# REPORT OF THE BOARD OF DIRECTORS

## I. DISCUSSION AND ANALYSIS OF OPERATIONS DURING THE PERIOD UNDER REVIEW

### (I). Result

The year 2006 is the first year of the "11th Five-year Plan". Profiting from the flourishing shipbuilding market and the medium and long term development plan as well as endeavor of the staffs, the Company sticks to the strategic goal of "to be the leader in the global handy-size tanker segment", and has achieved good results in producing, marketing, technical research and the management improvement and the level of integral gains made a considerable increase. During the year, the Company has finished the A share reform, the renovation of the dry dock, the regaining of the honor of the National Technical Centre, and so on, and made a affirmative impact on the capital operation, capacity expansion, science and technology innovation in the future.

During the period under review, the principal operating income and shipbuilding capacity made a considerable increase and improvement compared with those of last year. In the financial statements prepared in accordance with PRC Accounting Rules and Regulations for the year ended December 31, 2006, the principal operating income of the Group amounted to RMB3,322.3 million, representing an increase of 21.74% over that of last year. The audited consolidated net profit after taxation and minority interest amounted to RMB293.62 million representing an increase of 199.03% over that of last year. The earnings per share and that after deduction of exceptional items was RMB0.59 and RMB0.60 respectively, representing increases of 195% and 361.54% respectively.



In the financial statements prepared in accordance with HKFRS the year ended 2006, the turnover of the Group amounted to RMB3,322.30 million, representing an increase of 21.74% over that of last year. The profit attributable to shareholders after taxation and minority interest amounted to RMB266.64 million, representing an increase of 97.49% over that of last year. The earnings per share was RMB0.539.

**(II). Main work and results**

1. The Company has completed the renovation of the dry dock, and the dry dock has been put into production since August 28, 2006. It will provide a solid guarantee to expansion of the shipbuilding capacity of the Company, and also create a new economic growth point of the shipbuilding.

2. The Technical Center of the Company was re-honored as the National Technical Center. During the period under review, the Technical Center of the Company put more emphasis on the research and the development, and introduced several new types of product/chemical tankers, which were developed in accordance with the CSR based on the existing types of vessels. The research in respect of structure and capability of new types vessels which are well-received in the market and ordered by shipowners in batches, has reached leading level in domestic and advanced level in the world.

3. During the year, in order to enhance the management of shipbuilding, the Company has adjusted shipbuilding management function and worked up the organization to comply with the coexist of two assembly product lines of slipway and dry dock. Moreover, the Company developed the management improving and established modernized shipbuilding mode, centering on reformation of shipbuilding production system and assembly shipbuilding, and the improvement of the foundational management and information-based construction, and curtailed the construction circle on the berth and at the quay greatly and directly. The average construction circle on the berth in 2006 is six days fewer than that of 2005, and average construction circle at the quay of 2006 is twenty-one days fewer compared with that of 2005.

4. The shipbuilding orders made a great increase during the period under review. In 2006, The Company secured shipbuilding orders for the construction of 35 vessels, with a total tonnage of 1,516,200dwt and a contract value of RMB11.637 billion. As at December 31, 2006, the Group has secured orders for 59 vessels with a total tonnage of 2,501,600 million dwt and a total contract value of RMB18.454 billion. Moreover, the market share of the Company in the international segment market in 2006 rises to 14.5%(2005:14%).

5. Non-shipbuilding operation has created a new record. In the steel structure operation, the Company developed the market, and expanded the production through several cooperating manners such as pool and external assistance synchronously; In mechanical products operation, the Company exploited marine equipments, improved additional value of the hydraulic bending machine, hydraulic shearing machine and increased the output of elevators. The Company has achieved the sustainable and harmonious development of shipbuilding productions and non-shipbuilding productions.

**(III). Problems and difficulties of operation and their solutions**

During the period under review, the Company encountered problems and difficulties principally in talent shortage, work space restriction and the RMB exchange rate risk.

As a result of the development of China shipbuilding industry and the increase demand for shipbuilding talents, the Company was faced with talent shortage. For the purpose of attracting talents and decreasing the impact, the Company implanted several measures such as: pressing performance management, implementing reform of remuneration system, pressing the development and effective utilization of human resource and establishing talents achievements.

Along with the increase of the shipbuilding output of the Company, the work space restriction appeared gradually. The Company is facing strain of work space in block production, block painting, block assembly and re-outfitting. Recently, the Company is planning to invest new space or to search for partners to solve the problem in shipbuilding block supply.

As 70% of shipbuilding contracts of the Company are for export, and these contracts are settled by foreign currency and paid in several installments in accordance with shipbuilding progress, there are two or three years between signing the contract and the delivery of the vessels, and the appreciation in value of RMB is expected to get higher, so the Company is faced with certain RMB exchange rate risk. In order to reduce the impact of exchange rate change, the Company adopted a series of appropriate measures, such as establishing an exchange rate risk prevention team which was composed of senior management of the Company; raising the ration of first payment of new contracted vessels; promoting the proportion of domestic shipbuilding contracts properly; increasing the debt of U.S. dollar; using derivative financial instruments reasonably to minimize the exchange rate risk.

## II. OPERATION OF THE COMPANY DURING THE PERIOD UNDER REVIEW

### (I). Principal operation information

1. *Major operation information by products*

*Unit: RMB'000*

| Products | Principal operating income | Principal operating cost | Principal operating profit margin | Change in principal operating income over that of 2005 | Change in principal operating cost over that of 2005 | Change in principal operating profit margin over that of 2005 |
|---|---|---|---|---|---|---|
| | | | | *(%)* | *(%)* | *(%)* |
| Shipbuilding | 2,860,687 | 2,439,146 | 14.74 | 22.49 | 12.46 | 7.61 |
| Steel structure | 320,033 | 278,999 | 12.82 | 11.25 | 5.47 | 4.78 |
| Electrical & mechanical products and others | 141,579 | 88,674 | 37.37 | 33.91 | 13.18 | 11.48 |



Shipbuilding

In the year 2006, the Group completed 12 vessels with a total tonnage of 379,300dwt, commenced construction work for 12 vessels and launched 13 vessels. The main clients of the Company are European clients from Denmark, Sweden, Italy, Malta etc, and some domestic clients. The main vessels built during the period under review are 29,000dwt product/chemical tankers, 38,500dwt product oil tankers, 40,000/42,000dwt product oil tankers and 3,000dwt oil tankers.

The turnover from shipbuilding amounted to RMB2860.69 million which represented an increase of 22.49% over that of last year. The turnover attributable to shipbuilding represents 86.11% of the Group's turnover, the gross profit of shipbuilding products amounted to RMB421.54 million, and the gross profit rate accounted to 14.74%. The principal operating income of shipbuilding in 2006, which also supported the overall growth of the Company, made a considerable increase mainly due to better shipbuilding market, continual improvement of shipbuilding technology, ameliorative management, shorter shipbuilding cycles, more vessels having commenced the constructions during the period under review.

Steel structure

During this period under review, due to that the steel structure market took a favourable turn and the Company intensified to develop steel structure, the steel structure turnover of the Company made a big increase compared with that of the last year. In 2006, the steel structure completed by the Group amounted to 35,236 ton, and the turnover contributed from the steel structure operation amounted to RMB320.03 million and its gross profit amounted to RMB41.03 million with gross profit rate of 12.82%. The turnover attributable to the steel structure operation represented 9.63% of the Group's turnover. In 2006, the Company tried out project manager responsibility system and budget management in non-shipbuilding operation which made a certain effect on cost control and improving gross profit of the production.



Mechanical and electrical products and other operations

The mechanical and electrical equipment operations of the Group including hydraulic bending machine, hydraulic shearing machine, residential elevators manufacture and installation, maintenance and alternation of hydrofoil of hovercraft and shiprepairing. In 2006, the turnover from the mechanical and electrical equipment amounted to RMB141.58 million, and the gross profit amounted to RMB52.9 million with gross profit rate of 37.36%. The turnover attributable to mechanical and electrical and other operations represented 4.26% of the Group's turnover.

2. *Geographical analysis of turnover*

Unit: RMB'000

| Countries or Regions | Principal operation income 2006 | 2005 | Change (%) |
|---|---|---|---|
| Malta | 273,676 | 97,361 | 181.09 |
| Canada | 20,444 | 143,499 | -85.75 |
| Denmark | 1,004,955 | 1,280,912 | -21.54 |
| Macao | 50,136 | 25,599 | 95.85 |
| The Philippines | 0 | 5,060 | -100 |
| U.S.A | 202,039 | 1,021 | 19,694.91 |
| Hong Kong | 80,371 | 382,928 | -79.01 |
| The Marshall Islands | 21 | 209,737 | -99.99 |
| Taiwan | 3,478 | 4,643 | -25.08 |
| Sweden | 549,955 | 0 | 100 |
| Norway | 0 | 7,771 | -100 |
| Liberia | 637,893 | 0 | 100 |
| Oman | 31,626 | 0 | 100 |
| Others | 3,455 | 4,760 | -27.42 |
| Subtotal | 2,858,050 | 2,163,290 | 32.12 |
| Mainland China | 464,249 | 565,626 | -17.92 |
| Total | 3,322,299 | 2,728,916 | 21.74 |

During the year, the Group's turnover attributable to exports amounted to US$364.38 million (2005: US$268.1 million).

**(II). Major customers and suppliers**

In 2006, the turnover attributable to the Group's five largest customers amounted to RMB1,765.62 million and accounted for 53.13% of the turnover of the Group. Including of those, the turnover from A/S Dampsikibsselskabet Torm, Denmark, the Group's largest customer, amounted to RMB549,954,647.53, representing 16.55% of the total turnover of the Group.

In 2006, the purchase of raw materials and equipment from the Group's five largest suppliers amounted to RMB812.39 million and accounted for 41.11% of the total purchases of the Group. Including of those, the purchase from Chongqing Iron and Steel Co., Ltd., the Group's largest supplier, amounted to RBM383,792,761.63, representing 19.42% of the total purchase of the Group.

None of the directors, supervisors and their respective associates had any interests in the major customers and suppliers noted above, nor had any of the Company's shareholders disclosed to the Company that he or she had any interest in the above mentioned major customers or suppliers.

### (III). Major subsidiaries

The operation conditions of the Company's major subsidiaries, with 51% or more interest held, during the year are summarised as follows:

| | Company Name | Principal Activities | Registered Capital | Interest Attributable to the Company | Assets | Net profit (loss) |
|---|---|---|---|---|---|---|
| | | | *RMB'000* | *(%)* | *RMB'000* | RMB'000 |
| **Direct holding subsidiaries** | | | | | | |
| 1 | Guangdong Guangzhou Shipyard International Elevator Company Limited | Elevator production and sales | 21,000 | 95 | 52,984 | 4.018 |
| 2 | Guangzhou Hongfan Information Technique Company Limited | Development of computer software, system integration and sales of hardware | 5,000 | 77 | 9,176 | 861 |
| 3 | Guangzhou Xinsun Shipping Service Company Limited | Welding and coating of ships | 2,000 | 83 | 18,801 | 898 |
| 4 | Masterwood Company Limited | Furniture manufacturing | 3,315 | 51 | 9,055 | 478 |
| 5 | Guangzhou Guanglian Container Transportation Company Limited | Container transportation | 20,000 | 75 | 21,490 | (446) |
| 6 | United Steel Structures Limited | Large-sized steel structure | 73,573 | 51 | 195,037 | 21,590 |
| 7 | Glory Group Development Co., Ltd. | Trading | HKD10,000 | 100 | 65,726 | (485) |
| **Indirect holding subsidiaries** | | | | | | |
| 8 | Masterwood Company Limited | Furniture manufacturing | 3,315 | 25 | 9,055 | 478 |
| 9 | Guangzhou Hongfan Hotel | Traveling and catering services | 10,000 | 86.16 | 6,484 | 246 |
| 10 | Guangdong Guangzhou Shipyard International Elevator Company Limited | Elevator production and sales | 21,000 | 3.8 | 52,984 | 4,018 |
| 11 | Fonkwang Development Ltd. | General trade | HKD200,000 | 70 | 44,781 | 622 |

Except for Glory Group Development Co., Ltd. and Fonkwang Development Ltd. were registered in Hong Kong, other above-mentioned subsidiaries are cooperated affiliated companies established and operated in Mainland China.

## (IV). Financial position of the Group during 2006

*RMB'000*

| Item | Closing balance | Opening balance | Increase/ decrease (±) | Change ratio (±%) |
|---|---|---|---|---|
| Total assets | 7,481,033,647.00 | 2,544,604,337.13 | 4,936,429,309.87 | 194.00 |
| Principal operating profit | 506,186,415.86 | 215,188,764.16 | 290,997,651.70 | 135.23 |
| Net profit | 293,616,579.81 | 98,193,259.73 | 195,423,320.08 | 199.02 |
| Net increase in cash and cash equivalents | 3,693,577,108.19 | 266,729,465.63 | 3,426,847,642.56 | 1284.77 |
| Shareholders' equity | 1,099,913,516.29 | 808,455,948.62 | 291,457,567.67 | 36.05 |

1. *Balance sheet items*

| Balance Sheet Items | Closing balance (RMB'0000) | Opening balance (RMB'0000) | Change (±%) | Percentage in total assets (%) |
|---|---|---|---|---|
| Total current assets | 625,882 | 144,398 | 333.44 | 83.66 |
| Long-term investment | 7,282 | 1,574 | 362.79 | 0.97 |
| Fixed assets-net book value | 107,761 | 100,459 | 7.27 | 14.40 |
| Total assets | 748,103 | 254,460 | 194.00 | 100 |
| Total liabilities | 631,972 | 168,643 | 274.74 | 84.48 |

Reasons of change more than 30%:

① The total current assets increased by 333.44% over that of the same period of last year is mainly due to:

(1) Cash and bank balance increased by 70.62% which was mainly due to the increase of the new shipbuilding orders and the USD loan from the Export-import Bank of China.

(2) The increase of the new shipbuilding orders and the shipbuilding expansion results in 48.22% increase of the payments to suppliers and 261.14% increase of the inventories.

② The increase of the long-term investment is mainly due to:

(1) The eleventh meeting of the 5th term of the Board held on March 23, 2006 approved the Glory Group Development Company Limited, a subsidiary of the Company, to investment 2 million USD in CSSC Zhenjiang Hyundai Generator Co., Ltd. in 2006.

(2) The seventeenth meeting of the 5th term of the Board held on October 17, 2006 approved the Company to invest 10 million shares in China Merchants Energy Shipping Co., Ltd. amounted to RMB37.1 million as a strategic investor.

③ The total liabilities increased by 274%, which was mainly due to the 214.05% increase of current liabilities, thereinto:

(1) Receipts in advance increase by 40.25% that mainly due to the increase of the receipts in advance of other operations.

(2) Other payables increased by 88.25% main due to that the seventh meeting of the 5th term of the Board on January 4, 2006 approved to develop the housing monetary allowances policy for retirees and authorize the management to implement aforesaid policy. The meeting of presidents on March 21, 2006 approved the "Measures Concerning Housing Allowance" ("Measures"). In accordance with the Measures and reasonable prediction, the Company has made a provision of RMB23,391,335 to pay for the housing allowances for the retirees in 2006 and 2007, and RMB12,036,670.65 has been paid during the period under review.

(3) The increase of the long-term liabilities within one year is mainly due to returning part in 2007 of the special dollar loans applied from the Export-import Bank of China which was approved at the fourteenth meeting of the 5th term of the Board.

(4) Other current liabilities increased by 350.56% mainly due to that the increase of new-signed vessel orders led to the increase of the sum for shipbuilding contracts accordingly.

④ At the balance sheet day, the gearing ratio (84.48%) of the Group had great change, comparing with those (66.27%) at the beginning of the period, which was due to the increase of the prepayment for shipbuilding contracts and the USD loans from banks.

2. *Profit and loss statement items*

| **Profit and Loss Statement Items** | **As at Dec. 31, 2006 (RMB'0000)** | **As at Dec. 31, 2005 (RMB'0000)** | **Change (±%)** |
|---|---|---|---|
| Selling expenses | 467 | 407 | 14.72 |
| Administrative expenses | 22,000 | 11,632 | 89.13 |
| Financial expenses | 413 | 3,267 | -87.37 |
| Income tax | 584 | 272 | 115.01 |

Reasons for changes comparing the same period of last year:

① The administrative expenses increased by 89.13% mainly due to:

(1) The seventh meeting of the 5th term of the Board approved to implement the housing monetary allowances policy, and the Company has made the provision of RMB23,391,335 during the period under review.

(2) Due to debt restructuring, the Company has received partial assets of the trust deposit in Company and Guangzhou International Trust Investment Company ("GZITIC"), and has written back a bad debt provision amounting RMB36.17 million; Eliminating the above-mentioned non-comparable factors, the real increase of administrative expenses reached 28.93%, which is mainly due to: better operation benefit, the improvement of the staff's wages and the structure adjustment of function managing departments which results in the increase of wage expenses in administrative expenses; the expansion of production caused the increase of the investment in development and research of new productions; more business volume in this year made the increase of related tax.

② The financial expenses decreased by 87.37%, mainly because of the good cash flowing and less capital cost which is benefited from the increase of shipbuilding orders this year.

③ The income taxation of the Company made an increase mainly due to the great increase of the income taxation of the subsidiaries which is resulted from the increase of operation income.

3. *Cash flow statement items*

| Cash Flow Statement Items | As at Dec. 31, 2006 (RMB'0000) | As at Dec. 31, 2005 (RMB'0000) | Change (±%) | Reason for change |
|---|---|---|---|---|
| Net cash flow from operating activities | 261,925 | 84,558 | 209.76 | The increases are due to that the Company has sufficient capital, which is the result of the increase of operation orders, and money in advanced of orders during this period under review. |
| Net cash flow from operating activities per share | 5.29 | 1.71 | 209.36 | The considerable increase is mainly due to the good cash flowing. |
| Cash inflows from investing activities | 7,317 | 1,597 | 358.17 | The increase is mainly due to the Company received the cash and income of purchasing Central Bank Notes not exceeding RMB0.3 billion which was approved by the fifteenth meeting of the 5th term of the Board. |
| Cash outflows from investing activities | 44,809 | 8,893 | 403.92 | The increase in this item includes: 1) USD2 million invested in Zhenjiang CSSC Hyundai Generator Equipment Co., Ltd.; 2) The strategy investment amounting RMB37.1 million for purchasing initial public offer A share of China Merchants Energy Shipping Co., Ltd., and the payment for purchasing central bank notes; 3) The cash be used to purchase equipments as the operation expansion of the Company. |
| Cash inflows from financing activities | 191,543 | 43,380 | 341.55 | The increase of this item is mainly due to the special USD loan from the Export-import Bank of China to avoid the exchange rate risk. |
| Cash outflows from financing activities | 45,269 | 93,984 | -51.83 | The great decrease in this item is due to that the sufficient operation capital causes the decrease of the financial cost. |
| Net increase in cash and cash equivalents | 369,358 | 26,673 | 1,284.76 | The great increase in this item is due to the increase of the cash in the Company's operation and financing activities. |

### (V). Investments information

The Company had not raised funds during the year nor utilized any proceeds previously raised. During the period under review, the investment capital not from share offering of the Company amounted to RMB169.17 million, increasing by RMB68.16 million and representing an increase of 67.48% compared with that of last year. Except for the investment on equity, the major invested projects are technology investments which are as follows:

| Items | Amount (RMB'0000) | Progress | Income |
|---|---|---|---|
| Zhenjiang CSSC Hyundai Generator Equipment Co., Ltd. | 1,556 | Finished and is using | Hasn't generate any income |
| China Merchants Energy Shipping Co., Ltd. | 3,710 | Finished and is using | Has generate income |
| Normal reform projects inside the Company | 11,651 | Partially finished | Finished part generate the income |

### (VI). Responsibility ascertainment and treatment to relevant person for significant loss in assets

During the period under review, the Company had not happened any significant loss in assets.



### (VII). Profit distribution for the year 2006

As the Company has a profit of RMB293.62 million in the financial statements prepared in accordance with the PRC Accounting Rules and Regulations and a profit attributable to shareholders of RMB266.64 million in the financial statements prepared in accordance with HKFRS in 2006. Accumulated retained earnings of the Company is negative, the profit should offset loss first in accordance with the Articles of Association of the Company, the Board of Directors proposed not to recommend any profit distribution or capital increment for the year 2006. This proposal will be submitted to 2006 Annual General Meeting for approval.

## III. THE INFLUENCE ON THE FINANCIAL SITUATION AND OPERATING PERFORMANCE OF THE COMPANY BY THE CHANGES OF THE ACCOUNTING POLICIES AND ACCOUNTING ESTIMATES AFTER THE NEW ACCOUNTING STANDARD ARE APPLIED

Generally, there would not be significant effect on the operating performance of the Company after the new accounting standard being applied, but it is thought that there would be some impact in details, which mainly in the reclassification of the parts of the assets and liabilities items , and the fair value is applied to measure some assets, and so on. Moreover, there were some changes in items of expenses.

1. In accordance with the Accounting Standard for Business Enterprises No. 2 – Long-term equity investments, the investment on the subsidiaries would be accounted for at cost in the statement of the parent company, and it would be adjusted in accordance with the equity method of accounting when preparing consolidated financial statements. this policy would not affect the consolidated financial statements, but would affect the accounting for the long-term investment on the subsidiaries and the financial statements of the parent company instead.

2. In accordance with the Accounting Standard for Business Enterprises No. 4 – Fixed assets, the follow-up disbursement which couldn't meet the capitalization requirements would be recognized as the profit and loss (administrative expenses).

3. In accordance with Accounting Standard for Business Enterprises No. 6 – Intangible assets, our intangible assets would be reclassified as costs and accumulative amortizations. Both of the costs and accumulative amortizations would be adjusted correspondingly at the first day of adopting the new accounting standard. When the useful lives of intangible assets cannot be ascertained, the amortization is not accounted by the straight-line-method any longer, but the devaluation testing should be carried on at the end of the year. The change of the standard concerns the recover of the cost and the reclassification of the amortization accumulations, the policy that no amortization happened to the uncertainty useful lives intangible assets has not much effect on the profit and loss of the Company.



4. In accordance with the Accounting Standard for Business Enterprises No. 8 – Impairment of assets, such as the investment properties measured at cost, fixed assets, intangible assets, long-term investment , construction-in-progress and so on. If there is any evidence of devaluation, the assets would be measured at the lower between the book value and the net realizable value. In principle, the impairment is measured by single asset, when it is difficult to estimate the value receivable, it also might be measured by assets group. There is no any significant change in this policy and the effect is less to the Company.

5. In accordance with the Accounting Standard for Business Enterprises No. 9 – Employee compensation, the employee compensation includes various expenses of salaries, benefits and social securities for employees. Parts of the benefits and social securities which were accounted in the profit and loss formerly would be transferred to the cost of the assets correlative based on beneficial objects. The above-mentioned would have influence on some assets and the costs of production, but little on the profit and loss of the current period as a whole.

6. In accordance with the Accounting Standard for Business Enterprises No. 12 – Debt restructurings, repaying debt by the way of non-cash assets would be measured by fair value, the difference between the book value of the liabilities and fair value would be recognized as the profit and loss in current period. This policy changes in the measurement and accounting method of the assets in the debt restructurings, and would not influenced much to the Company.

7. In accordance with the Accounting Standard for Business Enterprises No. 16 - Government grants, the government grants except for those which should be transferred to the Special Project Payable according to relative guidance. The other items should be distinguished into the capital expenditure and the expense expenditure separately, and transferred into the deferred income or income of the current period by stages. The impact except for the changes of accounting items, the change of policy would also affect the method of accounting for the government grants, as well as the profit and loss of the current period.

8. In accordance with the Accounting Standard for Business Enterprises No. 17 – Borrowing costs, the borrowing costs of the special loan for assets acquisition or production would be capitalized. The borrowing costs of our special loans from the Export –Import Bank of China would be recognized as the cost of the shipping construction instead of financial expenses, and the net income of single ship would be reduced accordingly, also would affect the profit and loss of the current period. Whereas, the borrowing costs of the special exchange loan which does not meet requirement of capitalization would not be capitalized. The change in this policy is expected to influent the current profit and loss of the Company.

9. In accordance with the Accounting Standard for Business Enterprises No. 18 - Income taxes, the deferred income tax should be measured by an liabilities method. There should be some differences between the income tax deducted in the Income Statement and the one on basis of accrual basis, definitely, that would impact the net profit of the Company.

10. In accordance with the Accounting Standard for Business Enterprises No. 20 - Business Combinations. The consolidation of the enterprises which are not controlled by the same parent company would be measured at fair value. This would impact the method of accounting for the investment and the profit and loss of the current year.

11. In accordance with the Accounting Standard for Business Enterprises No. 22 - Recognition and measurement of financial instruments. The available-for-sale financial assets of the Company would be measured at fair value. The difference between the cost and fair value at the balance sheet day would result in the adjustment of the capital reserve. When the assets were sold, the capital reserve alteration would be recognized as the profit and loss. This change would affect shareholders equity and the profit and loss on the day when the assets were sold.

12. The forward foreign exchange contracts held for avoiding foreign exchange risk would be adjusted from the non-recognized in statement to recognize in statement. The difference between the contract price of derivative financial instruments and the alteration of the fair value would be recognized as the profit and loss and would impact the current earning.

13. Fair value estimation. If the financial assets and liabilities are traded in an active market, the fair value would be determined using the market price and revised with the consideration of other factors if necessary. Otherwise, the Company would determine it with specifically valuation technique, and try to use all the market parameters.

## IV. PROSPECTS FOR THE COMING YEAR

### (I). Prospects for 2007

During the period under review, the shipbuilding market has developed rapidly, and the shipbuilding capacity of China is expanding swiftly. In the face of fiercer competition in the market, the Company will keep on strengthening the management, integrating resource, optimizing the flow, consummating the foundation and improving the efficiency to strive for the improvement of shipbuilding capability compliant to the speedy development and overcoming the challenge from external market to achieve the well and rapidly sustainable development of the Company.

The main tasks in 2007 are as follows:

1. To consummate the assistant projects of dry dock renovation, move plate-cutting and block construction out of slipways area, to improve the efficiency of assembly shipbuilding and solve the bottleneck of capacity of the two assembly shipbuilding lines to support the realization of the "11th Five-year Plan".

2. To adjust the organization of the Company and strengthen the functional management and control of shipbuilding to meet the model of collective shipbuilding of two assembly product lines of slipways and dry dock and achieve the specialization of shipbuilding management and production.

3. To enhance the research of shipbuilding technique, keep on consummating the fundamental technology of hull construction precision management, improve and consummate the finished-production of interim products and optimize and extend the scope of assembly shipbuilding centering on the research of coating technology of ballast tank of vessels, to improve the efficiency of assembly shipbuilding.

4. To intensify trainings, improve the quality of administrative staff , professional technical staff, manufacturing staff, establish managing pattern of organizing workers in accordance with posts and working areas, incorporate the worker management in the managing system of the Company and optimize the human resource structure of the Company to adept to the rapid development of the Company's shipbuilding operation in the view of the lack of talents in 2006.

5. To establish the communication and consultation mechanism with professionals of finance and law to consummate the measures to avoid the exchange rate risk and capital risk.

6. To achieve the orders of the construction of vessels which would be delivered in 2011 with the opportunity of flourishing market.

7. To open up the market of steel structure and heavy mechanical and electrical products operations, combined with the requirements of conforming shipbuilding assistant work of the Company and seizing the opportunity of expansion of shipbuilding industry in China.

### (II). The profit forecast of the first quarter of 2007

Due to the completion of the reconstruction of the dry dock on the whole, the increased shipbuilding output and production efficiency, it is anticipated that the net profit in the first quarter of 2007 prepared under the PRC Accounting Rules and Regulation will increase by more than 300% over that of the same period of 2006.

## V. REPORT OF THE DAILY OPERATIONS OF THE BOARD OF DIRECTORS

### (I). Meetings of the Board of Directors

During the period under review, the Board of Directors held eleven meetings. The major points and resolutions arising from each of these meetings are as follows:

| Meetings | Convening date | Major Publications Disclosing Information | Date of Disclosing Information | Note |
|---|---|---|---|---|
| Eighth meeting of the 5th term of the Board | Jan. 12, 2006 | Shanghai Securities News, Hong Kong Commercial Daily, China Daily (overseas version) | Jan. 13, 2006 | |
| Ninth meeting of the 5th term of the Board | Jan. 24, 2006 | | Jan. 25, 2006 | |
| Tenth meeting of the 5th term of the Board | Mar. 10, 2006 | | Mar. 13, 2006 | |
| Eleventh meeting of the 5th term of the Board | Mar. 23, 2006 | | Mar. 24, 2006 | |
| Twelfth meeting of the 5th term of the Board | Apr. 24, 2006 | | Apr. 25, 2006 | |
| Thirteenth meeting of the 5th term of the Board | Jun. 16, 2006 | | – | *Note 1* |
| Fourteenth meeting of the 5th term of the Board | Aug. 17, 2006 | | Aug. 18, 2006 | |
| Fifteenth meeting of the 5th term of the Board | Aug, 24, 2006 | | – | *Note 2* |
| Sixteenth meeting of the 5th term of the Board | Oct. 26, 2006 | | Oct. 27, 2006 | |
| Seventeenth meeting of the 5th term of the Board | Oct. 31, 2006 | | – | *Note 3* |
| Eighteenth meeting of the 5th term of the Board | Nov. 20, 2006 | | Nov. 23, 2006 | |

Note:

1. The thirteenth meeting of the 5th term of the Board approved the Company to sell the real estate located in 702 located at No. 10 Tianxiang Street, Xingdong Road, and 901 and 902 located at No. 12 Tianxiang Street, Xingdong Road of Liwan District in Guangzhou City with the price not less than RMB500,000, and authorized the management to sign the relevant agreements.

2. The fifteenth meeting of the 5th term of the Board approved the Company to purchasing the People's Bank of China Notes not exceeding RMB0.3 billion, and authorized the executive directors and management of the Company to sign relevant documents.

3. The seventeenth meeting of the 5th term of the Board approved the Company to join the right issue of China Merchants Energy Shipping Co., Ltd. as a strategic investor with a total amount of 10million shares.

**(II). The execution by the Board of Directors in respect of the resolutions passed at General Meetings**

During the year, the Board of Directors had executed all the resolutions passed at the 2005 Annual General Meeting, the first Extraordinary General Meeting in 2006 and the General Meeting in relation to the A Share Market.



## VI. OTHER INFORMATION

**Financial summary**

Summaries of the results, assets and liabilities of the Group for the last five financial years prepared in accordance with the PRC Accounting Rules and Regulations and the HKFRS are set out in on page 8 and page 9, respectively.

**Results and profit distribution**

The results and profit distribution of the Group for the year ended December 31, 2006 prepared under PRC Accounting Rules and Regulations and the HKFRS are set out in the profit and profit distribution statement on page 74 and consolidated income statement on page 144.

**Reserves**

The movements in the reserves of the Group which are prepared under PRC Accounting Rules and Regulations and the HKFRS are set out in note (V)20 to 23 to the financial statements on page 107 to 109 and note 21 on page 190 to page 192 respectively.

### Fixed assets

Details of movements in fixed assets (including properties and other tangible assets) of the Group which are prepared under PRC Accounting Rules and Regulations and the HKFRS set out in note (V)7 to the financial statements on page 99 and note 6 to the notes to the consolidated financial statements on page 174 respectively.

As at December 31, 2006, the fixed assets pledged as security for the Group's banking facilities amounting to RMB140.45 million.

### Properties held for development or sale

The Group received the following properties in its efforts to recover accounts receivable and which are currently treated as properties held for investment purpose. Save as disclosed, the Group has no property held for development or sale or investment purpose, for which the percentage ratios as defined under rule 14.04(9) of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited exceed 5%, or which represents over 15% of the value of net tangible assets, or where contribution derived from properties exceeded 15% of pre-tax operating profit.

| Properties | Address | Use | Permanent freehold or not |
|---|---|---|---|
| Shops in Urumchi, Xinjiang | No. 3 Beijing Beilu New District Urumchi City, Xinjiang | Rent | No |
| Shops in Changchun, Jiling | Building 308 Guangfu Road, Nanguan in Changchun, Jiling Province | Rent | No |
| Real estate in Wushan | Jingfu Garden, Wushan Road, Guangzhou | Rent | No |
| Real estate in Heshan | Huayuan, 496 Xincheng Road, Shaping Town, Heshan City, Guangdong Province | Rent | No |
| Shops in Hengyang | 33 Jiefang Avenue, high-tech development zero, Hengyang City, Hunan Province | Rent | No |
| Real estate in Dongguan | Tower 1, Yunhe Xisan Road, Dongguan City, Guangdong Province | Rent | No |
| Real estate in Longgang | Dongsen Garden, Ailian Village, Longgang Town, Shenzhen | Rent | No |
| Real estate in Clifford Estates | A57, Street 11, Clifford Estates, Zhongcun Town, Panyu District, Guangzhou | Rent | No |

### Share capital

Details of the share capital of the Company are set out in "Change of the share capital" on page 13.

### Preemptive rights

As there is no provision for preemptive rights under the Company's Articles of Association, the Company had not arranged any scheme for such right during the year.

### Warrants and others

During the year, neither the Company nor its subsidiaries have issued any warrants, convertible securities, options or other securities with similar rights, nor had any person exercised any right noted above.

### Purchase, sale or redemption of the Company's securities

Neither the Company nor its subsidiaries made any purchase, sale or redemption of the Company's securities during the year.

### Bank loans, overdraft and other borrowings

Details of bank loans, overdraft and other borrowings of the Group as at December 31, 2006 are set out in note (V) 11 and note (V) 18 to the financial statements on page 101 and 106 and note 22 to the notes to the consolidated financial statement on page 192 to page 194, respectively.

### Capital expenditure



The Group expects that capital expenditure during 2007 would be approximately RMB288.65 million. The Group has sufficient financial resources to meet the demand for capital expenditure and its daily working capital.

### Contingent liabilities

As at December 31, 2006, the Group has no significant contingent liabilities.

### Connected transactions

During the period under review, relevant continuing connected transactions between the Group and CSSC Group were carried out in accordance with the framework agreements for connected transactions and their supplemental agreements (the "Framework Agreement"). Such transactions themselves are of an operational nature and in the normal and usual course of business of the Group, they allow the Group to leverage the reputation and bargaining power of the CSSC Group, provide a steady source of materials, labor and design and technology services necessary for the Group to conduct its business, and allow flexibility in handling excess resources which are in short supply for the CSSC Group. The Directors including four independent non-executive directors have reviewed the transactions and confirm that they have been entered into in the ordinary and usual course of business of the Group, on normal commercial terms or, where there are not sufficient comparable transactions to judge whether they are on normal commercial terms, on terms no less favourable to the Group than terms available to or from (as appropriate) independent third parties, and in accordance with the Framework Agreement on terms that are fair and reasonable and in the interests of the shareholders of the Company as a whole.

### Comprehensive services contract

In accordance with the comprehensive services contract signed on December 8, 2005 between the Company and a connected person Guangzhou Shipyard, Guangzhou Shipyard agreed to provide the Group, the staff and their family members with various services, including medical services, catering services, infant care and nursery, primary and secondary school education, training programs for skilled labors and management of staff quarters for an annual service charge not exceeding HKD10 million. Such comprehensive service agreement was approved at the sixth meeting of the 5th term of the Board. The Company's independent directors have reviewed these continuing connected transactions and confirm that they have been entered into in the ordinary and usual course of business of the Group, on normal commercial terms, and in accordance with the comprehensive services contract on terms that are fair and reasonable and in the interests of the shareholders of the Company as a whole.

Details of the transactions above-mentioned are set out in note (VI) to the financial statements on page 121. Furthermore, the above transactions, which also constitute continuing connected transactions under the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited, require disclosure in accordance with Chapter 14A thereof, which have been complied with. Details are set out in note 38 to the financial statements prepared under the HKFRS on page 206.

### Employees' pension scheme

The Company and certain subsidiaries have joined the defined contribution retirement scheme operated by the provincial government of Guangdong Province since 1st January 1994. Under the scheme, during the period under review, the Company had made contributions to the scheme at the rate of 18% of the total salary (for purpose of calculating pensions, of all working employees). Upon retirement, the retirees will receive monthly payments from the Social Insurance Bureau of Guangdong Province. The contribution made by the Group for 2006 was RMB29.09 million (2005: RMB23.93 million). In addition, during the year the Company had made payments of RMB2.07 million (2005: RMB1.39 million) as subsidies to retirees.

### Purchase of staff quarters by employees

Guangzhou Shipyard owns staff quarters occupied by employees of the Company. The sale of staff quarters to the Company's employees by Guangzhou Shipyard are in accordance with the State and Guangzhou City's housing reform policy and the Company was not involved in the selling of staff quarters to the employees.

With respect to the document (Sui Fu [2000] 18) issued by Guangzhou Municipal Government concerning the one-time cash accommodation allowance to those employees to whom the Company has not allocated staff quarters and those aged employees whose allocated staff quarters do not meet required standard. Directors considered that the said document is not legally binding on the Company. However, in order to ensure the stabilization of the operation circumstances of the Company, to undertake social responsibility and to stabilize the staff team, the seventh meeting of the fifth Board of Directors approved the proposal to initiate the lump-sum housing allowance, which amount would not exceed RMB24 million for retired employees to whom the Company has not allocated staff quarters. During the period under review, the total allowance was affirmed to be RMB23.39 million, RMB12.04 million in which has been paid in during the period under review, and other RMB11.35million will be paid in 2007. Relevant information has been settled in the profit and loss statement.

**Significant litigation**

The significant litigation of the Group happened during the period under review is set out in item 1 and 2 of Significant Events.

**Certified Accountants' Special Statement on the Capital Impropriation by the Controlling Shareholder and Connected Parties**



In accordance with the requirement of relevant notice from China Securities Regulatory Commission, we audited the transacted of funds of the Company by its controlling shareholder, CSSC and other connected parties. As at 31st December 2006, the funds transacted between the Company and CSSC and other connected parties are delivered from connected transactions in the normal operation of the Company. Apart from these, We have not found any breach by the Company of the requirements stated in "Notice of Standard Current Funds between Listed Companies and Connected Parties and External Guarantees of Listed Companies".

**Independent Directors' Special Statement and Independent Opinion on the External Guarantees of the Company**

In accordance with the regulation stated in "Notice of Regulating the Finance Dealing with Connected Parties and the External Guarantees of Listed Companies", Zheng Jian Zi [2003] No. 56 (the "Notice") issued by the China Securities Regulatory Commission, we, the independent directors of the Company, have thoroughly reviewed and checked the external guarantees and its decision procedure of the Company and found that, the decision procedure of the Company is in accordance with the regulations of relevant law, regulations and rules and *Articles of Association* of the Company, and has not provided any guarantee for the controlling shareholder, other connected parties with less than 50% shares controlled by the Company, any unincorporated unit or individuals up to December 31, 2006.

### Resolutions for significant assets loss resulted from external guarantees

During the period under review, the Company had not provided any external guarantees, and there were not any matters resulted from external guarantees.

### Auditors

The financial statements for the year ended December 31, 2006 prepared under PRC Accounting Rules and Regulations and the HKFRS have been audited by Ascenda Certified Public Accountants, Limited (Beijing) and PricewaterhouseCoopers, Certified Public Accountants, respectively. They shall respectively retired and, being eligible, offer themselves for re-appointment.

### Public float of the H-shares

Based on the information that is publicly available to the Company as at the latest practicable date for preparation of this annual report and within the knowledge of the Directors, there was a sufficient public float of the Company's H-shares as required under the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited.

### Acknowledgment

The Board of Directors would like to extend its sincere gratitude to its customers for their trust in the Company, and to the shareholders for their valuable support to the Company, and to the staff for their efforts and dedication to the Company's development.

On behalf of the Board of Directors
*Chairman*
**Li Zhushi**

Guangzhou, March 29, 2007