daily and China Security Daily in the PRC and in Wen Wei Po in Hong Kong; the English version was published on the same day in The Standard in Hong Kong.

By order of the Board
Mr. Zhu Yuanchao
Chairman of the Board of Directors

1 April 2003