

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 players 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 2003, all staff of the Company worked towards achieving the objective of “securing orders; satisfying deliveries and cost reduction”. Facing the booming power construction in the electric power-generating equipment market, the Company took initiatives to facilitate its arduous production and operation tasks, and by effectively organizing its production, increasing investment on marketing and equipment, the Company accomplished its annual targets ahead of schedule.

For the year ended 31 December 2003, in accordance with the PRC accounting standards, revenue from principal activities of the Company amounted to RMB1,199,622,000, representing an increase of 22.50% over the previous year; net profit amounted to RMB33,126,000; earnings per share was RMB0.074; in accordance with accounting principles generally accepted in Hong Kong, profit after taxation attributable to shareholders was RMB18,618,000; earnings per share was RMB0.041.

In 2003, the Company produced 28 sets of hydro turbine generators with electric power generation capacity of 1,346MW; 22 sets of steam turbine generators with electric power generation capacity of 6,215MW; 31 sets of modules of equipment installed at the Three Gorges Project; 62 sets of A.C. motors with electric power generation capacity of 94.615MW; 67 sets of D.C. motors with electric power generation capacity of 46.923MW.

During the year, the total value of new orders received by the Company amounted to over RMB9 billion.



Report of the Board of Directors *(continued)*

(2) REVENUE FROM PRINCIPAL OPERATIONS AND COST FROM PRINCIPAL OPERATIONS (PREPARED UNDER THE PRC ACCOUNTING STANDARDS)

	Income from principal operations <i>RMB'000</i>	Percentage of income from principal operations (%)	Costs of principal operations <i>RMB'000</i>	Gross profit from principal operations (%)
Electric power generating equipment	1,085,191	90	830,258	23.49
Technology improvement services and others	114,431	10	70,499	38.39
Total	1,199,622	100	900,757	

(3) OPERATION AND RESULT OF SUBSTANTIAL CONTROLLING COMPANIES

Name	Nature of Business	Main Business	As at 31 December 2003			
			Registered Capital	Interests held	Total asset	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%	6,222.26	93.45
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%	18,147.05	(467.61)
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%	2,009.35	96.04
DFEM Equipment	Manufacturing	Overhaul of electrical machinery, technological transformation; installation and test run of complete set of electrical machinery; design, manufacture and sale of complete set of electrical machinery control system; environmental protection equipment; design, manufacture, installation and sale of special equipment etc.; manufacture and sale of machinery spare parts and general spare parts; technical consultancy and service for electrical machinery	1,350	97.04%	2,097.01	28.83

(4) MAJOR SUPPLIERS AND CUSTOMERS OF THE COMPANY

As at 31 December 2003, purchases from the top five suppliers amounted to RMB214,704,000, representing 25.76% of the total purchases. Sales to the top five customers amounted to RMB458,979,000, representing 38.26% 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. The Company's profit from principal operations for the year amounted to RMB292,582,000, representing an increase of 25.86% from RMB232,457,000 of last year, which is attributable to a significant increase in sales revenue.
2. Profit from other operations for the year amounted to RMB10,371,000, representing an increase of 250.61% from RMB2,958,000 of last year, which is attributable to: 1) a significant increase in profit from sales of materials and half-finished products; and 2) a noticeable increase in income from consultancy service.
3. Net profit for the year amounted to RMB33,126,000, representing an increase of 99.40% from RMB16,613,000 of last year, which is attributable to: 1) an increase of RMB60,125,000 in profit from principal operations; 2) an increase of RMB7,413,000 in profit from other operations; 3) a reduction of RMB12,393,000 in financial cost; and 4) an increase of RMB5,459,000 in income from export tax refund.
4. Cash and cash equivalent recorded a net increase of RMB603,723,000, representing an increase of RMB636,402,000 from last year (2002: RMB-32,679,000), which is mainly attributable to a significant increase in monetary fund.
5. Closing balance of total assets amounted to RMB3,714,721,000, increased by 34.73% as compared with RMB2,757,060,000 of the previous year. Such change is attributable to: 1) an increase of RMB529,738,000 or 68.98% in monetary fund over last year due to the increased contract deposit arising from the significant increase in sales contracts signed in the year; 2) an increase of RMB40,404,400 or 616.24% in notes receivable over last year due to settlement by clients' bank acceptances in order to cut down collection risks; 3) an increase of RMB95,206,000 or 109.91% over last year in prepaid accounts due to the significantly increased production and the increased prices of raw materials; and 4) an increase of RMB110,173,000 or 22.99% in fixed assets from last year, which is a result of acquisition and renovation of certain equipment, machinery and plant premise, so as to meet the requirement of significantly increased production.
6. Closing balance of total liabilities amounted to RMB2,764,699,000, increased by 50.22% as compared with RMB1,840,453,000 of the previous year. The increase is mainly attributable to an increase of RMB1,177,094,000 or 310.17% in prepayment received from clients over last year due to more sales contract signed during the year.
7. During the year, the gearing ratio of the Company was 74.43%, basically unchanged as compared with the previous year.

(6) CHANGE IN ACCOUNTING POLICY

According to the newly adopted accounting policy, revenue from contracts of complete set of hydro-electrical machinery of the Company can be realized on the balance sheet day on the percentage of completion method, provided that materials have commenced to be input into hydro-electrical machinery and outcome of the construction contract can be reliably estimated. Previously, revenue from contracts of complete set of hydro-electrical machinery of the Company can only be realized on the balance sheet day on the percentage of completion method, when over 70% of the project progress has been completed and outcome of the construction contract can be reliably estimated. Under the relevant provisions in 《會計準則一會計政策、會計估計變更和會計差錯更正》("Accounting Standard - Accounting Policies, Accounting Estimation and Rectification of Accounting Error") issued by the Ministry of Finance, the Company made retrospective adjustment to items in connection with such changed accounting policy. Accordingly, revenue from principal operations for 2002 was adjusted upward by RMB46,330,000, and profit for 2002 was adjusted upward by RMB18,120,000.

In accordance with the relevant requirements of 《會計準則一債務重組》("Accounting Standards For Enterprise - Debt Restructuring") issued by Finance Ministry of PRC, the Company conducted retrospective adjustments in line with Accounting Error Rectification Principles in relation to the valuation of the real estate transferred by Chongqing Heima Real Estate Company Limited (重慶黑馬物業有限公司) and Sichuan Hua Xin Energy Investment Company Limited (四川華信動力投資有限公司) to the Company as compensation. The adjustment resulted in decrease in the value of fixed asset by RMB19,280,000 and an increased administrative expenses by RMB19,280,000.

(7) DIFFICULTIES AND CORRESPONDING MEASURES IN OPERATION

In view of its production value and volume reaching a historical new high, the Company adopted a series of persistent and effective initiatives to meet the requirements from the arduous production arrangement. With the combined efforts of its staff, the Company achieved its goal of annual production assignment one month ahead of schedule. The following initiatives were implemented: to properly arrange operation shifts for loaded running of the key equipment; to enhance implementation of economic accountability assessments system, to conduct various competitions among the work force to facilitate completion of production targets on time in key and difficult production processes; to increase outsourcing and adopt procurement of half-finished products to shorten the processing cycle within the plant; to optimise the production process and procedures for an improving efficiency by achieving better layout and set-up; to strengthen and promote key technical renovation projects, so as to enhance production capacity to meet the increasing production demand.

2. INVESTMENT

(1) INVESTMENT IN 2003

In 2003, the effective investments made by the Company amounted to RMB156,040,000, which was made up of the following projects: technical renovation for expansion of power production capacity, for which an investment of RMB105,600,000 (including the raised proceeds of RMB37,130,000) has been made; the special tax refund project under the three-tier preferential taxation policy, for which an investment of RMB3,950,000 has been made; and other technical renovation projects totalling RMB46,490,000.

(2) USE OF PROCEEDS

In line with the use of proceeds set out in the Company's Prospectus for the issue of A Shares and H Shares, the proceeds of RMB752,548,000 from the issue of A Shares and H Shares applied in the four projects which involve technological renovation for improving the electric power generation capacity of hydro turbine generator sets. The use of proceeds up to 31 December 2003 was reported as follows:

Projects set out in the Company's Prospectus:

- (i) Technological renovation projects for enhancement of production capacity of hydroelectric power: the total planned investment was RMB670,000,000. During the reporting period, the actual investment amounted to RMB37,130,000. To date, the cumulative actual investment in this project amounted to RMB278,482,000. Through the implementation of the technological renovation, the production capacity of hydroelectric power and technology level of hydro and steam turbine generator sets of the Company have been enhanced.
- (ii) Capital contribution to the Sino-foreign in joint venture projects 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 Sino-foreign joint venture projects relating to production of large-scale hydro turbine generators and large-scale steam turbine generators, into the use as additional working capital to make up the insufficiency. Currently, the change of use for this proceeds has been put into effect.
- (iii) Additional capital: the total planned investment was RMB150,000,000. The actual investment amounted to RMB150,000,000. The project had been completed.
- (iv) 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 2003, the balance of proceeds amounted to approximately RMB75,617,000. The Company has deposited the balance of proceeds with domestic banks.

3. DEVELOPMENT TREND OF THE COMPANY IN 2004

Following the fast growing national economy, reform of the electricity system and extensive electrical power shortage nationwide, the PRC is expediting its pace of expanding its electrical power production capacity, which resulted in an unprecedented trend of growth in the domestic electric power-generating equipment market.

The Company is one of the largest manufacturers of electric power generating equipment in the PRC. With its surging outstanding orders, it is necessary for the Company to put much emphasis on production and timely delivery in its 2004 schedule. In 2003, the Company achieved an annual hydro and steam turbine electric power generation of an aggregate capacity of 7,700 KW, which was the best record in history. In 2004, the planned production of the Company will hit 12,000 KW.

As such, the Company will follow its guideline of 2004 of “improving workflow, efficiency and quality control to secure production and sales” The Company will focus on the following aspects to:

- (1) improve production management in the whole procedure. In light of a policy of “scientific organization, exploitation of every potential, proper investment on equipment and reasonable outsourcing”, the Company aims to expedite its improvement in manufacturing capacity, build an organization model for batch and specialized production, and speed up its production to secure delivery on schedule.
- (2) enhance and accelerate its progress in technical renovation. The Company will pay attention to investment efficiency and rational acquisition of key equipment to realize and increase its production capacity in time.
- (3) keep on improving quality and its quality assurance system, and encourage success in one shot. Based on improvement in its quality system of passing card, the Company will carry out a grading system in position quality and performance to promote steady improvements in product quality.
- (4) as for R&D, strengthen development of core technologies, so as to promote interaction between technology and market to achieve breakthrough in key projects.
- (5) as for marketing, improve its study on marketing strategy, strengthen marketing of key projects, and advance its expansion of market.
- (6) enhance its cost control, asset management efficiency, asset structure to secure achievements of its profit target.
- (7) improve its incentive system, focus on performance assessment, and carry out a comprehensive training scheme for the staff.
- (8) foster a corporate culture of “keeping pace with the times to pursue eminence”, so as to promote overall qualification of the staff and a leap in the Company’s development.

4. DAILY MANAGEMENT BY THE BOARD OF DIRECTORS

(1) BOARD MEETINGS HELD AND THE RESOLUTION PASSED DURING THE REPORTING PERIOD

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

1. The 2nd meeting of the fourth Board of Directors was held on 22 January 2003 for considering and approving: the Company’s 2003 administration guideline and objective; fixed assets investment plan for 2003; and a proposal for nominating Mr. Xie Songlin as an independent director candidate for the Board of the Company.
2. The 3rd meeting of the fourth Board of Directors was held on 1 April 2003 for considering and approving the 2002 financial statements of the Company; the 2002 profit after taxation distribution plan of the Company; the 2002 annual report and its summary; the 2003 financial budget of the Company; the holding of the 2002 annual general meeting; a proposal for nominating Mr. Xie Songlin as an independent director candidate for the Board of the Company; a proposal for resign of certain directors. At the meeting, Mr. Zhu Yuanchao, a director, was elected as Chairman of the Company, and Mr. Han Zhiqiao, a director was elected as Vice Chairman and appointed as the General Manager of the Company.
3. The 4th meeting of the four Board of Directors was held on 25 April 2003 for considering and approving the first quarterly report of the Company for 2003; the appointment of auditors; application to the banks for banking facilities; and investments on certain equipment.
4. The 5th meeting of the fourth Board of Directors was held on 13 June 2003 for considering and approving: amendments and supplements to the Company’s Development Outline for the 10th Five-year Plan; and treatment of certain historical issues relating to costs.

Report of the Board of Directors *(continued)*

5. The 6th meeting of the fourth Board of Directors was held on 12 August 2003 for considering and approving: the obsolescence treatments for certain raw materials, the write-off of certain accounts receivable and the write-off of certain long term receivables; the unaudited interim financial statements of the Company for 2003; the 2003 interim report and its summary; and investments on certain equipment.
6. The 7th meeting of the fourth Board of Directors was held on 27 October 2003 for considering and approving: the write-off of certain accounts receivable for exported products and the write-off of certain other receivables; the 2003 third quarterly report of the Company; the remedial solution report for problems raised by Chengdu Securities Administration Office of CSRC in its tour inspection and rules of procedures of certain committees.
7. The 8th meeting of the fourth Board of Directors was held on 12 November 2003 (by written resolutions) for approving the 2004-2006 Service Agreement between DFEW and the Company.
8. The 9th meeting of the fourth Board of Directors was held on 8 December 2003 for considering and approving the proposal for arrangement of pledge contracts.

The announcements of the above discloseable resolutions passed by the Board meetings were published in 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 carried out decisions of the Board and will continue to act honestly and diligently in the best interests of the Company and its shareholders.

5. PROFIT DISTRIBUTION

No interim dividend was declared or paid during the year ended 31 December 2003. The Board recommended 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.

6. SPECIAL STATEMENT FROM THE CERTIFIED ACCOUNTANTS FOR FUNDS APPROPRIATED BY THE CONTROLLING SHAREHOLDER AND OTHER CONNECTED PARTIES OF THE COMPANY

Pursuant to the requirement in 《關於上市公司大股東及關聯方資金佔用和違規擔保情況的通知》("Notice in relation to the use of capital by substantial shareholders and connected parties of listed companies and guarantee in violation of laws"), the (2003) No.13 circular of the Listing Division, Inspection Division of Listed Companies of CSRC, Shenzhen Pan-China Schinda made a special statement for funds appropriated by the controlling shareholder and other connected parties of the Company.

(1) FUNDS APPROPRIATED BY THE CONTROLLING SHAREHOLDER AND OTHER CONNECTED PARTIES

1. As at 31 December 2003, funds appropriated by the controlling shareholder and other connected parties of DFEM are set out as follows:

Name of connected party	2003.1.1 Balance of the appropriated funds RMB	Accumulative appropriated funds for the year (debit) RMB	Accumulative appropriated funds for the year (credit) RMB	2003.12.31 Balance of the appropriated funds RMB	Relationship	Reasons for the appropriated funds	Form of the appropriated funds
1. Le Shan city Dong Le Heavy Piece Handling Company Limited	11,857,852.00	—	250,551.60	11,607,300.40	An associate company of DFEM	a current loan account	Funds appropriated for non-operating purpose

* For details please refer to the notes to "Accounts receivable and other receivables" in the financial statements.

2. During 2003, no additional fund was appropriated by the controlling shareholder and other connected parties of DFEM.

(2) GUARANTEE

As at 31 December 2003, no guarantee has been provided by DFEM and its subsidiaries to its controlling shareholder or any other connected party.

7. SPECIAL STATEMENT AND INDEPENDENT OPINION FROM INDEPENDENT DIRECTORS FOR GUARANTEE PROVIDED BY DFEM TO OUTSIDE PARTIES

In accordance with 《關於上市公司大股東及關聯方資金往來及上市公司對外擔保若干問題的通知》("Notice in relation to the capital flow between the Company and connected parties, and certain issues in relation to the external guarantees of the Company") as set out in Zhen Jian Fa (2003) No. 56 circular of CSRC, the independent directors of the Company performed prudent inspection on accumulative and current guarantee provided by DFEM to outside parties and made statements as follows:

During the reporting period, No guarantee has been provided by the Company to its controlling shareholder or any of its subsidiaries, nor any guarantee in any form has been provided by the Company to any of its subsidiaries or other connected parties in which the Company held interests less than 50% or parties not being legal persons or individuals.

The independent directors are of opinion that the Company has been adhering to its internal control system and there is neither guarantee given in violation of regulations nor of a misconduct nature. The Company strictly controlled exposure to guarantee risks and has protected interests of medium and minority shareholders.

8. OTHER MATTERS

(1) FINANCIAL SUMMARY

The financial summary of the Group for the five years ended 31 December 2003 prepared under HK GAAP is set out on page 30 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 14 and note 12 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 25 to the financial statements prepared under HK GAAP and note 16, 25 to the financial statements prepared under PRC GAAP. Interest capitalised by the Company during the year amounted to RMB2,138,000.

(5) RESERVES

Movements in reserves during the year are set out in note 27 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 9 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, with a period of ten years, and expired on 31 December 2003.

The 8th meeting of the fourth Board of Directors was held on 12 November 2003 for approving the 2004 Service Agreement entered into between DFEW and the Company. After the meeting, DFEW and the Company signed the said agreement in relation to the reciprocal provision of composite services between DFEW and the Company. Pursuant to the agreement, the Company will provide to DFEW services including utility services, procurement of materials security and patrol, fire services, and information services; while DFEW will provide to the Company services including environment protection services, rental and land licencing, medical services, vocational training, community welfare, warehousing and packaging of finished products, delivery of products, with a term of 3 year from 1 January 2004 to 31 December 2006. The transactions under the Service Agreement are on-going connected transactions pursuant to the Listing Rules and are subject to disclosure requirements in the form of press announcements, despatchment of circular to shareholders and approval by independent shareholders. On 14 November 2003, the Company published an announcement and despatched the circular in relation to the on-going connected transactions to the holders of its H Shares. The Company has also applied to the Stock Exchange of Hong Kong for a conditional waiver from strict compliance with the Listing Rules requirements in respect of the transactions. On 30 December 2003, the Company convened the 2003 Extraordinary General Meeting at which the 2004-2006 Service Agreement between DFEM and DFEW was considered and approved by independent shareholders by ordinary resolution. On 2 January 2004, the Stock Exchange of Hong Kong granted a conditional waiver from strict compliance with the Listing Rules requirements in respect of the on-going connected transactions.

(10) RETIREMENT PLAN

Particulars of the retirement plan of the Company are set out in note 31 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) SINCE THE FOREIGN CURRENCY BUSINESS OF THE COMPANY ARE SETTLED IN USD AND THE EXCHANGE RATE OF RMB TO USD IS RELATIVELY STABLE, THERE IS NO SIGNIFICANT EXPOSURE TO FOREIGN EXCHANGE RISKS.

(15) THE COMPANY HAD INCURRED NO CONTINGENT LIABILITY DURING THE REPORTING PERIOD.

(16) DURING THE REPORTING PERIOD, THE COMPANY DID NOT PLEDGE ANY OF ITS ASSETS.

(17) HEALTH CARE SCHEME

On 26 June 2003, the Group has abolished the socialised health care scheme and carried out a defined contribution health care scheme. Under this scheme, the Company is required to make annual contributions to the health care scheme on 7% of employees' salaries. The maximum amount of reimbursed medical expenses for each staff is RMB34,000 per annum. In addition, the Company has offered additional health care scheme to the staffs, which is also an insurance scheme and operated by China Life Insurance Company Limited. This additional healthcare scheme covered the protection over the basis maximum amount of reimbursed medical expenses. For the year ended 31 December 2003, the health care scheme contributions made by the Company amounted to RMB6,213,000 (2002 : Nil).

(18) ANNOUNCEMENT OF ANNUAL RESULTS

The Chinese version of the 2003 Annual Results was published on 22 March 2004 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

19 March 2004

