

# Report of the Board of Directors

Year 2004 was a milestone in the history of development of DFEM Machinery Company Limited. It is also a year the Company forded through difficulties, achieved glorious results and realize transcendent development with its pioneering spirit. Employees of the Company focused on the targets and requirements, overcoming diverse difficulties such as the great pressure in the delivery of goods, undersupply of raw materials and the shortfall in electricity supply. With detailed organization and efficient execution, production and operation missions were fulfilled thoroughly, achieving an annual production volume ranking the first in the world with business results hitting a historic high.

25

## I. OPERATIONS OF THE COMPANY DURING THE REPORTING PERIOD

### 1. Scope and Status of Principal Operations

#### (1) Operating status of principal operations

The Company is one of the leading electric power-generating equipment manufacturers 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.

For the year ended 31 December 2004, the Company's consolidated production volume of power-generating equipment broke through the 10,000MW threshold by reaching 15,360MW. This amounts to 200% of the historic high attained in 2003, making the Company rank first in the world in terms of its production volume in power-generating equipment. The Company's accumulated production volume of power-generating equipment increased to 84,000MW. Of them, 35 sets of hydro turbine generators accounted for 2,266MW; 36 sets of steam turbine generators accounted for 13,100MW; 27 sets of equipment modules were installed at the Three Gorges Project; 64 sets of A.C. motors accounted for 961.25MW; 64 sets of D.C. motors accounted for 525.42MW, together with 132 sets of auxiliary machine equipment.

During the reporting period, the operating results grew considerably along with the significant increase in production volume. In accordance with HK GAAP, turnover of RMB2.05 billion was realized, representing an increase of 71% over that of last year; profit after tax amounted to 253 million, representing an increase of 1,257% over that of last year; earnings per share amounted to RMB0.561, representing an increase of RMB0.52 when compared with RMB0.041 last year. In accordance with the PRC GAAP, sales revenue of RMB2.05 billion was realized by the Company, representing an increase of 71% over that of last year; net profit amounted to RMB265 million, representing an increase of 699% over that of last year; earnings per share amounted to RMB0.588, representing an increase of RMB0.514 as compared with RMB0.074 last year.

Leveraging the rapid development in the mainland's power infrastructure during the reporting period, the Company seized the opportunity by securing over RMB9 billion of additional orders in the year through careful and decisive planning, and by entering into a number of significant contracts. With the signing of contracts for four sets of 700MW hydro turbine generators for the right bank power plant of the Three Gorges Project, the Company is to cherish its dream of designing and manufacturing its own hydro turbine generator with the world's highest quality. The contract for manufacturing two sets of 1,000 MW ultra-supercritical steam turbine generators in Shandong Zouxian Power Plant enabled DFEM to get listed among the 1,000 MW steam turbine generation manufacturers. The signing of the contract for 300MW large pumped storage generation units offered an opportunity for the Company to develop in the market of pumped storage generation unit. Coupled with the contracts of large tubular-turbine generation unit, tangential flow generation unit and 200MW air-cooled generation unit, the product mix and product structure of the Company is further enhanced and optimised.

# Report of the Board of Directors *(continued)*

## (2) Principal operations by business

Unit: RMB'000

By business	Revenue from principal operations	Percentage in the total revenue from principal operations (%)	Profit from principal operations	Percentage in the total profit from principal operations (%)
Machinery manufacturing	2,051,360	100	741,947	100
Including: connected transaction	11,429	0.56	4,672	0.63
Total	2,051,360	—	741,947	—

## (3) Principal operations by product

Unit: RMB'000

By product	Revenue from principal operations	Percentage in the total revenue from principal operations (%)	Profit from principal operations	Percentage in the total profit from principal operations (%)
Electric power-generating equipment	1,925,095	93.84	699,527	94.28
Technological renovation, provision of services and others	126,265	6.16	42,420	5.72
Including: connected transaction	11,429	0.56	4,672	0.63
Total	2,051,360	—	741,947	—

Including: the connected transactions for sale of products to its controlling shareholder and its subsidiaries amounted to RMB40,020,000 during the reporting period.

## (4) Principal operations by region

Unit: RMB'000

By region	Revenue from principal operations	Percentage in the total revenue from principal operations (%)	Profit from principal operations	Percentage in the total profit from principal operations (%)
In the PRC	2,051,360	100	741,947	100
Including: connected transaction	11,429	0.56	4,672	0.63
Total	2,051,360	—	741,947	—

## (5) Reasons for changes in the profit of principal operations as compared with last year

The gross profit margin of principal operations of the Company for the year increased by 11.26 percentage points over that of last year. This was mainly attributable to the increase in production volume, sales revenue and the changes in product structure.

# Report of the Board of Directors *(continued)*

## 2. Operation and Results of Substantial Controlled Companies and Investee Companies

### (1) Operation and results of substantial controlled companies

Unit: RMB'000

27

Name	Nature of business	Major products and services	Registered capital	Total assets	Net profit
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	9202	114
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	27111	996
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	2447	62
DFEM Equipment Engineering Company Limited	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	2047	45

## 3. Major Suppliers and Customers

Unit: RMB'000

Purchase from the top 5 suppliers	340,405	Percentage in the total purchase	19.16%
Sales to the top 5 customers	541,178	Percentage in the total sales	26.37%

## 4. Problems and difficulties which arose during the operation, and their solutions

With its production value and volume reaching a historic new high in 2004, DFEM encountered a major and difficult problem, namely, how to ensure its products are delivered as scheduled despite its heavy production task. In view of such a heavy production task, the Company took decisive initiatives to improve its work by reinforcing internal management, improving labour allocation mechanism, effectively expanding outsourcing and properly investing in equipment. Hence, the Company's production and delivery ability were significantly improved. Through the efforts of all its staff members, the Company has outperformed its targets in production value, production volume, sales volume and profit for the year despite the great difficulty in production, undersupply of major raw materials, the tight production schedule and great difficulties in technological preparations.

# Report of the Board of Directors *(continued)*

## II. INVESTMENT OF THE COMPANY

### 1. Investment in 2004

The actual investment in 2004 amounted to RMB169,450,000. It mainly included: technological renovation project for improving yield of hydro electric power generators, in which actual investment amounted to RMB79,150,000 (including RMB75,620,000 of raised proceeds); special tax rebate under the three-tier taxation preferential policy, in which actual investment amounted to RMB75,920,000; and actual investment in other technological renovation totalling RMB14,380,000.

### 2. Use of proceeds

In accordance with the pledges on the use of proceeds set out in the Company's prospectus for the issue of H Shares and A Shares, the proceeds of RMB752,548,000 from the issue of A Shares and H Shares were utilized in four technological renovation projects for improving production capacity of hydro turbine generator sets. The use of proceeds till 31 December 2004 was reported as follows:

Projects set out in the Company's prospectus:

- (1) 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 RMB75,617,000. To date, the cumulative actual investment in this project amounted to RMB354,099,000.

Through the implementation of the technological renovation, the Company's production capacity and research and development standard have been enhanced.

- (2) Chinese party's capital contribution to the Sino-foreign 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 fund insufficiency. Currently, the change of use for this proceeds has come into effect.
- (3) Additional capital: the total planned investment was RMB150,000,000. The actual investment amounted to RMB150,000,000. The project had been completed.
- (4) Repayment of the loans in the Seventh and Eighth Five-Year Plan in relation to the technological renovation of infrastructure: the total planned investment was RMB75,000,000. The actual investment amounted to RMB88,449,000. The investment had been completed.

As of 31 December 2004, all of the proceeds of the Company have been completely used.

# Report of the Board of Directors *(continued)*

## III. ANALYSIS ON THE FINANCIAL STATUS AND OPERATING RESULTS OF THE COMPANY DURING THE REPORTING PERIOD

### 1. Changes in Major Financial Indicators

Unit: RMB'000

29

Item	2004.12.31	2004.1.1	Increase/ decrease	Increase/ decrease (%)
Total assets	6,374,067	3,714,721	2,659,346	71.59
Profit from principal operations	729,262	292,582	436,680	149.25
Net profit	264,721	33,126	231,595	699.13
Net increase in cash and cash equivalents	1,708,777	603,723	1,105,054	183.04
Shareholders' equity	1,269,939	949,137	320,802	33.80

- (1) The change in total assets was mainly attributable to (a) the increase of RMB2,000,169,000, or 154.13%, in cash at bank and in hand over that of last year, due to the noticeable rise in deposits as a result of the signing of numerous sales contracts; (b) the increase of RMB297,451,000, or 163.59%, in prepayment due to the considerable rise in purchase of raw materials resulting from the signing of considerable sales contracts; (c) the increase of RMB343,104,000, or 59.02%, in inventories over that of last year due to the significantly increased reserve of raw materials and work in progress as a result of substantial growth in production tasks.
- (2) The change in profit from principal operations was mainly attributable to the considerable increase in revenue from principal operations and gross profit.
- (3) The change in net profit was mainly attributable to (a) the increase in profit from principal operations; (b) the increase in profit from other operations; (c) the substantial decrease in financial expenses.
- (4) The change in net increase in cash and cash equivalents was mainly due to the considerable increase in cash at bank and in hand.
- (5) The change in shareholders' equity was mainly due to the considerable increase in net profit.

### 2. Financial status

As at 31 December 2004, the current assets of the Company amounted to RMB5,675,616,000 (2003: RMB3,097,794,000), including cash and bank deposits (inclusive of fixed deposits of more than three months' terms) amounted to RMB3,158,763,000, restricted bank deposits (premium of guarantee letter) amounted to RMB139,083,000, trade account receivables amounted to RMB718,272,000 and cash and cash equivalents at the end of the year which mainly included the Company's receipt of deposits from sales contracts and manufacturing contracts of products owing to the sound market momentum in electricity generation.

As at 31 December 2004, the current liabilities of the Company amounted to RMB5,076,256,000 (2003: RMB2,699,699,000), including trade payables of RMB173,453,000 and payment in advance inclusive of prepayment of RMB4,311,496,000 from construction contracts. Current liabilities increased by RMB2,376,557,000 as compared with 2003, mainly attributable to the increase in payment in advance in product contracts of the Company. With respect to the existing plans of the Company's current capital and future cash flow, the Company expected that it has sufficient repayment ability to maintain its high speed development.

### 3. Capital structure

As at 31 December 2004, the liability ratio of the Company was 421.21% (2003: 286.45%). The increase as compared with 2003 was mainly attributable to the increase in payment in advance by 239.15% over that of last year, reflecting the favorable conditions of market demand of the Company, with production and operations stepped into a new stage. The debt to equity ratio was 3.28% (2003: 46.16%), mainly due to the Company's contraction in loans. At present, the Company maintains a relatively strong debt repayment ability and it has a relatively strong financing ability in the future.

# Report of the Board of Directors *(continued)*

## 4. Cash flow

As at 31 December 2004, the cash and cash equivalents of the Company increased by RMB1,708,778,000 as compared with that of last year. (2003: RMB603,723,000). The net cash inflow from operations of the year amounted to RMB2,585,100,000 (2003: RMB1,046,390,000), including mainly the down payment from signed contracts and amount received in the course of implementing the of manufacturing product contracts. During the year, the cash outflow included transfer of fixed deposits with terms exceeding three months and pledged bank deposits amounted to RMB291,391,000, capital expenses such as the purchase of fixed assets and intangible assets amounted to RMB207,297,000 and the expenses in the repayment of long-term and short-term loans amounted to RMB435,600,000.

## 5. During the reporting period, the Company did not pledge any of its assets.

## 6. Gearing ratio

The total assets and total liability of the year amounted to RMB6,348,184,000 and RMB5,129,397,000 respectively. Thus, the gearing ratio was 80.80%.

## 7. The risk in the fluctuation of exchange rate and any related hedging.

The assets held by the Company denominated in foreign currency were very small and were mostly in US dollars. The Company's foreign currency business were mainly cleared and settled in US dollars. Since the exchange rate of US dollars and Renminbi was stable, the Company is subjected to a relatively low risk in exchange rate. Meanwhile, relevant risk precaution terms were included in the business contracts denominated in foreign exchange.

## 8. Contingent liabilities

As of the end of the period, the Company had incurred no contingent liability.

## IV. REASONS AND IMPACT OF CHANGES IN ACCOUNTING POLICIES AND ACCOUNTING ESTIMATES AND CORRECTION TO MATERIAL ACCOUNTING ERRORS

### 1. Changes in percentage of bad debts provisions for receivables

Before 1 January 2004, the bad debts provisions for receivables is calculated by the Company according to the method of balance percentage. Percentage of bad debt provision for other receivables of the Company amounted to 40% as calculated according to the method of ageing analysis. In accordance with the resolution passed at the 13th meeting of the fourth Board, starting from 1 January 2004, various kind of account receivables (including account receivables and other receivables) of the Company and its subsidiaries, as calculated according to the past experience, financial conditions of debtor, cash flow and other relevant information by ageing analysis at the final accounting date, will be charged into profit and loss account of the year. The percentage of bad debt provisions charged before and after changes are as follows:

Age	Percentage or provision charged of provision before changes	Percentage of provision charged after changes
Within one year	5%	5%
One to two years	6%	10%
Two to three years	7%	20%
Three to four years	8%	40%
Four to five years	10%	50%
Over five years	30%	100%*

\* For those receivables of connected parties which are more than five years old, 90% of bad debts provision of receivables was charged.

The net profit of the year decreased by RMB83,393,980.41 by using future applicable method for the aforesaid matter in accordance with the resolution of the Board and the Accounting Standards for Enterprises - Changes in Accounting policy and Accounting Estimates and Correction to Accounting Errors.

# Report of the Board of Directors *(continued)*

## 2. Changes in time limit and method for the depreciation of fixed assets

Before 1 January 2004, the calculation of depreciation rate for fixed assets by adopting the straight line average method and in accordance with the estimated economic use of life and estimated residual value (3% of the original price) according to the original price of the relevant class of fixed assets was as follows:

Type	Time limit for depreciation (years)	Yearly depreciation rate (%)
Buildings		
Including: Building for production	30	3.23
Building for non-production use	35	2.77
Machinery	9	10.78
Equipment	6	16.17
Motor vehicles	6	16.17

As the machinery of the Company has a high usage rate all the year round, the Company had to reflect the actual conditions of the machinery and speeded up the recovering and renewal of machinery facilities, it is approved at the 13th meeting of the fourth Board of Director that starting from 1 January 2004, the calculation of depreciation for fixed assets such as machinery facilities, equipments and instruments and electronic calculators will be changed by adopting the double residual diminishing method instead of the straight line method. After changes, the depreciation rate confirmed by the Company and its subsidiaries according to original cost of relevant classes of fixed assets, estimated economic life expectancy and estimated residual value were as follows:

Class of assets	Time limit (years)	Residual rate (%)	Yearly depreciation rate (%)
Buildings for production	20	5	4.75
Buildings for non-production use	25	5	3.80
Machinery	10	5	double residual diminishing method
Equipments	6	5	double residual diminishing method
Computer	5	5	double residual diminishing method
Motor vehicles	6	5	15.83

The net profit of the year decreased by RMB41,452,287.21 by using future applicable method for the aforesaid items in accordance with the resolution of the Board and the Accounting Standards for Enterprises - Changes in Accounting policy and Accounting Estimates and Correction to Accounting Errors.

## V. OPERATING PLAN FOR THE NEW YEAR

2005 marked the last year of the tenth five-year plan in the PRC. At present, the Company has entered a new phase of development. Production and operations of high quality continued to run with strenuous work of various tasks lying ahead. In 2005, the Company has to grasp the opportunity, face the challenge, adopt new measures and scale a new height to achieve its operational targets. By doing so, a new chapter can be written on DFEM's development and the Company is heading towards becoming the world's first class power-generating equipment manufacturing enterprise.

The Company's working objective in 2005: specialized management, swift execution, high quality and guaranteed delivery.

The core missions will be the following:

1. Strengthening coordination with efficient execution, together with scientific organizational structure and disciplined management style as well as perfection of appraisal system and contracting-out, the accomplishment of production targets of the year is ensured.
2. Continuing to insist on the sales strategy with focus on market and technology and sticking to strategic projects by sparing no efforts on vying for domestic strategic projects and competing for market share by striving the market commanding point, developing proactively the international market and preparing for sufficient orders for the long-term and continuous development of the Company.
3. According to the States' macro-economic control as well as relevant industry policy, integrating with corporate internal practice, setting up a sound risk precaution mechanism and system to proactively respond and stringently prevent risk as well as enhance the risk control ability of the Company. A timely communication and unified coordination between related sections such as market sales, project management, financial management, asset management, technological renovation investment and production organization can effectively prevent risk in market, technology and operations.

# Report of the Board of Directors *(continued)*

4. Prioritizing safety to the first to prevent accidents and be determined in working dedicatedly along with scientific management to effect permanent cure and track from the roots and sources of problem as a way to avoid serious accidents and to comprehensively upgrade safety level.
5. Planning reasonably and accelerating the pace of implementation, while thoroughly implementing technological renovation projects, both designated and under construction, so as to ensure work progress and quality and to ensure the completion of renovation projects are on schedule.
6. Strengthening the ability in the development of products based on its own proprietary intellectual property rights and patents, complied with improving reserve in technology and introducing technological innovation and progress as a way to enhance the pace in upgrading competitiveness in core technology.
7. Implementation of specialized management and perfecting mechanism while conducting an in-depth investigation into the feasibility and effectiveness of various management mode and incentive mode in order to further enhance implementation efficiency and diligently promote the regularization, scheduling and rationalization of management.
8. Continuing the training for all staff members while continuously perfecting an enterprise with learning culture in order to steadily boost the fostering of a corporate culture of "progress with times, pursuit of excellence" as a way to upgrade team quality and assist the sustainable development of the Company.

## VI. DAILY MANAGEMENT BY THE BOARD OF DIRECTORS

### 1. Board Meetings Held and Resolutions Passed

- (1) The 10th meeting of the fourth Board of Directors was held on 4 January 2004 for considering and approving the Company's 2004 administrative guidelines and objectives, fixed assets investment plan for 2004, the proposed write-off of underperformed assets and non-performing of asset checking on the Company.
- (2) The 11th meeting of the fourth Board of Directors was held on 19 March 2004 for considering and approving the 2003 financial statements of the Company, the 2003 profit after taxation distribution plan of the Company, the 2003 annual report and its summary, the 2004 financial budget of the Company, proposal for convening the 2003 annual general meeting and the proposal for appointment of accountants.
- (3) The 12th meeting of the fourth Board of Directors was held on 27 April 2004 for considering and approving the Company's first quarterly report for 2004, the proposed application to bank for the composite credit facilities and the financial management plan for bank deposit.
- (4) The 13th meeting of the fourth Board of Directors for considering and approving proposed change in the depreciation method of fixed assets, the proposed change in the proportion of bad debt provisions in the account receivables, the proposed recognition of certain long-term receipts in advance as income, the proposed write-off of certain account receivables, the proposed retirement of certain fixed assets, the unaudited interim financial statements for 2004, the interim profit appropriation plan for 2004, the interim report of 2004, the proposed change in investment method in DFEM Power Equipment Company Limited and DFEM Equipment Engineering Company Limited; and resignation of Director Ada Ying Kay Wong.
- (5) The 14th meeting of the fourth Board of Directors was held on 26 October 2004 for approving the third quarterly report of the Company for 2004.

All directors of the Board of Directors have attended in person or by proxy all the Board meetings of the Company in 2004.

The announcements of the above discloseable resolutions passed by the Board meetings were published in Shanghai Securities Post, China Securities Journal, Wen Wei Po and The Standard on the day following the holding of each meeting.

### 2. Implementation of resolutions passed at general meetings by the Board of Directors

The Board of the Company has strictly implemented all resolutions passed at the general meeting during the reporting period and will continue to honestly and diligently serve the Company and its shareholders for their maximized interests.



# Report of the Board of Directors *(continued)*

## VII. PROFIT DISTRIBUTION PLAN

The Company plans to appropriate 10% for the statutory surplus reserve fund and 5% for the statutory public welfare fund, and RMB0.12 (A share inclusive of tax) per share in cash will be distributed.

## VIII. FUND APPROPRIATED BY CONNECTED PARTIES AND ITS REPAYMENT

Unit: RMB0'000

Appropriated by	Connection with the Company	Opening balance	Increase in 2004	Decrease in 2004	Closing balance	Form of appropriated funds	Reason for appropriated funds	Way of repayment
Leshan City Dongle Heavy Piece Handling Company Limited	Associates	1,161	0	111	1,050	A current loan account	Funds appropriated for non-operating purpose	(1) use handling fees to set off the loan; (2) repay certain cash

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

Pursuant to the Notice of Certain Issues in Capital Transactions between Listed Companies and Connected Parties and External Guaranties of Listed Companies (《關於上市公司與關聯方資金往來及上市公司對外擔保若干問題的通知》, Zheng Jian Fa (2003) No. 56 circular of CSRC), we made a special statement for funds appropriated by connected parties of DFEM Machinery Company Limited ("DFEM") while auditing its consolidated financial statements for 2004. We have reviewed the financial information, connected transaction agreements, announcements of connected transactions and other relevant information and made enquiries to relevant management member of DFEM. This special statement is made for the purpose of understanding funds appropriated by connected parties of DFEM exclusively.

### 1. As at 31 December 2004, funds appropriated by connected parties of the Company are set out as follows (RMB):

Name of connected party	Connection with the Company	Ledger	Balance as of 1 January 2004	Increase	Decrease	Balance as of 31 December 2004	Provision for bad debt	Reasons for appropriated funds	Means of the appropriated funds
1. Leshan City Dongle Heavy Piece Handling Co., Ltd. ("Dongle Heavy Piece")	Associate	Other receivables	11,607,300.40	—	1,109,118.00	10,498,182.40	9,448,364.16	a current loan account	Funds appropriated for non-operating purpose

Dongle Heavy Piece is an associate company in which the Company is 49% interested. During the period between 17 September 1996 and 21 December 1998, the Company entered into 8 loan agreements with Leshan City Chuanjiang Harbor Shipping Development Company (another shareholder of Dongle Heavy Piece) in respect of prepayments, shipping charges and other payments at a total amount of RMB12,000,000 to be advanced by the Company for the purchase of Leshan Heavy Piece Terminal 550/50/10T Crane used by Dongle Heavy Piece and the accrued interest at the prevailing rate of bank deposit.

On 9 April 1999, Leshan City Chuanjiang Harbor Shipping Development Company, Dongle Heavy Piece and the Company entered into an "Agreement on the One-time Transfer of All the Loan Agreements in respect of Leshan Heavy Piece Terminal Crane Project", pursuant to which all of the above loan of RMB12,000,000.00 provided by the Company to Leshan City Chuanjiang Harbor Shipping Development Company shall be changed to a loan due to the Company from Dongle Heavy Piece and the ownership of the assets purchased with the loan shall be transferred to Dongle Heavy Piece.

On 15 March 2001, Dangfang Electrical Works Company Limited, Dongle Heavy Piece and the Company entered into an "Agreement on the Implementation of Preferential Pricing Differences in respect of Leshan Heavy Piece Handling Project", pursuant to which all of the handling charge for heavy piece shall be billed by Dongle Heavy Piece using 100% invoice, the Company will only pay 60% of the charges, and the remaining 40% will be set off with the above mentioned loan.

# Report of the Board of Directors *(continued)*

34

- During 2004, repayment of funds appropriated by the controlling shareholder and connected parties of the Company are set out as follows (RMB):

Name of connected party	Repayment of appropriated funds	Including: repayment in cash	Non-cash repayment	Reasons for non-cash repayment
1. Leshan City Dongle Heavy Piece Handling Co., Ltd.	1,109,118.00	329,270.00	779,848.00	*
* As set out above, during 2004, Dongle Heavy Piece repaid a total of RMB1,109,118.00 for the loan, of which RMB779,848.00 was set off by handling charges and RMB329,270.00 was repaid in cash.				

- During 2004, no additional fund was appropriated by the controlling shareholder and other connected parties of the Company.

## X. SPECIAL STATEMENT AND INDEPENDENT OPINION FROM INDEPENDENT NON-EXECUTIVE DIRECTORS FOR GUARANTEE PROVIDED BY DFEM TO OUTSIDE PARTIES

In accordance with the spirit of the Notice of Certain Issues in Capital Transactions between Listed Companies and Connected Parties and External Guaranties of Listed Companies (《關於上市公司與關聯方資金往來及上市公司對外擔保若干問題的通知》, (Zheng Jian Fa (2003) No. 56 circular of CSRC), the independent non-executive directors of the Company performed prudent inspection on accumulative and current guarantee provided by DFEM to outside parties and, with a pragmatic, serious and responsible attitude, they 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 non-executive 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 the interests of medium and minority shareholders.

## XI. OTHER DISCLOSEABLE MATTERS

### 1. Substantial Shareholders' Interests in Contracts

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 provisions of composite services between DFEW and the Company. Pursuant to the agreement, the Company will provide to DFEW services including utility services, procurement of raw materials, security and patrol, fire services, filing and despatch services; while DFEW will provide to the Company services including greening, environment protection services, property, welfare and education, vocational training, community welfare, medical services, warehousing and packaging of finished products, and transport on a term of 3 years 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.

The Company's Independent Non-executive directors and international auditors have reviewed the continuing connected transaction in 2004, and confirmed that the transaction was conducted in normal commercial terms and in the ordinary course of business of the Company. The amount of transaction did not exceed the stipulated caps.

# Report of the Board of Directors *(continued)*

## 2. Purchase, Sales or Redemption of Shares

As of the end of the reporting period, the Company, its subsidiaries or entities collectively controlled by the Company did not purchase, sell or redeem any of the shares of the Company.

## 3. Pre-emptive Rights

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

## 4. Compliance with the Code on Corporate Governance Practices and Model Code

During the reporting period, no directors were aware of any information which can reasonably indicate that the Company was in non-compliance with the requirements of the Code on Corporate Governance Practices under Appendix 14 of the Rules Governing the Listing of Securities on Hong Kong Stock Exchange at any time during the reporting period. During the reporting period, the Company had adopted a set of standard for the securities transactions of directors which was not lowered than the required standards of the Model Code for Securities Transactions by Directors of Listed Issuers under Appendix 10 of Rules Governing the Listing of Securities in Hong Kong. Upon specified enquiry to all the directors of the Company, all directors have expressed that they have complied with the above model code.

## 5. Audit Committee

The Board of the Company had set up an Audit Committee in accordance with the requirements of Rule 3.21 of Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong. The Audit Committee had reviewed the audited Annual Results of the Company in 2004.

The Audit Committee comprised of Independent Non-executive directors Zheng Peimin, Chen Zhangwu, Xie Songlin and Non-executive director Jing Jiachuan, with Independent Non-executive director Zheng Peimin acted as the Chairman of the Committee. In 2004, the Audit Committee convened two meetings, with all members of the committee attended the meetings. The meetings considered matters in relation to the Annual Report of 2003, the Interim Report of 2004, the connected transaction and the internal control system of the Company.

## 6. The Board of Directors has received confirmation letters, from all independent non-executive directors on their independence, as required under Rule 3.13 of the Rules Governing the Listing of Securities on the Stock Exchange, and considers that the existing independent non-executive directors meet the relevant guidelines set out in Rule 3.13 of the Rules Governing the Listing of Securities on the Stock Exchange and remain as independent parties.