# AIR CHINA LIMITED
# 中國國際航空股份有限公司


## We serve with passion and we grow through innovation

Annual Report 2005

stock code : 753 Hong Kong
AIRC London

Air China Limited is the national flag carrier and a leading provider of air passenger, air cargo and airline related services in China.

Air China Limited is primarily based in Beijing, China, one of the most important hubs for air transportation in China. Taking advantage of its balanced network of extensive and complementary domestic and international routes serving 70 domestic and 36 international destinations, Air China Limited aims to become the best partner of all passengers in providing safe, convenient, comfortable and customised services.

Air China Limited has set its mission statement as: to be the favored airline for mainstream passengers; to be the most valuable and profitable airline in China and to be an airline with international competitiveness.

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# Corporate Information

## Registered Chinese Name
中國國際航空股份有限公司

## English Name
Air China Limited

## Registered Office
9/F, Blue Sky Mansion
28 Tianzhu Road
Zone A, Tianzhu Airport Industrial Zone
Shunyi District
Beijing, China

## Principal Place of Business in Hong Kong
5th Floor, CNAC House
12 Tung Fai Road
Hong Kong International Airport
Hong Kong

## Website Address
www.airchina.com.cn

## Directors
Li Jiaxiang
Kong Dong
Wang Shixiang
Yao Weiting
Ma Xulun
Cai Jianjiang
Fan Cheng
Hu Hung Lick, Henry
Wu Zhipan
Zhang Ke

## Supervisors
Zhang Xianlin
Liao Wei
Zhang Huilan
Liu Feng
Liu Guo Qing

## Legal Representative of the Company
Li Jiaxiang

## Joint Company Secretaries
Zheng Baoan
Li Man Kit *(ACIS, ACS)*

## Qualified Accountant
David Tze-kin Ng *(CPA)*

## Authorised Representatives
Cai Jianjiang
Li Man Kit

## Legal Adviser to the Company
Haiwen & Partners (as to PRC Law)
Freshfields Bruckhaus Deringer
(as to Hong Kong and English Law)

## Independent Auditors
Ernst & Young

## H Share Registrar and Transfer Office
Computershare Hong Kong Investor Services Limited
Rooms 1712-1716
17th Floor Hopewell Centre
183 Queen's Road East
Wanchai
Hong Kong

## Listing Venues of our H Shares
Hong Kong and London

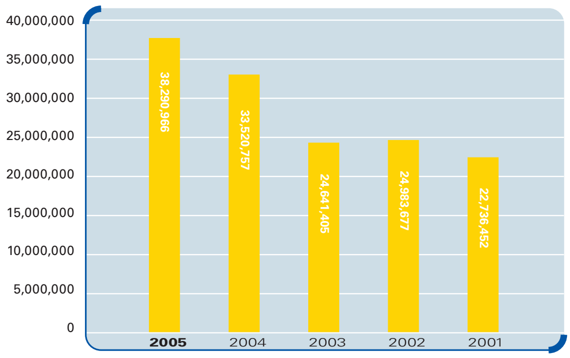
# Summary of Financial Information

*(RMB'000)*

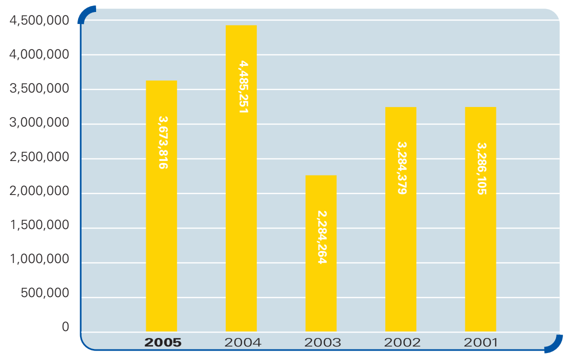
| | **2005** | 2004 | 2003 | 2002 | 2001 |
|---|---|---|---|---|---|
| Operating Revenue | **38,290,966** | 33,520,757 | 24,641,405 | 24,983,677 | 22,736,452 |
| Profit from operations | **3,673,816** | 4,485,251 | 2,284,264 | 3,284,379 | 3,286,105 |
| Profit before tax | **3,374,254** | 3,559,559 | 178,279 | 1,039,826 | 1,609,722 |
| Net profit after tax (including net profit attributable to minority shareholders) | **2,470,380** | 2,548,695 | 88,498 | 670,753 | 1,057,062 |
| Net profit/(loss) attributable to minority shareholders | **64,124** | 162,731 | (71,106) | 171,143 | 108,774 |
| Net profit attributable to equity holders of the parent | **2,406,256** | 2,385,964 | 159,604 | 499,610 | 948,288 |
| EBITDA[1] | **8,186,496** | 7,948,503 | 5,661,736 | 6,535,950 | 6,528,723 |
| EBITDAR[2] | **9,928,427** | 9,207,230 | 6,753,854 | 7,391,360 | 7,225,208 |
| Earnings per share (RMB) | **0.255** | 0.360 | N/A | N/A | N/A |
| Return on owners' equity (%) | **11.98** | 14.42 | 2.32 | 9.95 | 22.31 |

(1) EBITDA represents earnings before finance revenue and finance costs (including interest expense, interest income, exchange gains/losses, gains/losses on fuel derivatives and dividend income on long-term investments), income taxes, share of profits less losses of associates, dilution gains on investments and depreciation as computed under the International Financial Reporting Standards.

(2) EBITDAR represents EBITDA less operating lease expenses on aircraft and engines as well as other operating lease expenses.



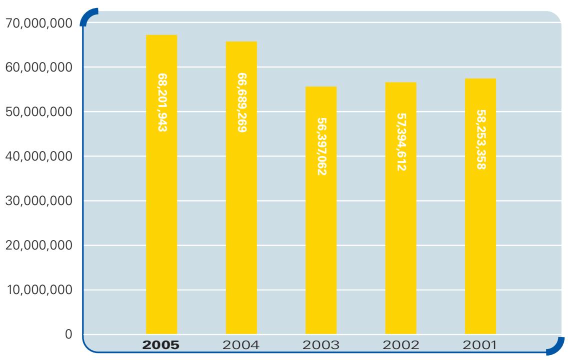

Operating Revenue



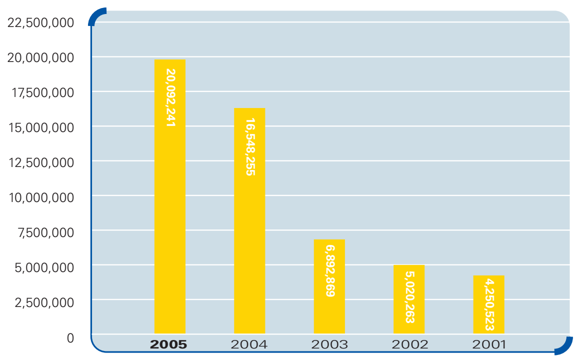

Profit from opoerations

*(RMB'000)*

| | **31 December 2005** | 31 December 2004 | 31 December 2003 | 31 December 2002 | 31 December 2001 |
|---|---|---|---|---|---|
| Total assets | **68,201,943** | 66,689,269 | 56,397,062 | 57,394,612 | 58,253,358 |
| Total liabilities | **46,651,337** | 48,660,727 | 48,081,813 | 50,866,224 | 52,685,546 |
| Minority interests | **1,458,365** | 1,480,287 | 1,422,380 | 1,508,125 | 1,317,289 |
| Owners' equity (excluding minority interests) | **20,092,241** | 16,548,255 | 6,892,869 | 5,020,263 | 4,250,523 |
| Owner's equity per share (RMB) | **2.13** | 1.83 | – | – | – |




Total assets




Owners' equity

# Summary of Operating Data

Including entire Air China Cargo Co., Ltd. ("Air China Cargo") but excluding Air Macau Company Limited ("Air Macau")

| | **2005** | 2004 | Change (%) |
|---|---|---|---|
| **Traffic** | | | |
| **RPK (in millions)** | **52,404.8** | 46,644.5 | 12.3 |
| International | **21,773.7** | 19,627.9 | 10.9 |
| Domestic | **28,884.1** | 25,487.2 | 13.3 |
| Hong Kong and Macau | **1,747.0** | 1,529.5 | 14.2 |
| **RFTK (in millions)** | **2,759.6** | 2,581.7 | 6.9 |
| International | **2,062.8** | 1,976.4 | 4.4 |
| Domestic | **636.6** | 544.1 | 17.0 |
| Hong Kong and Macau | **60.2** | 61.2 | (1.6) |
| **Passengers carried (in thousands)** | **27,694.7** | 24,500.0 | 13.0 |
| International | **4,651.0** | 4,219.0 | 10.2 |
| Domestic | **22,162.1** | 19,521.7 | 13.5 |
| Hong Kong and Macau | **881.7** | 759.2 | 16.1 |
| **Cargo and mail (tonnes)** | **732,995.1** | 665,252.7 | 10.2 |
| **Kilometres flown (in millions)** | **388.2** | 338.7 | 14.6 |
| **Block hours (in thousands)** | **597.5** | 510.2 | 17.1 |
| **Number of flights** | **217,863** | 183,693 | 18.6 |
| International | **31,031** | 28,366 | 9.4 |
| Domestic | **178,414** | 148,751 | 19.9 |
| Hong Kong and Macau | **8,418** | 6,576 | 28.0 |
| **RTK (in millions)** | **7,440.0** | 6,751.4 | 10.2 |
| **Capacity** | | | |
| **ASK (in millions)** | **70,661.5** | 64,894.0 | 8.9 |
| International | **29,582.1** | 27,896.8 | 6.0 |
| Domestic | **38,385.7** | 34,626.6 | 10.9 |
| Hong Kong and Macau | **2,693.6** | 2,370.6 | 13.6 |
| **AFTK (in millions)** | **5,062.6** | 4,843.0 | 4.5 |
| International | **3,590.9** | 3,481.7 | 3.1 |
| Domestic | **1,347.9** | 1,253.2 | 7.6 |
| Hong Kong and Macau | **123.7** | 108.1 | 14.4 |
| **ATK (in millions)** | **11,422.1** | 10,683.5 | 6.9 |
| **Load factor** | | | |
| **Passenger load factor (RPK/ASK)** | **74.2%** | 71.9% | 2.3 ppt |
| International | **73.6%** | 70.4% | 3.2 ppt |
| Domestic | **75.2%** | 73.6% | 1.6 ppt |
| Hong Kong and Macau | **64.9%** | 64.5% | 0.4 ppt |
| **Cargo and mail load factor (RFTK/AFTK)** | **54.5%** | 53.3% | 1.2 ppt |
| International | **57.4%** | 56.8% | 0.6 ppt |
| Domestic | **47.2%** | 43.4% | 3.8 ppt |
| Hong Kong and Macau | **48.7%** | 56.6% | (7.9) ppt |

# Summary of Operating Data

Including entire Air China Cargo but excluding Air Macau

| | 2005 | 2004 | Change (%) |
|---|---|---|---|
| **Yield** | | | |
| **Yield per RPK (RMB)** | **0.57** | 0.56 | **1.8** |
| International | **0.54** | 0.51 | **5.9** |
| Domestic | **0.59** | 0.60 | **(1.7)** |
| Hong Kong and Macau | **0.66** | 0.67 | **(1.5)** |
| **Yield per RFTK (RMB)** | **2.03** | 1.99 | **2.0** |
| International | **2.16** | 2.10 | **2.9** |
| Domestic | **1.40** | 1.39 | **0.7** |
| Hong Kong and Macau | **4.27** | 3.62 | **18.0** |
| **Fleet** | | | |
| Total aircraft in service at period end | **176** | 151 | 16.6 |
| Daily utilization (block hours per day per aircraft) | **10.4** | 10.2 | 2.0 |
| **Unit cost** | | | |
| Operating expenses per ASK (RMB) | **0.45** | 0.42 | **7.1** |
| Operating expenses per ATK (RMB) | **2.78** | 2.54 | **9.4** |

# Chairman's Statement

During 2005, along with the rapid growth in demand in the PRC's aviation industry, the operations of Air China Limited (the "Company"), its subsidiaries and joint ventures (collectively the "Group") maintained good momentum throughout the year and the Group achieved continued, steady and well-balanced development. In 2005, the Company and Air China Cargo recorded revenue tonne kilometres of 7.44 billion and carried 27.69 million passengers and cargos and mails of 733,000 tonnes, representing increases of 10.2%, 13.0% and 10.2% from 2004 respectively. The Group's total revenue amounted to RMB38.3 billion in 2005, representing an increase of 14.2% compared with last year. Operating profit was RMB3,674 million, representing a decrease of 18.1% from 2004, mainly due to the significant increase in the cost of jet fuel arising from the soaring international oil prices.

**Li Jiaxiang**
*Chairman*

The continual increase in international oil prices presented severe challenges to the aviation and transportation enterprises. In 2005, the cost of jet fuel as a percentage of operating expenses of the Group rose from 28.8% in 2004 to 34.0%, representing an increase of RMB3.423 billion compared with 2004. The Group implemented various measures to mitigate the impact of rising jet fuel prices, such as the enhancement of operation control, promotion of computerised planning system, flight route optimisation, redespatch, purchase of advanced aircraft with lower fuel consumption, and jet fuel hedging transactions. As a result of our measures to reduce costs and increase efficiency, the Group substantially mitigated the impact of rising jet fuel price. In addition, the collection of jet fuel surcharge also relieved pressure on operating costs to a certain extent. The Group's net profit attributable to equity holders for 2005 was RMB2,406 million, representing an increase of 0.9% from last year, which was principally attributable to factors such as the appreciation of Renminbi. The Group continued to maintain its leading position among fellow PRC airlines in terms of profitability.

In 2005, we introduced a new flight route between Hangzhou and Hong Kong and resumed the Lhaza – Chengdu – Hong Kong route. The Group also introduced or resumed 20 domestic routes, such as the Beijing – Ningbo route, bringing the Company's total number of routes to 316 with destinations spanning across 22 countries (regions) and 106 cities.

In 2005, 25 new aircraft were added to the Company and Air China Cargo's fleet, increasing the number of aircraft to 176. During the year, the Company also entered into purchase contracts for 35 aircraft and lease agreements for 17 aircraft. The scale of the Company's fleet will be expanded further to meet the needs for additional routes and increased flight frequency. The expanded fleet capacity will directly contribute to its service capacity for the 2008 Olympic Games.

As at 16 September 2005, the Company successfully issued corporate bonds of RMB3 billion in aggregate. The bonds received overwhelming subscription from investors upon issue and were completely taken up on the first date with more than 10-time oversubscription. Prior to the this, on 25 May 2005, the Company has successfully issued short-term commercial papers in the amount of RMB2 billion. As such, the Company became a listed issuer of stocks, corporate bonds and short-term commercial papers.

We are committed to providing passengers with safe, convenient, comfortable and customised flight services. With our special service enhancement programme, our service quality continued to improve and the Company won the Excellent Award for Travellers' Satisfaction in a 2005 travellers' satisfaction survey. During 2005, the Company recorded 599,000 hours of safe flight hours, 243,000 landings and take-offs with flight incident rate of as low as 0.134 per 10,000 flight hours. As a result, the Group was honoured the "2005 Golden Roc Cup" by CAAC.

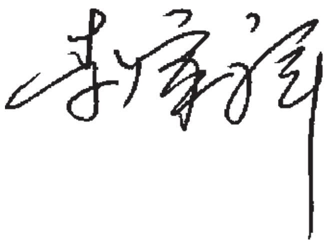
# Chairman's Statement

The Company is the only national flag carrier in the PRC, providing private and chartered plane services to national leaders, cultural and sports representatives as well as diplomatic delegations etc. As such, the Company enjoys extensive brand awareness and good reputation among consumers. During 2005, the Company ranked the 35th among "Top 500 Most Valuable Brands of 2005 in China" sponsored by World Brand Laboratory. The Company topped the list among PRC airlines and was the only transportation services provider among the 29 mainland companies with international influence. In a survey of the PRC's top ten world brands conducted by *Financial Times* of the U.K. and McKinsey & Company, the Company ranked the eighth and the second respectively in terms of overall ranking and best brand awareness. Capitalising on its unique position as the sole passenger aviation partner for the 2008 Olympic Games, the Group is aggressively boosting its brand awareness and presence to enlarge its brand effect and influence among passengers.

2006 will be a year full of opportunities and challenges. The Company will continue to face the severe challenge of oil price hike in the international market. Besides, with the rapid growth in the PRC's aviation industry, the continued deregulation in civil aviation industry to allow investments by different entities, and the shortage in resources such as air route rights, time slots and key technicians, the Company is expected to face more intense market competition. The Company will continue to overcome these unfavourable factors, through taking full advantage of the golden opportunities arising from the 2008 Beijing Olympic Games, maintaining our strategy of building hubs and networks through strategic alliance, optimising of resources allocation and actively developing external cooperation such as code sharing arrangement and aviation alliance. Moreover, the Company will continue to promote organisational transformation, expand its service network and streamline its operation flow. The Company plans to establish an objective appraisal and performance management system to enhance its overall management standard; further improve corporate governance, strengthen the function of special committees; continue to strengthen decision-making function and improve enforceability of decisions, pay attention to risk control and the construction of internal control system, aiming to position itself as a highly recognised and most valuable and profitable airline in the PRC with international competitive strength.



Passenger recognition is the best reward for our efforts. I am pleased to see the growing number of passengers that have chosen our service and placed their trust in us. Over the past year, the members of the Board and the management discharged their duties diligently and faithfully for furtherance of the Company's growth. Our staff also contributed their professionalism and skills. I am very pleased with the performance of the Company in 2005. Finally, on behalf of the Board, I would like to express my heart-felt gratitude to the shareholders for their trust and support.



**Li Jiaxiang**
*Chairman*

Beijing, PRC
18 April 2006

# Business Overview


## Business Review of the Company and Air China Cargo

Passenger services: In 2005, the Company's passenger traffic reached 52,405 million RPKs, representing an increase of 12.3% from 2004. Passenger traffic from international routes, domestic routes and Hong Kong and Macau routes increased by 10.9%, 13.3% and 14.2% respectively. The higher growth in domestic and Hong Kong and Macau routes compared with international routes reflected the robust growth potential of the domestic and Hong Kong and Macau aviation markets. For 2005, the number of passengers carried increased by 13.0% from 2004 to 27.69 million, available seat kilometres of the Company increased by 8.9% from 2004 to 70,662 million kilometres, while passenger load factor increased by 2.3 percentage points from 2004 to 74.2% and income per RPK increased by 1.8% from 2004 to RMB0.57.

Cargo services: During 2005, turnover volume of cargo and mail of the Company increased by 6.9% from 2004 to 2,760 million RFTKs. Cargo and mail carried increased by 10.2% from 2004 to 733,000 tonnes. On 18 December 2005, the first B747-400 cargo aircraft acquired by Air China Cargo, a 51% owned joint venture of the Company, was delivered to Beijing International Airport, which enabled Air China Cargo to catch up with the growth of the industry in terms of transport capacity. Subsequent to that, three more B747-400 cargo aircraft and three TU204 cargo aircraft will join the fleet of Air China in succession. For 2005, available freight tonne-kilometres of the Company increased by 4.5% to 5,063 million, while cargo and mail load factor increased by 1.2 percentage points from 2004 to 54.5%, and cargo yield per RFTK increased by 2.0% to RMB2.03.

## Business Review of Air Macau

The Company holds 51% of the capital share of Air Macau through China National Aviation Corporation (Macau) Company Limited, a wholly-owned subsidiary of China National Aviation Company Limited. Air Macau was established in Macau in 1994 and is a domestic airline in Macau. It commenced operation in November 1995 under a franchise agreement entered into with the Macau government, pursuant to which Air Macau enjoys an exclusive franchise for a term of 25 years until 2020. Key operating data of Air Macau in 2005 are set out as follows:

| | **2005** | 2004 | Change (%) |
|---|---|---|---|
| **Traffic** | | | |
| **RPK (in millions)** | **2,449.8** | 2,145.6 | 14.2 |
| **RFTK (in millions)** | | | |
| – passenger aircraft | **22.5** | 23.2 | (3.0) |
| – cargo aircraft | **147.5** | 84.4 | 74.8 |
| **Passengers carried (in thousands)** | **2,059.6** | 1,808.0 | 13.9 |
| **Cargo carried (in tonnes)** | | | |
| – passenger aircraft | **19,251** | 19,601 | (1.8) |
| – cargo aircraft | **132,662** | 83,683 | 58.5 |
| **Capacity** | | | |
| **ASK (in millions)** | **3,425.4** | 3,068.2 | 11.6 |
| **ATK (in millions)** | | | |
| – passenger aircraft | **392.44** | 349.20 | 12.4 |
| – cargo aircraft | **206.92** | 117.14 | 76.6 |

# Business Overview

| | 2005 | 2004 | Change (%) |
|---|---|---|---|
| **Load Factor** | | | |
| **Passenger load factor (RPK/ASK)** | **72** | 70 | 2 |
| **Cargo load factor (RFTK/AFTK)** | | | |
| – passenger aircraft | **45.1** | 54.8 | (9.7) ppt |
| – cargo aircraft | **71.3** | 72.1 | (0.8) ppt |
| **Yield** | | | |
| **Yield per RPK (avos)** | **65** | 65 | – |
| **Yield per RFTK (MOP)** | | | |
| – passenger aircraft | **5.05** | 4.97 | 1.61 |
| – cargo aircraft | **4.85** | 4.88 | (0.61) |

## Business Review of Associated Airlines

### Shandong Airlines Company Limited ("Shandong Airlines")

The Company holds 22.8% of the capital share of Shandong Airlines. Shandong Aviation Group, which is owned as to 48.0% by the Company, also holds 42.0% of the shares of Shandong Airlines. During 2005, total traffic turnover of Shandong Airlines increased by 28.9% from 2004 to 439 million tonne kilometres, while passengers carried increased by 33.8% from 2004 to 4.01 million person-time.



### Shenzhen Airlines Company Limited ("Shenzhen Airlines")

The Company holds 25% of the capital share of Shenzhen Airlines. During 2005, total traffic turnover of Shenzhen Airlines increased by 23.4% from 2004 to 840 million tonne kilometers, while passengers carried increased by 18.5% from 2004 to 5.73 million person-time.

## Hub Building

During 2005, through expanding transport capacity, securing time slots and improving flight connection, the Company continued to strengthen hub building in Beijing, Chengdu and Shanghai and, in particular, reinforced its control over the Beijing hub.

Beijing is one of the most important international gateways and domestic transit hubs in China. The Company has the most extensive route network with Beijing as its base. In 2005, passenger throughput of the Company at the Beijing base was 16.57 million, representing a market share of 44.4%, while cargo and mail throughput was 475,500 tonnes, representing a market share of 50.2%. During the reporting period, the Company increased the number of aircraft serving the Beijing hub to 104, which was 12 aircraft more compared with 2004. The time slots in the Beijing Capital International Airport were also increased to 2,750 time slots per week. As for flight connection, the Company reinforced its advantage in transit connection of international and domestic networks, increasing the total number of connecting flights available per week by 23% to 36,400. Average number of connecting flights increased from 14.3 in 2004 to 16.5.

Compared with other domestic airlines, the Company has the most extensive route network in southwestern China with particular strengths in main routes within the region, such as Chengdu-Lhasa and Chengdu-Jiuzhai routes. In 2005, the Company reinforced transit connection function of Chengdu as regional hub, and preliminarily actualised two-way connection arrangement between western China and South East Asia. As a result, passenger traffic through connecting flights increased significantly. Chengdu has become an important hub for flights connecting Jiuzhai, Lhasa and domestic and international routes. Network coverage of the Chengdu hub in the western regional market has been gradually increasing.

# Business Overview

The Company has a long history of operation in Shanghai, and is currently providing domestic and international passenger and cargo services at both Shanghai Hongqiao Airport and Shaghai Pudong International Airport. As Shanghai is growing into an important hub in the global aviation network, the Company accelerated the development of its operation in the Shanghai international gateway and expanded the transport capacity of routes originally departing from Shanghai. In 2005, the Company established four new routes from Shanghai to Guangzhou, Kunming, Xiamen and Wuhan respectively. During the year, the Company's transport capacity in Shanghai increased by 5 aircraft from 2004 to 28 aircraft in 2005.



## Route Network

As a major part of hub building, the Company continued to improve and optimize its route network structure. As for passenger services, the Company increased flight frequency and made appropriate adjustments on the transport capacity of routes with substantial seasonal fluctuation. Top 20 domestic routes with the highest revenues from passenger services received a boost in transport capacity and such growth accounted for 46.5% of the total growth in transport capacity in the PRC. On the international front, emphasis was placed on routes to and from Europe, America and Korea with 1,283 more flights schedules, resulting in marked improvement in the overall efficiency of these routes. As for cargo services, regular flights serving the Chengdu-Beijing-Frankfurt route was formally launched on 18 December 2005. Being the first regular international cargo route at Chengdu, this route not only strengthened the position of the Company in western China, but also contributed substantially to the economic development in the region.

Leveraging on its hub network strengths, the Company further expanded its transit business. In 2005, the Company launched quasi-international flights(虛擬國際航班) from eight cities, including Chengdu, to Beijing. In addition, it also rolled out one-off transit services for flights from 8 terminals, including Guangzhou terminal, or Hong Kong to domestic destinations with transit at Beijing. The Company also entered into cooperation with Air Canada and launched one-off boarding services in the PRC and Canada. In 2005, the Company's transit and connecting flights served 718,000 passengers, fully reflecting the value of its hub network.

## Fleet Maintenance

The fleet of the Company and Air China Cargo continued to expand. During the year, there was a net increase of 25 aircraft in the fleet. As at 31 December 2005, we and Air China Cargo operated a fleet of 176 aircraft with an average age of 8.1 years (2004: 8.1 years). Details of the fleet are set out in the table below:

# Business Overview

| Aircraft Model | No. of Aircraft | | | |
|---|---|---|---|---|
| | Self-owned | Finance Lease | Operating Lease | Subtotal |
| **Passenger Aircraft** | | | | |
| Airbus | 22 | 8 | 7 | 37 |
| Boeing | 64 | 38 | 26 | 128 |
| CRJ-200 | – | – | 3 | 3 |
| **Cargo Aircraft** | **5** | **–** | **1** | **6** |
| **Business Jet** | **–** | **–** | **2** | **2** |
| **Total** | **91** | **46** | **39** | **176** |

As at 31 December 2005, Air Macau operated a fleet of 18 aircraft (2004: 15 aircraft), of which 13 were passenger aircraft and 5 were cargo aircraft.

To improve our service quality to high-end customers and expand the Company's market share in long haul business travel segment that offers higher yield, the Company embarked on improving first class and business class cabins of certain passenger aircraft, which were mainly used in for long haul routes, including flights to Frankfurt and New York. As at 31 December 2005, renovation work was completed for 5 aircraft, including 4 B747-400 aircraft and 1 A340-300 aircraft.

On 26 January 2005, the Company and Air China Group Import and Export Trading Co. entered into a A330-200 aircraft purchase agreement with Airbus S.A.S., pursuant to which the Company agreed to purchase 20 A330-200 aircraft from Airbus S.A.S., mainly for serving routes to international destinations in Europe, Australia and North America as well as certain major domestic routes to destinations such as Lhasa.



On 28 January 2005, the Company, other PRC airlines, China Aviation Supplies Import and Export Group Corporation and Boeing Company entered into a framework agreement regarding the acquisition of Boeing 787 aircraft. On 8 August 2005, the Company and Boeing Company entered into a formal agreement for the purchase of 15 Boeing 787 aircraft.

On 22 April 2005, the Company entered into an agreement with ILFC for the lease of 2 B737-800 aircraft from ILFC. On 19 May, the Company entered into an agreement with Sunrock for the lease of 5 B737-800 aircraft from Sunrock. On 2 June, the Company entered into an agreement with GECAS for the lease of 5 B737-800 from GECAS. The Company leased a total of 12 Boeing 737-800 aircraft from these companies.

On 27 March 2005, the Company and Shandong Airlines entered into an agreement whereby the Company wet leased 3 CRJ-200 aircraft from Shandong Airlines.

On 8 August 2005, the Company and Hong Kong Dragon Airlines Limited ("Dragonair") entered into an agreement whereby the Company wet leased 1 A330 and 1 A320 aircraft from Dragonair.

The above aircraft purchases and leases will further enhance the passenger transportation capacity of the Company's fleet and in turn provide more comfortable service to passengers.

# Business Overview

## Market Expansion

By strengthening connecting flight management, the Company provided effective support to the hubs and gateway with operations in the secondary markets. Sales efforts of the first and business classes were substantially reinforced, while international flights with one-off boarding service were rolled out at a faster pace. The Company also enriched its connecting flight service categories. Leveraging on its centralised control structure, the Company optimised the number of subclasses with the aim of maximizing the revenue of its routes.



For 2005, income from connecting flights increased by 16.1% from 2004 to RMB8,830 million. The number of direct sales customers reached 2,105 while frequent flyers membership expanded by 960,000 members to 3.01 million members. The Company sold 4.20 million electronic tickets with an aggregate value of RMB3,540 million, representing an increase of 51% from 2004 and accounting for nearly 20% in the total sales of electronic tickets in the PRC.

A network marketing strategy was adopted for cargo services. The Company established regional sales centres in overseas markets and consolidated regional sales resources in the domestic market with a focus on developing the sales network in hub regions, thereby consolidating its sales resources and the relevant transport capacity. Air China Cargo improved the load factor and yield rate of return flights by reducing the proportion of block cargo space, and promoting sales of round trip tickets and connecting flight tickets. The Company also improved domestic sales by carrying out direct sales and the "Mail Revival Scheme"（郵件復興計劃）.

## Business Cooperation for Mutual Benefits

The Company actively promoted bilateral cooperation. In 2005, it entered into codeshare agreements with Cathay Pacific Airways Limited ("Cathay Pacific"), Kuwait Airways Corporation, Qatar Airways and Varig Brasil Airlines of Italy, enlarging its codeshare partnership to 19 airlines. In addition, the Company also entered into 108 special prorate arrangements (SPA) with 84 airlines.

As at the end of 2005, the Company entered into codeshare arrangements for a number of international and Hong Kong and Macau passenger flight routes with 16 airlines, including United Airlines, Cathay Pacific and All Nippon Airways. For domestic routes, the Company entered into codeshare arrangements with three airlines, namely China Southern Airlines Company Limited, Shanghai Airlines Company Limited and Shandong Airlines, on a number of domestic routes.

For cargo services, Air China Cargo, a 51% owned joint venture of the Company, entered into codeshare arrangements with 6 airlines, including Lufthansa German Airlines (jointly operating route with the Company) and Nippon Cargo Airlines.

# Business Overview

## Post Balance Sheet Events

On 17 January 2006, the Company and Air China Group Import and Export Trading Co. entered into an aircraft purchase agreement with Boeing Company for the purchase of 10 B737-800 aircraft from Boeing Company.

On 28 March 2006, when the first extraordinary general meeting and class meeting of the Company in 2006 were held, a resolution in relation to the public offering of up to 27,000,000,000 Renminbi denominated ordinary shares (i.e. A Shares) by the Company in the PRC was approved.

On 24 January 2006, CNAC, a subsidiary of the Company, entered into an agreement with Shun Tak Air Transport Limited and its subsidiaries ("Macau Asia Express Agreement") in respect of the establishment of a joint venture in Macau named Macau Asia Express Limited ("Macau Asia Express"), which would primarily engage in the provision of low-cost air transportation services in Macau. Taking into account indirectly held interests, CNAC holds 43.7% equity interests in Macau Asia Express.

# Management's Discussion and Analysis of Financial Position and Operating Results


Financial statements of the Group set out from pages 55 to 135 of the annual report for the year, comprising the consolidated income statement, consolidated balance sheet, consolidated statement of changes in equity, consolidated cash flow statement, balance sheet and notes to financial statements, were prepared in accordance with International Financial Reporting Standards ("IFRS"). The following discussion and analysis are designed to assist the reader in understanding the information provided in this annual report so as to fully comprehend the financial position of the Group as a whole.

## Profit From Operations and Net Profit Attributable to Equity Holders

In 2005, the Group's profit from operations was RMB3,674 million, representing a decrease of 18.1% compared with 2004. Net profit attributable to equity holders amounted to RMB2,406 million, representing a decrease of 0.9% compared with 2004. The decrease in profit from operations was mainly due to the rising jet fuel price.

The consolidated financial statements include the operating results of all subsidiaries of the Group. During the reporting period, share of profits from associates was RMB225 million, representing a decrease of 51.5% from the corresponding period last year, primarily due to the decrease in profits from three associates, namely Dragonair, Shenzhen Airlines and Shandong Airlines.

### Profit Contribution by Business Segments

| *(RMB'000)* | **2005** | 2004 | Change (%) |
|---|---|---|---|
| Airline operations | **3,367,949** | 4,146,402 | (18.8) |
| Engineering services | **153,779** | 93,269 | 64.9 |
| Airport terminal services | **123,679** | 203,133 | (39.1) |
| Others | **28,409** | 42,447 | (33.1) |
| Profit from operations | **3,673,816** | 4,485,251 | (18.1) |

## Earnings Per Share

In 2005, the Group's earnings per share was RMB25.5 cents, a decrease of 29.2% compared with RMB0.36 for 2004. This was mainly due to the initial public offering of 2,550,618,182 shares upon the Company's listing in late 2004 and the issue of 382,592,727 shares pursuant to the over-allotment option in the beginning of 2005, which increased the weighted average number of shares compared with last year. Details of earnings per share are set out in note 14 to the financial statements.

# Management's Discussion and Analysis of Financial Position and Operating Results

## Operating Revenue

In 2005, the Group's operating revenue was RMB38,291 million, representing an increase of 14.2% compared with last year. Increase in the Group's operating revenue was mainly attributable to the rapid growth of air traffic revenue, which increased by 14.5% in 2005. In 2005, the daily utilization of aircraft averaged at 10.4 hours, increased 0.2 hours as compared with 2004.



### Revenue Contribution by Business Segments

| *(RMB'000)* | **2005** | 2004 | Change (%) |
|---|---|---|---|
| Airline operations | **37,380,669** | 32,766,164 | 14.1 |
| Engineering services | **376,437** | 296,775 | 26.8 |
| Airport terminal services | **320,477** | 287,905 | 11.3 |
| Others | **213,383** | 169,913 | 25.6 |
| Total operating revenue | **38,290,966** | 33,520,757 | 14.2 |

The Group's operating revenues principally included air traffic and other operating revenue. Most of our operating revenue was from air traffic revenue, which represented 92.2% of the Group's total revenue in 2005, while the other operating revenue represented only 7.8% of the total operating revenue. Among air traffic revenues in 2005, 89.5% was generated from passenger services and 10.5% was from cargo and mail transport.

The passenger transport income increased by 14.2% to RMB31.58 billion in 2005 from RMB27.67 billion in 2004. It was mainly attributable to the increase in transport capacity, passenger load factor and profitability level. The Company's transport capacity in terms of available seat kilometres increased by 8.9% to 70.66 billion in 2005 from 64.89 billion million in 2004 . The Company's passenger load factor rose to 74.2% in 2005 as compared with 71.9% in 2004. The Company's passenger yield increased by 1.8% to RMB0.57 in 2005 from RMB0.56 in 2004.

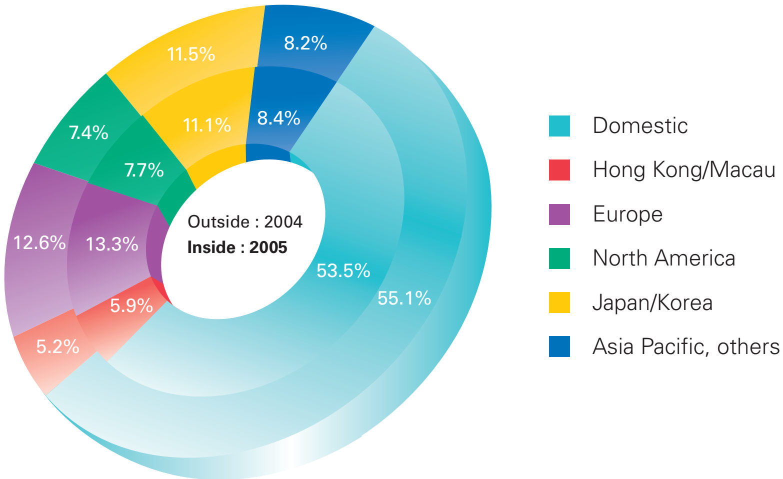
Revenue from cargo and mail increased by 17.2% to RMB3,716 million in 2005 from RMB3,170 million in 2004. Such increase was primarily as a result of the improvements in the traffic capacity, cargo and mail load factor and profitability level. Cargo transport capacity in terms of available freight tonne-kilometres increased by 4.5% to 5,063 million in 2005 from 4,843 million in 2004.

The load factor of cargo transport increased to 54.5% in 2005 from 53.3% in 2004. The overall cargo yield increased by 2% to RMB2.03 for each yield tonne kilometre in 2005 from RMB1.99 for each yield tonne kilometre in 2004.

# Management's Discussion and Analysis of Financial Position and Operating Results

## Revenue Contribution by Geographical Segments

| *(RMB'000)* | **2005** | 2004 | Change (%) |
|---|---|---|---|
| Domestic | **20,490,055** | 18,482,949 | 10.9 |
| Hong Kong/Macau | **2,269,256** | 1,744,590 | 30.1 |
| Europe | **5,081,774** | 4,232,489 | 20.1 |
| North America | **2,964,247** | 2,477,214 | 19.7 |
| Japan/Korea | **4,250,255** | 3,846,973 | 10.5 |
| Asia Pacific, others | **3,235,379** | 2,736,542 | 18.2 |
| Operating revenue | **38,290,966** | 33,520,757 | 14.2 |






## Operating Expenses

The operating expenses of the Group primarily comprise jet fuel costs, take-off, landing and depot charges, depreciation, aircraft maintenance, repair and overhaul expenses, employee compensation costs and air catering charges. In 2005, the Group recorded RMB34.617 billion in operating expenses, representing an increase of 19.2% compared with RMB29.036 billion in 2004, primarily as a result of the rising jet fuel costs.

| *(RMB'000)* | **2005** | 2004 | Change (%) |
|---|---|---|---|
| Jet fuel | **11,777,129** | 8,353,752 | 41.0 |
| Take-off, landing and depot charges | **4,442,585** | 4,230,349 | 5.0 |
| Depreciation | **4,512,680** | 3,463,252 | 30.3 |
| Aircraft maintenance, repair and overhaul | **1,341,773** | 2,835,648 | (52.7) |
| Employee compensation costs | **3,406,825** | 2,921,322 | 16.6 |
| Air catering expenses | **1,242,933** | 1,171,784 | 6.1 |
| Others | **7,893,225** | 6,059,399 | 30.3 |
| Total Operating Expenses | **34,617,150** | 29,035,506 | 19.2 |

Jet fuel costs increased by 41.0% to RMB11.7 billion in 2005 from RMB8,354 million in 2004 and accounted for 34.0% of operating expenses as compared with 28.8% in 2004. This increase was primarily due to jet fuel price rise and the increased consumption of jet fuel as a result of the increased number of flights operated.

# Management's Discussion and Analysis of Financial Position and Operating Results

Take-off, landing and depot charges increased by 5% to RMB4,443 million in 2005 from RMB4,230 million in 2004, primarily due to the increased number of flights operated.

Depreciation expenses increased by 30.3% to RMB4,513 million in 2005 from RMB3,463 million in 2004, primarily due to the accounting changes and fleet expansion. Details on the accounting changes are set out in note 2 to the financial statements.

Aircraft maintenance, repair and overhaul expenses decreased by 52.7% to RMB1,342 million in 2005 from RMB2,836 million in 2004, primarily due to accounting changes. Details on the accounting changes are set out in note 2 to the financial statements.

Employee compensation costs increased by 16.6% to RMB3,407 million in 2005 from RMB2,921 million in 2004, primarily due to the increased flight hours, growth of the number of employee, and increased income of employee.

Air catering charges increased by 6.1% to RMB1,243 million in 2005 from RMB1,172 million in 2004, primarily due to an increase in the number of passengers carried.

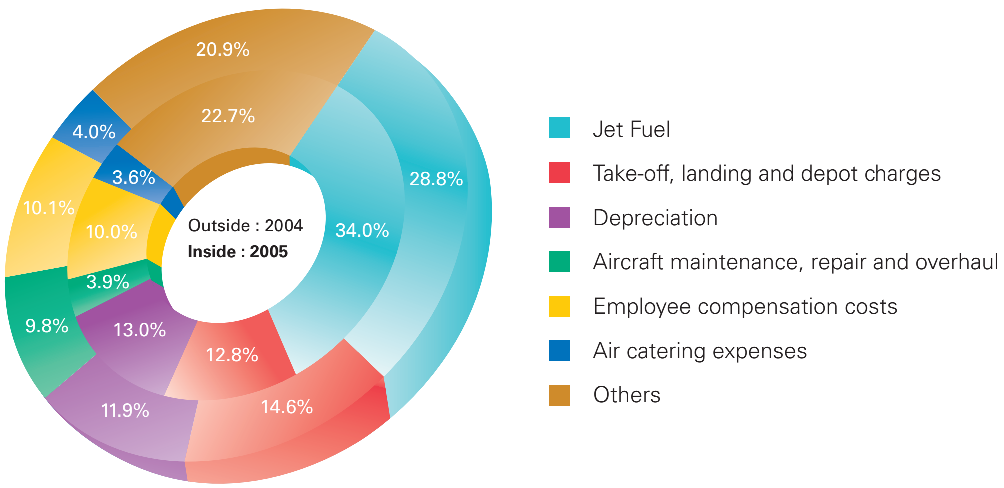
Other operating expenses, including aircraft and engines operating lease expenses, other flight operation expenses, selling and marketing expenses and general and administrative expenses, increased by 30.3% to RMB7,893 million in 2005 from RMB6,059 million in 2004.

Expenses on operating leases of aircrafts and engines increased from RMB1,071 million in 2004 to RMB1,531 million in 2005, mainly due to the increase in operations with leased aircrafts as well as wet lease of aircrafts from Air Macau Company Limited, Hong Kong Dragon Airlines Limited and Shandong Airlines Company Limited.



Other flight operation expenses increased to RMB3,745 million in 2005 from RMB2,698 million in 2004, primarily due to the adjustments in the accounting policies and the increase in CAAC Infrastructure Development Fund as a result of the increased number of routes.

Selling and marketing expenses increased to RMB1,775 million in 2005 from RMB1,387 million in 2004, primarily due to higher related expenses as a result of increased sales income.



# Management's Discussion and Analysis of Financial Position and Operating Results

## Analysis of Assets

As at 31 December 2005, the Group had total assets of RMB68.2 billion, representing an increase of 2.3% from 31 December 2004. Of the total assets, RMB7,540 million of current assets accounted for 11.1%, while RMB60.66 billion of non-current assets accounted for 88.9%. Among the current assets, cash and cash equivalents were RMB2,248 million, decreasing by 76.1% as compared with 31 December 2004, while trade receivables increased by 16.9% as compared with 31 December 2004 to RMB2,764 million. Among the non-current assets, property, plant and equipment were RMB47.191 billion, representing an increase of 8.6% as compared with 31 December 2004.

## Assets Mortgage

As at 31 December 2005, the Group mortgaged certain aircraft with an aggregate carrying value of approximate RMB26.958 billion (compared with RMB28.585 billion as at 31 December 2004) pursuant to certain loan and finance lease agreements. In addition, certain bank deposits of the Group in the sum of approximately RMB177 million (compared with approximately RMB117 million as at 31 December 2004) were pledged against the Group's certain loans and obligations in respect of certain operating leases and financial derivatives.

## Debt Structure of the Group

| | **Bank, other loans and corporate bonds** | | **Obligations under finance leases** | |
|---|---|---|---|---|
| *(In RMB'000)* | **2005/12/31** | 2004/12/31 | **2005/12/31** | 2004/12/31 |
| Within one year | **10,401,170** | 8,806,051 | **1,954,873** | 1,705,146 |
| In the second year | **2,747,158** | 3,063,899 | **1,949,802** | 1,943,630 |
| In the third to fifth years, inclusive | **4,699,654** | 6,215,259 | **6,071,492** | 6,722,448 |
| After five years | **5,376,067** | 3,617,464 | **57,377** | 1,910,163 |
| Total | **23,224,049** | 21,702,673 | **10,033,544** | 12,281,387 |



A significant portion of the Group's debts will fall due within one year. The Group expects to meet its liabilities with bank loans, internal resources and other resources as they fall due. The Group is not exposed to any insolvency risk for the reasons set out in the sections titled "Liquidity and Capital Resources" and "Objective and Policy of Financial Risk Management".

## Gearing Ratio

As at 31 December 2005, the Group's gearing ratio, which represents total liabilities divided by total assets, was 68.4%, which dropped by 5 percentage points from 73.0% as at 31 December 2004.

## Interest Expense

In 2005, interest expense of the Group decreased from RMB1.824 billion in 2004 to RMB1.773 billion, primarily due to the repayment of certain bank loans and decrease in obligations under finance leases.

## Interest Cover

In 2005, earnings before finance revenue and finance costs (including interest expense, interest income, exchange gains/losses, net gains on fuel derivatives and dividend income from available-for-sale investments), enterprise income taxes, share of profits less losses of associates, dilution gains on investments and depreciation ("EBITDA") as computed under IFRS, divided by interest expense, were 4.62 times, compared with 4.36 times in 2004. The increase in interest cover was attributable to the decrease in interest expense and rise in EBITDA.

# Management's Discussion and Analysis of Financial Position and Operating Results

## Capital Commitments and Contingent Liabilities

As at 31 December 2005, capital commitments of the Group increased substantially from RMB11.832 billion as at 31 December 2004 to approximately RMB38.514 billion, primarily due to commitments in the purchase of certain aircraft and relevant flight equipment to be delivered in the coming years, and for the construction of certain properties.

As at 31 December 2005, the Group had contingent liabilities in respect of bank and other guarantees and other matters arising in the ordinary course of business. Details of contingent liabilities of the Group will be set out in note 41 to the financial statements.

## Liquidity and Capital Resources

The Group finances its operations through cash inflow from operating activities and bank loans. Like many other airline groups in the PRC, the Group has been operating with a net current liabilities position. As at 31 December 2005 and 31 December 2004, net current liabilities of the Group were RMB16 billion and RMB9.053 billion respectively. The increase in net current liabilities was primarily due to a decrease in current assets, in particular, a RMB7.165 billion decrease in cash and cash equivalents.

In 2005, the Group's net cash inflow from operating activities decreased by 2% to RMB6.048 billion from RMB6.156 billion in 2004. Net cash outflow from investing activities in the same period increased by 151% to RMB12.500 billion from RMB4.979 billion in 2004, primarily due to an increase in prepayment for purchase of aircraft. The Group recorded a net cash outflow in financing activities of RMB0.766 billion, primarily due to the repayment of bank loans and the distributions to shareholders pursuant to the Group's restructuring in 2004. The major sources of finance of the Group are bank loans. As at 31 December 2005, the Group had obtained bank facilities of up to RMB78.570 billion from a number of banks in the PRC.



As at 16 September 2005, the Company successfully issued corporate bonds of RMB3 billion in aggregate. The bonds received overwhelming subscription from investors upon issue and were completely taken up on the first date with more than 10-time oversubscription. Prior to this, on 25 May 2005, the Company has successfully issued short-term commercial papers in the amount of RMB2 billion.

## Capital Expenditure

For 2005, the capital expenditure of the Company amounted to RMB10.547 billion. Among the capital expenditure of the Company, total investment in aircraft was RMB9.069 billion, including a prepayment of RMB6.183 billion for purchasing aircraft from 2006 onwards.

Other investments in capital expenditure items were RMB1.478 billion, which mainly involved the improvement of first class and business class cabins of certain aircraft, ancillary projects in No. 3 Terminal of Beijing International Airport, as well as certain long-term investment projects.

The Group intended to fund its capital expenditure with internal generated source of funds, bank loans, corporate bonds and the proceeds from the proposed issue of A shares.

## Objective and Policy of Financial Risk Management

The Group is exposed to the fluctuations in jet fuel price during its ordinary operations. International jet fuel prices have been historically, and will in the future continue to be, subject to price volatility and fluctuations in supply and demand. The Group's strategy for managing its jet fuel price risk aims to provide itself with protection against sudden and significant price increases. Subject to the applicable laws of the PRC, the Group started to engage in fuel hedging transactions in March 2001. The subjects of hedging instruments were mainly Singapore jet fuel and Brent crude oil derivatives that are closely linked to jet fuel. In 2005, the Group applied hedging to 12.3% of the procured jet fuel, and the net gain on jet fuel derivatives was RMB222 million, representing an increase of 440% compared with 2004.

# Management's Discussion and Analysis of Financial Position and Operating Results

Foreign liabilities constitute a large proportion of the Group's liabilities. As at 31 December 2005, loans denominated in US dollar and Hong Kong dollar were equivalent to RMB11.352 billion and RMB224 million respectively. Appreciation of the Renminbi will benefit the Company with exchange gains. In 2005, the net exchange gains of the Group was RMB918 million (2004: net exchange losses of RMB55 million). The foreign exchange income and expenses of the Group are generally the same. The Group adopted "natural immunity" method to achieve a matching structure of income and expenses by adjusting the proportion of its liabilities in foreign currencies. The Company will continue to avoid exposure to the risk of exchange rate fluctuation by adopting a strategy that matches the income and payment in certain principal currencies.

Information on financial risk management objectives and polices in other aspects of the Group's operations will be set out in note 44 to the financial statements.

# Corporate Governance Report


The Company has been committed to maintaining and enhancing the level of its corporate governance so as to ensure greater accountability and transparency and bring long-term return to the Shareholders. Except a few deviations set out in the chapter of corporate governance in the interim report of 2005, the Company has complied with the principles and code provisions of the Code on Corporate Governance Practices ("Code") under Appendix 14 of the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited ("Stock Exchange") ("Listing Rules"). Since April 2005, the Company has remedied the deviations to strictly comply with the code provisions under the Code. The Company's corporate governance practices and deviations from the Code are summarised and discussed below.



## Governance Structure

**Board of Directors of Air China Limited**

(comprising 3 executive directors, 4 non-executive directors and 3 independent non-executive directors)

Special committees under the board of directors of Air China Limited

- Audit and risk control committee (comprising 2 independent non-executive directors and 1 non-executive director)
- Nomination and remuneration committee (comprising 2 non-executive directors and 3 independent non-executive directors)
- Strategy and investment committee (comprising 2 non-executive directors and 2 executive directors)

# Corporate Governance Report

## Major Corporate Governance Principles and Practices of the Company

### A. Board of Directors ("Board")

*The power of board is balanced by comprising independent non-executive directors representing at least one-third of the board.*

- The Board of the Company currently comprised ten directors, three of which are independent non-executive directors. The directors of the Company are elected by the general meeting to have a three-year term of office, and eligible for re-election upon expiry of the term.

- Pursuant to the Listing Rules, each of the independent non-executive directors has confirmed his/her independence with the Stock Exchange. Each of the independent non-executive directors re-confirmed his/her independence on 31 December 2005. The Company considered that they were independent.

Deviation: Nil

*The board should have a balance of skills and experience appropriate for the requirements of the business of the issuer.*

- With reference to the nature of the objectives of the Company's specialised operations, the non-executive directors' extensive expertise and experience in the fields of aviation, finance and financial management provide substantial support for the effective performance of the Board.



- The list of the directors and their biographical details and respective roles in the Board and Board committees are set out in the annual report and published on the Company's website.

Deviation: Nil

*Distinguished roles of the chairman and chief executive officer*

- The Chairman, Mr. Li Jiaxiang, a non-executive director, is responsible for leading the Board and ensuring the Board's efficient operation and that all major and relevant issues are discussed by the Board in a prompt and constructive manner.

- The Chairman shall be elected and dismissed by a majority of all directors. The term of office of the Chairman shall be three years, and the Chairman is eligible for re-election upon expiry of the term.

- The Company has a Chief Executive Officer who shall be nominated, appointed or dismissed by the Board.

- The Chief Executive Officer, Mr. Ma Xulun, is authorised to oversee the Group's business operations and implement its strategies to attain overall commercial goals.

Deviation: Nil

*Non-executive directors should be appointed for a specific term, and all directors appointed to fill a casual vacancy should be subject to election by shareholders at the first general meeting after their appointment.*

- The term of office of the existing non-executive directors is three years. Mr. David Muir Turnbull resigned as director of the Company with effect from 13 December 2005. The Company has published an announcement in respect of his resignation.

# Corporate Governance Report

Deviation: Nil

*The board should assume responsibility for leadership and control of the company and be collectively responsible for promoting the success of the company.*

- The Board is accountable to the shareholders' general meeting and determines the investment proposals of the Company and delimits the approval authority regarding disposal of the Company's fixed assets according to the authorisation of the shareholders' general meeting. The Company formulated the *Rules and Procedures for Shareholders' General Meetings*, *Rules and Procedures for Board Meetings* and *Rules and Procedures for Chief Executive Officer Work Meetings*.

- The Chief Executive Officer shall be authorised by the Board to implement various strategies and oversee the day-to-day operations of the Company.

- The Board shall have independent access to the senior management personnel for enquiries in relation to the Company's management.

- The Board shall have specialised committees, the chairmen of which shall report to the Board on a regular basis.

Deviation: Nil

*The board should meet regularly to carry out its duties. The board and its committees shall be provided with adequate information in a timely manner.*



- Board meetings are held regularly throughout the year and shall generally include annual meeting, biannual meetings and meetings for the first and third quarters. Board meetings shall be convened by the Chairman and a 10-day notice shall be served to all directors before each meeting. The meetings may be attended through personal participation or other electronic means of communication.

- The secretary to the Board shall be responsible for the communications and liaison with all directors from the time the notice is served to the commencement of the meeting, and shall provide the necessary information to the directors to facilitate their decision-making concerning matters set out in the agenda.

- For the purpose of considering resolutions or matters during Board meetings, the directors may require presence of the persons in charge of the relevant departments to answer queries, so that the directors can have a thorough understanding of the key issues and the general situation.

- During each Board meeting, the Chief Executive Officer or other relevant departments shall report to the Board in writing in respect of the implementation of resolutions of the previous Board meeting. The Board shall review such implementation at the meeting.

- All directors shall have access to the Board secretary. Under the leadership of the Board and the Chairman, the Board secretary shall take the initiative to acquaint himself or herself with the implementation progress of Board resolutions, and report to and advise the Board in a timely manner on major issues arising in the course of implementation.

- Minutes of Board meetings shall be kept by the Board secretary and available for inspection by any director at anytime.

# Corporate Governance Report

- All directors have actively participated in the business operations of the Company. Attendance of all directors at Board meetings in 2005 is as follows:

**Attendance of individual director at Board meetings in 2005**

| **No. of meetings** | **5** | |
|---|---|---|
| **Non-executive director:** | | |
| Li Jiaxiang *(Chairman)* | 4/5 | 80% |
| Kong Dong | 4/5 | 80% |
| Wang Shixiang | 4/5 | 80% |
| Yao Weiting | 4/5 | 80% |
| **Executive Director:** | | |
| Ma Xulun *(Chief Executive Officer)* | 5/5 | 100% |
| Cai Jianjiang | 5/5 | 100% |
| Fan Cheng | 4/5 | 80% |
| **Independent non-executive director:** | | |
| Hu Hung Lick, Henry | 5/5 | 100% |
| Wu Zhipan | 4/5 | 80% |
| Zhang Ke | 3/5 | 60% |
| **Average attendance rate:** | | **84%** |



Deviation: A 10-day notice is served to all directors before Board meetings are convened. However, the Code requires a notice of at least 14 days before each meeting. The reason for the Board's practice is that service of a 10-day notice to the directors is deemed sufficient under the PRC laws.

Remedy: Article 98 of the articles of association of the Company has been amended so that a notice of at least 14 days must be serviced to all directors before a meeting of the Board, except for extraordinary meeting. The amendment to the articles of association of the Company has been approved by the extraordinary general meeting held on 28 March 2006 and will become effective upon approval by the relevant authorities.

*Each director is required to keep abreast of his responsibilities as a director of the company and of the operating manner, business activities and developments of the company.*

- The management shall provide members of the Board and Board committees with relevant and sufficient information in a timely manner so as to update them with the latest developments of the Company and facilitate their discharge of duties.

- Newly appointed directors shall be given introduction in relation to the Company to ensure that they have a proper understanding of the management, business and governance practices of the Company.

- The Company also encourages its directors to participate in seminars and courses conducted by eligible institutions so as to enable them to boost necessary skills and update them with the latest changes or developments in the laws, Listing Rules and the Code with which they are required to comply in discharging their duties.

Deviation: Nil

*The company should arrange appropriate insurance in respect of legal action against its directors.*

- the Company has purchased liability insurance for its directors.

# Corporate Governance Report

Deviation: Nil

*Compliance with the Model Code for Securities Transactions by Directors of Listed Companies ("Model Code")*

- After making specific enquiries, the Company confirmed that each director and each supervisor have complied with the required standards of the Model Code as set out in Appendix 10 of the Listing Rules throughout 2005.
- The Model Code contained in Appendix 10 of the Listing Rules requires the Board to adopt written guidelines regarding transactions of securities of the issuer by its employees on terms no less exacting than the required standard of the Model Code.
- On 5 September 2005, the Company adopted a code of conduct regarding securities transactions by directors on terms no less exacting than the required standards of the Model Code. The code of conduct of the Company also applies to supervisors and relevant employees.

Deviation: The Company did not adopt any special code of conduct regarding securities transactions by directors, supervisors and relevant employees before 5 September 2005.

Remedy: the Company has adopted the Model Code set out in Appendix 10 of the Listing Rules, and on 5 September 2005 adopted a code of conduct regarding securities transactions by directors, supervisors and relevant employees on terms not less exacting than the required standards of the Model Code.

## B. Remuneration of Directors and Senior Management



*Issuers should establish a remuneration committee with specific written terms of reference. A majority of the members of the remuneration committee should be independent non-executive directors.*

- the Company has established a nomination and remuneration committee to make recommendation to our Board regarding the compensation of other executive directors as well as candidates to fill vacancies on our Board. In addition, the nomination and remuneration committee reviews the performance and determines the compensation structure of the senior management.
- A majority of the members of the nomination and remuneration committee are independent non-executive directors. The current members of the nomination and remuneration committee are Mr. Li Jiaxiang, Mr. Kong Dong, Dr. Hu Hung Lick, Henry, Mr. Zhang Ke and Mr. Wu Zhipan, with Mr. Wu Zhipan acting as the chairman of such committee.
- Attendance at the meetings of the nomination and remuneration committee in 2005 is as follows:

| **Attendance at the meetings of the nomination and remuneration committee in 2005**<br>**No. of meeting** | **1** | |
|---|---|---|
| Wu Zhipan | 1/1 | 100% |
| Hu Hung Lick, Henry | 1/1 | 100% |
| Zhang Ke | 1/1 | 100% |
| Li Jiaxiang | 1/1 | 100% |
| Kong Dong | 1/1 | 100% |
| Average attendance rate: | | **100%** |

# Corporate Governance Report

- The articles of association of the Company provides that a shareholder holding 5% or more of the total shares of the Company is entitled to nominate a director through the nomination and remuneration committee, which will scrutinize the candidates for directorship and senior management according to the standards set out in the articles of association of the Company and report to the Board.

- On a meeting of the nomination and remuneration committee on 25 January 2005, the Board received a recommendation letter from Cathay Pacific Airways Limited nominating Mr. David Muir Turnbull as a non-executive director of the Company. The nomination and remuneration committee confirmed that the nomination conformed to the articles of association of the Company and the strategic placing agreement and, therefore, recommended that the Board nominate Mr. David Muir Turnbull as a non-executive director of the Company for a term up to the expiry of the term of the current session of the Board. It was also proposed that Mr. David Muir Turnbull shall be nominated before the next general meeting for official election. The Board received the resignation of Mr. Fan Cheng as the Board secretary and joint company secretary. It received a recommendation letter from CNAHC, the controlling shareholder, nominating Mr. Zheng Baoan as Board secretary of the Company. The nomination and remuneration committee of the Board confirmed that Mr. Zheng Baoan conformed to the requirements of the articles of association of the Company and the applicable laws regarding qualifications of board secretary and joint company secretary. The committee recommended the Board to engage Mr. Zhang Baoan as the Board secretary and joint company secretary of the Company until the expiry of the term of the current session of the Board. The resignation and appointment were subject to approval of the Stock Exchange.

- Remuneration payable to directors shall be determined according to the terms of their respective employment contract, if any, and recommendation of the nomination and remuneration committee. Details of the remuneration of the directors are set out in the financial statements.



Deviation: The Company did not adopt any terms of reference for the remuneration committee before 12 April 2005.

Remedy: The Company adopted the terms of reference for the remuneration committee (the nomination and remuneration committee) on 12 April 2005 in accordance with the requirements of the Code.

## C. Accountability and Audit

*The board should present a balanced, clear and comprehensible assessment of the company's performance, position and prospects.*

- the Company has established an audit and risk control committee to review the financial information of the Company and the relevant disclosure, and review the internal controls of the Company.

- The Company shall publish its annual and interim results in a timely manner within four months and three months, respectively, after the end of the relevant periods.

- The Company has set up an investor relation webpage, on which figures of operating results are published monthly in order to improve transparency of the Company's performance and provide the latest developments of the Company in a timely manner.

- The Company has good environment for the implementation of internal controls. The Company has set up an effective electronic information system to support business development. The electronic information system comprises various operation systems, settlement system and a core accounting and audit platform, i.e. the Oracle financial information system. For the management of capital funds, the Company implemented a global online banking management system. An effective accounting information circulation system was also established.

# Corporate Governance Report

Deviation: Nil

*The board should ensure that the issuer maintains sound and effective internal controls to safeguard the shareholders' investment and the Company's assets.*

- The Board takes ultimate responsibility for the internal controls of the Company, and shall review the effectiveness of the system through the audit and risk control committee.

Deviation: Nil

*The board should establish formal and transparent arrangements for how to apply the financial reporting and internal control principles and for how to maintain an appropriate relationship with the company's auditors.*

- The audit and risk control committee comprises 2 independent non-executive directors and 1 non-executive director, who are proficient in financial matters. The audit and risk control committee is primarily responsible for:

  1. making recommendations to the Board on the appointment and replacement of the external auditor;

  2. reviewing and monitoring the internal audit system of the Company and its implementation;

  3. liaison between the internal auditor and external auditor;

  4. reviewing the financial information of the Company and the relevant disclosure;

  5. reviewing the internal controls of the Company;

  6. other matters designated by the Board of the Company.

- The primary duties of the audit and risk control committee are to review and supervise our financial reporting process. The audit and risk control committee currently comprises two independent non-executive directors, Mr. Wu Zhipan and Mr. Zhang Ke, and one non-executive director, Mr. Yao Weiting, with Mr. Zhang Ke acting as chairman of the committee.

- Attendance at the meetings of the audit and risk control committee in 2005 is set out as follows:

**Attendance at meetings of the audit and risk control committee in 2005**

| **No. of meetings** | **2** | |
|---|---|---|
| Zhang Ke | 2/2 | 100% |
| Yao Weiting | 2/2 | 100% |
| Wu Zhipan | 1/2 | 50% |
| Average attendance rate: | | **83%** |

- The audit and risk control committee passed the following resolutions at the first meeting held on 8 April 2005: the auditors' report for 2004 was considered and approved and would be submitted to the 8th meeting of the first session of the Board for consideration and approval; accounting system of the Company was considered and approved and would be submitted to the 8th meeting of the first session of the Board for consideration and approval after further amendments; the distribution policy and the distribution proposal for 2004 were agreed upon in principle and would be submitted to the 8th meeting of the first session of the Board for consideration and approval; the *Working Procedures of the Audit and Risk Control Committee of the Board* was considered and approved.

# Corporate Governance Report

- At the second meeting of the audit and risk control committee held on 19 August 2005, the 2005 interim financial report of the Company was approved.

Deviation: The Company did not adopt any terms of reference for the audit and risk control committee before 12 April 2005.

Remedy: The Company adopted the terms of reference for the audit and risk control committee on 12 April 2005 in accordance with the requirements of the Code.

**The responsibility of the directors in relation to the financial statements**

The company prepares annual reports and interim reports each year. The responsibilities of the directors in relation to the financial statements are set out below and shall be read together with the Report of the Auditors set out on page 54.

- *annual report and account*

  The directors acknowledged that they are responsible for preparing the financial statements for each financial year so as to present a true and fair view of the position of the Company.

- *accounting policy*

  When preparing the financial statements of the Group, the directors have consistently applied appropriate accounting policies under the international accounting standards and observed all applicable accounting standards.

- *accounting records*

  The directors shall be responsible for keeping accounting records of the Company, which shall reflect the financial position of the Company with reasonable accuracy, enabling the Group to prepare the financial statements in accordance with the requirements of the Companies Ordinance and applicable accounting standards.

- *ongoing operation*

  After making appropriate enquiries, the directors believe that the Group has sufficient resources for operation in the foreseeable future. Accordingly, the financial statements should be prepared on a going concern basis.

  The statement of reporting responsibility of the auditors is set out in the Auditors' Report on page 54.

*Auditor's Remuneration*

The international and domestic auditors of the Company are Ernst & Young and Ernst & Young Hua Ming respectively. Breakdown of the remuneration to the Company's external auditors for audit service provided and other non-audit service assignment for the year ended 31 December 2005 are as follows:

Audit service

RMB7,400,000 for the audit of the Group's financial statements for the year ended 31 December 2005, subject to adjustments based on the actual time incurred for the audit.

# Corporate Governance Report

Non-audit service assignment

RMB2,000,000 for agreed-upon procedure review on the Group's financial statements prepared in accordance with International Financial Reporting Standards for the six months ended 30 June 2005.

## D. Delegation by the Board

The company should formalise the functions reserved to the board and those delegated to management. There shall be division of responsibility between the board committees, and each committee should be formed with specific terms of reference.

- To regulate the operations of the Board of the Company, the Company has formulated the *Rules and Procedures for Board Meetings*, setting out the powers and duties of the Board. The terms of reference of the Chief Executive Officer, who shall be accountable to the Board, are set out in the articles of association of the Company.

- For general investment projects where the five ratios, namely total investment to total assets, consideration to total market value, income from investment to total income of the Company, gain from investment to total gain of the Company and proportion of nominal value of shares as consideration to the total capitalisation of the issuer, are higher than 3% but lower than 25%, they will be subject to examination and approval by the Board. Upon approval of the investment plan and relevant budget, the Board may delegate the management to be in charge of the details and implementation. Where the above ratios do not exceed 3%, the management will directly approve the project.

- For projects involving connected transactions, the Board has the right to approve projects with four of the ratios, namely total investment to total assets, consideration to total market value, income from investment to total income of the Company and proportion of nominal value of shares as consideration to the total share capital of the issuer, lower than 2.5% and a consideration of less than HK$10 million. For projects with the above four ratios lower than 0.1% or not lower than 0.1% but lower than 2.5% and a consideration of less than HK$1 million, the approving power may be delegated to the management's working meeting.

- Investment projects involving an investment amount beyond the approving power of the Board as well as risky investment projects, including but not limited to investments in bonds, shares, futures, options and other financial derivatives, shall be submitted by the Board to the shareholders' general meeting for approval.

- In respect of the fixed assets of the Company, if the expected value of fixed assets proposed to be disposed, together with the amount received from the disposal of fixed assets within four months preceding the proposed disposal, does not exceed 33% of the fixed assets value as set out in the latest balance sheet approved by the general meeting, such proposed disposal may be approved by the Board. Otherwise, the Board may not dispose or agree to dispose such fixed assets prior to obtaining approval from the general meeting.

- The Company has established an audit and risk control committee in compliance with the Code as set out in Appendix 14 of the Listing Rules. The primary duties of the audit and risk control committee are to review and supervise our financial reporting process. The audit and risk control committee currently comprises two independent non-executive directors, Mr. Wu Zhipan and Mr. Zhang Ke, and one non-executive director, Mr. Yao Weiting, with Mr. Zhang Ke acting as chairman of the committee.

- The Company has established a nomination and remuneration committee to make recommendations to our Board regarding the compensation of other executive directors as well as candidates to fill vacancies on our Board. In addition, the nomination and remuneration committee reviews the performance and determines the compensation structure of the senior management. The current members of the nominations and remuneration committee are Mr. Li Jiaxiang, Mr. Kong Dong, Dr. Hu Hung Lick, Henry, Mr. Zhang Ke and Mr. Wu Zhipan, with Mr. Wu Zhipan acting as the chairman of such committee.

# Corporate Governance Report

- The Company has established a strategy and investment committee to analyse and identify our development strategy and to decide on matters related to our investment as authorised by the Board. The current members of the strategy and investment committee are Mr. Kong Dong, Mr. Wang Shixiang, Mr. Ma Xulun and Mr. Cai Jianjiang, with Mr. Ma Xulun as chairman of such committee.

The Supervisory Committee is responsible for monitoring our financial matters and supervising the conduct of our Board and the management. The functions and authority of the Supervisory Committee include: reviewing the financial reports and other financial information prepared by the Board and proposed to be tabled before the shareholders' general meeting, as well as supervise the work of the directors, Chief Executive Officer, Deputy Chief Executive Officer and other senior personnel so as to prevent abuse of power or actions detrimental to the Company's interests. The current members of the Supervisory Committee are Mr. Zhang Xianlin, Mr. Liao Wei, Ms. Zhang Huilan and Mr. Liu Feng, with Mr. Zhang Xianlin acting as the chairman. In the event that any director has conflict of interests with the Company, the Supervisors may negotiate with the director concerned or bring the case to court on behalf of the Company. Resolution of meetings of the Supervisory Committee shall be passed by at least two-thirds of all Supervisors.

Deviation: Nil

## E. Communications of the Company

The board should endeavour to maintain an on-going dialogue with shareholders and in particular, use general meetings to communicate with shareholders.



- The Company established and maintains various communication channels with the shareholders such as the publication of annual and interim reports, press releases and announcements on the Company's website. The Company also formulated the *Investors Relation Management System*.

- The annual general meetings represent an effective means for the shareholders to exchange views with the Board. The Chairman of the Board, as well as the respective chairman of the audit and risk control committee, nomination and remuneration committee, and strategy and investment committee, will attend the general meetings to answer queries raised by shareholders.

- At the annual general meeting, the Board shall report to the shareholders and made announcement in respect of the implementation of resolutions which were passed on the previous annual general meeting and shall be carried out by the Board.

- Resolutions in respect of independent matters, including the election and replacement of the directors of the Company, shall be separately tabled before the annual general meeting.

Deviation: Mr. Li Jiaxiang, being the Chairman of the Company, failed to attend the annual general meeting of the Company on 30 May 2005 as required by the Code.

Reason for deviation: Mr. Li Jiaxiang, the Chairman of the Company, is a member of the Chinese government delegation and was required to attend the annual meeting of the International Air Transport Association. As such, he was unable to attend the annual general meeting of the Company on 30 May 2005.

# Report of the Directors

The board of directors (the "Board") of the Company hereby presents this report and the audited consolidated financial statements of the Group for the year ended 31 December 2005 to all the shareholders.

## GROUP ACTIVITIES AND RESULTS

The Group is a provider of air passenger, air cargo and airline-related services.

The results of the Group for the year ended 31 December 2005 and the financial positions of the Company and the Group as of the same date are set out in the audited financial statements on pages 55 to 135 of this annual report.

## FIVE-YEAR FINANCIAL HIGHLIGHTS

The summary of the Group's results and balance sheets for the five years from 2001 to 2005 are set out under the section headed "Financial Summary" on page 3 of this annual report.

## SHARE CAPITAL

The Company issued 2,805,680,000 H shares in 2004 (including 255,061,818 H shares sold by selling shareholders). On 7 January 2005, the international underwriters of the Company's initial public offering had exercised in full the over-allotment options referred to in the Company's prospectus dated 3 December 2004 (the "Prospectus") for over-allocation of shares (equivalent to approximately 15% of the H shares initially offered under the global offering) solely for satisfying over-allocation under the international offering. The Company issued and allotted 382,592,727 over-allotment shares at HK$2.98 per H Share (being the offer price per H Share under the international offering, exclusive of brokerage, SFC transaction levy, investor compensation levy and Stock Exchange trading fee). The net proceeds of approximately HK$1.1 billion (after deduction of various costs, which mainly comprise underwriting commission, Stock Exchange trading fee, SFC transaction levy and investor compensation levy) from the issue of 382,592,727 over-allotment shares will be used by the Company for the acquisition of various aircraft and repayment of liabilities due within one year.

Additionally, due to the reduction of State-owned shares, 29,749,686 state-owned legal person shares and 8,509,587 Non-H foreign shares were converted into H shares with a nominal value of RMB1.00 each.

As at 31 December 2005, the Company's total share capital amounted to RMB9,433,210,909, divided into 9,433,210,909 shares with a nominal value of RMB1.00 each. As at 31 December 2005, the share capital structure of the Company is as follows:

| | As at 31 December 2004 | | **As at 31 December 2005** | |
|---|---|---|---|---|
| **Class of shares** | Number of shares | Percentage of total issued share capital | **Number of shares** | **Percentage of total issued share capital** |
| Domestic shares | 4,855,945,675 | 53.65% | **4,826,195,989** | **51.16%** |
| Non-H Foreign shares | 1,388,992,507 | 15.35% | **1,380,482,920** | **14.63%** |
| H shares | 2,805,680,000 | 31.00% | **3,226,532,000** | **34.21%** |
| Total | 9,050,618,182 | 100% | **9,433,210,909** | **100%** |

# Report of the Directors

## SIGNIFICANT INTERESTS AND SHORT POSITIONS IN SHARES AND UNDERLYING SHARES OF THE COMPANY

As at 31 December 2005, the interests and short positions of the following persons (other than the Company's directors, chief executives or supervisors) in the shares and underlying shares or equity derivatives of the Company as recorded in the register of the Company required to be kept pursuant to Section 336 of the Securities and Futures Ordinance of Hong Kong (the "SFO") were as follows:

| Name of shareholder | Class and number of shares held | Nature of ownership | Percentage of the relevant class of shares in the Company | Percentage of the total issued share capital of the Company |
|---|---|---|---|---|
| CNAHC | 4,826,195,989 Domestic shares | Beneficial owner | 100% | 51.16% |
| CNAHC[(1)] | 1,380,482,920 Non-H Foreign shares | Attributable interest | 100% | 14.64% |
| CNACG | 1,380,482,920 Non-H Foreign shares | Beneficial owner | 100% | 14.64% |
| Cathay Pacific | 943,321,091 H Shares | Beneficial owner | 29.24% | 10.00% |
| Swire Pacific Limited[(2)] | 943,321,091 H Shares | Attributable interest | 29.24% | 10.00% |
| John Swire & Sons Limited[(2)] | 943,321,091 H Shares | Attributable interest | 29.24% | 10.00% |
| John Swire & Sons (H.K.) Limited[(2)] | 943,321,091 H Shares | Attributable interest | 29.24% | 10.00% |
| Temasek Holdings (Private) Limited[(3)] | 400,450,000 H Shares | Attributable interest | 12.41% | 4.25% |

*Notes:*

(1) By virtue of CNAHC's 100% interest in China National Aviation Corporation (Group) Limited, CNAHC is deemed to be interested in the 1,380,482,920 foreign shares (excluding H shares) of the Company directly held by China National Aviation Corporation (Group) Limited.

(2) By virtue of John Swire & Sons Limited's 100% interest in John Swire & Sons (H.K.) Limited and their approximately 30% equity interest and 53% voting rights in Swire Pacific Limited, and Swire Pacific Limited's approximately 46% interest in Cathay Pacific, John Swire & Sons Limited, John Swire & Sons (H.K.) Limited and Swire Pacific Limited are deemed to be interested in the 943,321,091 H shares of the Company directly held by Cathay Pacific.

(3) Temasek Holdings (Private) Limited, through its controlled entities, had an attributable interest in 400,450,000 H shares of the Company, out of which the interest in 292,500,000 H shares (representing approximately 9.07% of the total issued H shares) was held directly by Aranda Investment (Mauritius) Pte Ltd. and interest in the remaining 107,950,000 H shares was held directly by Dahlia Investments Ptd Ltd, FPL Alpha Investment Pte Ltd and Fullerton (Private) Limited.

(4) On 18 January 2006, the Company received a notification from HSBC stating that HSBC Halbis Partners (Hong Kong) Limited held 163,840,000 H shares in the Company, which represented 5.08% of the total issued H shares of the Company.

# Report of the Directors

As at 31 December 2005, the interests and short positions of the following persons in the shares and underlying shares of CNAC, as recorded in the register of the Company required to be kept under Section 336 of the SFO were as follows:

| Name of interests holder | Type of interests | Number of relevant ordinary shares of CNAC | Percentage of the total issued share capital of CNAC |
|---|---|---|---|
| CNAHC(1) | Attributable interest | 2,264,628,000 (1) | 68.36% |
| Air China Limited(2) | Beneficial owner | 2,264,628,000 (2) | 68.36% |
| Best Strikes Limited | Beneficial owner | 187,656,000 | 5.66% |
| Novel Credit Limited(3) | Attributable interest | 322,856,000 (3) | 9.75% |
| Novel Enterprises (BVI) Limited(3) | Attributable interest | 322,856,000 (3) | 9.75% |
| Novel Enterprises Limited(3) | Attributable interest | 322,856,000 (3) | 9.75% |
| Novel Holdings (BVI) Limited(3) | Attributable interest | 322,856,000 (3) | 9.75% |
| Novel Investment Holdings Limited(3) | Attributable interest | 322,856,000 (3) | 9.75% |
| On Ling Investments Limited(3) | Attributable interest | 322,856,000 (3) | 9.75% |
| Westleigh Limited(3) | Attributable interest | 322,856,000 (3) | 9.75% |

*Notes:*

(1) CNAHC owns approximately 51.16% of the total issued share capital of the Company and the entire issued share capital of CNACG, a company incorporated in Hong Kong, which in turn owns approximately 14.64% of the total issued share capital of the Company. Accordingly, CNAHC's interests in CNAC duplicate those held by the Company.

(2) CNACG, the former immediate controlling shareholder of CNAC, transferred approximately 69% shareholding interest in CNAC to the Company in September 2004 by way of capital contribution in exchange for the Company's foreign shares (excluding H shares). As such, the Company became the immediate controlling shareholder of CNAC. Accordingly, CNAHC's interests in CNAC duplicate those held by the Company.

(3) 5.6% of the interest held by each of these companies in CNAC duplicates with Best Strikes Limited's interest in CNAC. The interests of these companies in CNAC also duplicate each other.

## PUBLIC FLOAT

Pursuant to public information available to the Company and to the best knowledge of the directors of the Company, at least 25% of the total issued share capital of the Company is held by the public.

# Report of the Directors

## DIVIDEND

The Board recommends the payment of a final dividend of RMB0.2383 per 10 shares for the year ended 31 December 2005, totalling approximately RMB225 million. A resolution for the dividend payment will be submitted for consideration at the annual general meeting to be convened on 12 June 2006. The dividend will be denominated and declared in Renminbi. Dividends on domestic shares will be paid in Renminbi, whereas those on non-H foreign shares and H shares will be paid in Hong Kong dollars. The relevant exchange rate will be the mean of the average rate of Renminbi to Hong Kong dollars as announced by the People's Bank of China for the week prior to the date of declaration of dividends. The final dividends are expected to be paid around 30 June 2006 after its approval by the annual general meeting.

## TAXATION ON DIVIDENDS

Taxes paid by PRC companies are generally PRC withholding tax levied at flat rate of 20%. However, pursuant to the applicable rules of the taxation authority of the PRC, dividends paid by companies in the PRC to shareholders on shares listed on an overseas stock exchange, such as H Shares, are not subject to the abovementioned PRC withholding tax.

## PURCHASES, SALES AND REDEMPTION OF SHARES

During the year ended 31 December 2005, neither the Company nor any of its subsidiaries purchased, sold or redeemed any of the Company's listed securities.



## PRE-EMPTIVE RIGHTS

Neither the Articles of Association of the Company nor the laws of the PRC provide for any pre-emptive rights requiring the Company to offer new shares to existing shareholders in proportion to their existing shareholdings.

# Report of the Directors

## DIRECTORS AND SUPERVISORS OF THE COMPANY

Information of the directors and supervisors of the Company during 2005 and up to the date of this report is as follows:

### Directors

| Name | Age | Position in the Group | Date of appointment as director/supervisor |
|---|---|---|---|
| Li Jiaxiang | 56 | Chairman and non-executive director | 30 September 2004 |
| Kong Dong | 57 | Vice chairman and non-executive director | 30 September 2004 |
| Wang Shixiang | 56 | Vice chairman and non-executive director | 30 September 2004 |
| Yao Weiting | 58 | Non-executive director | 30 September 2004 |
| Ma Xulun | 41 | Executive director and president | 30 September 2004 |
| Cai Jianjiang | 42 | Executive director and vice president | 30 September 2004 |
| Fan Cheng | 50 | Executive director and chief financial officer | 18 October 2004 |
| Hu Hung Lick, Henry | 86 | Independent non-executive director | 22 November 2004 |
| Wu Zhipan | 49 | Independent non-executive director | 30 September 2004 |
| Zhang Ke | 52 | Independent non-executive director | 30 September 2004 |

*Notes:*

(1) Subsequent to his appointment as a director of the Company on 30 May 2005, Mr. David Muir Turnbull resigned as chairman of Cathay Pacific, and then resigned as a director of the Company on 12 December 2005.

(2) On 5 September 2005, the resolution proposed by the Board for the appointment of Mr. Jia Kang as an independent non-executive director of the Company was passed at the annual general meeting held on 28 March 2006. The appointment will come into effect upon the approval from or filing with the relevant authorities in respect of the amendments to the articles of association of the Company regarding the number of directors of the Board.

(3) Cathay Pacific, a shareholder of the Company, nominated Mr. Christopher Dale Pratt as a non-executive director of the Company. After nomination is approved by the Board of the Company it will be proposed for approval by the general meeting of the Company.



### Supervisors

| Name | Age | Position in the Group | Date of appointment as director/supervisor |
|---|---|---|---|
| Zhang Xianlin | 52 | Chairman of Supervisory Committee | 30 September 2004 |
| Liao Wei | 41 | Supervisor | 18 October 2004 |
| Zhang Huilan | 45 | Supervisor | 30 September 2004 |
| Liu Feng | 47 | Supervisor | 30 September 2004 |
| Liu Guo Qing | 44 | Supervisor | 23 August 2005 |

## INDEPENDENCE OF THE INDEPENDENT NON-EXECUTIVE DIRECTORS

The Company has confirmed its receipt of, from each of the independent non-executive directors of the Company, a confirmation of his independence pursuant to Rule 3.13 of the Listing Rules. The Company considers all of the independent non-executive directors to be independent.

# Report of the Directors

## BOARD COMMITTEES

The Board committees include the strategy and investment committee, audit and risk control committee and nomination and remuneration committee. The composition of each committee is set out in the "Corporate Governance Report" in this annual report.

## DIRECTORS' AND SUPERVISORS' INTERESTS AND SHORT POSITIONS IN THE SHARES, UNDERLYING SHARES AND DEBENTURES OF THE COMPANY

As at 31 December 2005, Mr. Zhang Xianlin, a supervisor of the Company, had interests in 33,126,000 shares, which represented 1% of the share capital of CNAC, a subsidiary of the Company. Save as mentioned above, none of our directors, supervisors and chief executives had any interests or short positions in the shares, underlying shares or debentures of the Company or its any associated corporations (within the meaning of Part XV of the SFO), as recorded in the register required to be kept under section 352 of the SFO or as notified to the Company and the Stock Exchange pursuant to the Model Code for Securities Transactions by Directors of Listed Companies.

## REMUNERATION OF DIRECTORS AND SUPERVISORS

Details of the remuneration of directors and supervisors are set out in note 10 to the financial statements for the year.

## INTERESTS OF DIRECTORS AND SUPERVISORS IN CONTRACTS AND SERVICE CONTRACTS



Each of the Directors has entered into a service contract with the Company for a term of three years from 30 September 2004 other than Mr. Fan Cheng, whose service contract has a term of three years from 18 October 2004, and the service contract is thereafter subject to termination by either party giving written notice to the other party.

None of the Directors has any existing or proposed service contract with any member of the Group which is not expiring or terminable by the Group within one year without payment of compensation (other than statutory compensation).

Apart from the service contract entered into between the Company and its subsidiaries (if applicable), in the year ended 31 December 2005, none of the directors and supervisors of the Company was materially interested, whether directly or indirectly, in any contract of significance to which the Company, its subsidiary or holding company or a subsidiary of the Company's holding company is a party.

## CONVENTION OF BOARD MEETINGS AND COMPLIANCE WITH THE CODE OF BEST PRACTICE

The Company held eight Board meetings during the year. The Company has been improving its corporate governance structure since listing. The Board is committed to conducting normative operations to protect the interests of the Company and its shareholders.

The directors of the Company are of the opinion that the Company has complied with the requirements set out in the revised Code on Corporate Governance Practices (the "Code") contained in Appendix 14 to the Listing Rules to revise the internal governance structure of the Company.

# Report of the Directors

## EMPLOYEES

As at 31 December 2005, the Group had 18,447 employees and its subsidiaries and associated companies had 12,145 employees. The following table sets forth the numbers and percentages of employees in different departments of the Company:

| Employees | Number | Percentage of total (%) |
|---|---|---|
| **Flight crew** | **5,066** | **27.5** |
| Pilots | 2,492 | 13.5 |
| Flight attendants | 2,574 | 14.0 |
| **Ground crew** | **13,381** | **72.5** |
| Ground services | 2,669 | 14.5 |
| Maintenance | 3,297 | 17.9 |
| Others | 2,098 | 11.4 |
| Marketing and sales | 2,101 | 11.4 |
| Management | 3,216 | 17.4 |
| **Total** | **18,447** | **100** |

## COMPENSATION POLICY

Employees of the Company receive cash remuneration consisting of salary and other cash subsidies. In general, employees' salaries are determined based on the employees' qualification, position, seniority and performance. Cash subsidies to employees include living subsidies and are subject to changes. The Company also provides various non-cash benefits, including medical insurance, unemployment insurance, early retirement and other social welfare benefits. In addition, all of our full-time employees in the PRC are covered by a defined contribution retirement scheme operated by the PRC government, to which the Company is required to make annual contributions at rates ranging from 15% to 20% of our employees' basic salaries.

In 2005, thanks to the effort of our staff as a whole, the Company maintained good performance. To enhance staff productivity and the Company's competitive strengths, the Company adjusted staff salary on the basis of RMB300 per month on average in the second half of the year, thereby incurring an expense of approximately RMB62 million for the whole year.

In addition, in order to provide incentives to the flight crew, the Board of the Company approved the Proposal on the Reform of Remuneration and Benefits System for the Flight Crew (飛行人員薪酬福利制度改革方案) on 30 December 2005, which came into effect on 1 March 2006.

## EMPLOYEES AND EMPLOYEES' PENSION SCHEME

All employees of the Company are covered by a defined contribution retirement scheme operated by the PRC government, to which the Company is required to make annual pension contributions to the government at rates ranging from 15% to 20% of the aggregate salary of all our staff.

145 employees of the Company retired in 2005. These retired employees are entitled to benefits under the social pension scheme approved and provided by the labour and social security authority of the local government. Details of the staff pension scheme and other welfare are set out in note 11 to the financial statements.

# Report of the Directors

## SHARE APPRECIATION RIGHTS

The Share Appreciation Rights Scheme of the Company has been approved by the State-owned Assets Supervision and Administration Commission ("SASAC") under the State Council of the PRC. The implementation measures of the Share Appreciation Rights Scheme will come into effect upon approval by the Board and filing with the SASAC. Details of the Share Appreciation Rights Scheme are set out in note 39 to the financial statements for 2005.

## SUBSIDIARIES AND ASSOCIATED COMPANIES

As at 31 December 2005, details of the subsidiaries and associated companies of the Company are set out respectively in notes 18 and 19 to the financial statements for 2005.

## USE OF PROCEEDS FROM INITIAL PUBLIC OFFERING

The net proceeds from its the global initial public offering of H shares of the Company amounted to HK$8,246,014,864. As stated in the prospectus of the Company, it is intended that approximately RMB4.8 billion of the proceeds will be used to acquire ten Airbus 319 aircraft and four Boeing 737-700 aircraft, and the remaining balance estimated to be approximately RMB3.97 billion will be used to repay liabilities falling due within one year and to supplement our cash flow.

As of 31 December 2005, the Company settled the payment of approximately RMB4,283,256,876 for acquiring ten Airbus 319 aircraft and four Boeing 737-700 aircraft in accordance with the proposed use of proceeds set out in the prospectus, saving the Company approximately RMB516,743,124 compared to the estimated RMB4.8 billion disclosed in the prospectus. The surplus amount have been used to repay liabilities falling due within one year and to supplement our cash flow in accordance with proposed use of proceeds set out in the prospectus. As such, all proceeds from the H share offering have been used up.



The Board of the Company considers that the use of proceeds by the Company conformed to the undertakings set out in the prospectus and the relevant projects were completed as scheduled with satisfactory capital efficiency.

## BANK AND OTHER BORROWINGS

Details of bank and other borrowings of the Company and the Group are set out in note 33 to the financial statements.

## FIXED ASSETS

Movements in fixed assets of the Group for the year ended 31 December 2005 are set out in note 15 to the financial statements for 2005.

## INTERESTS CAPITALISED

Details of interests capitalised of the Group for the year ended 31 December 2005 are set out in note 8 to the financial statements for 2005.

## RESERVES

Movements in the reserves of the Company and the Group during the year are set out in note 38 to the financial statements and consolidated statement of changes in equity.

# Report of the Directors

## CHANGES IN EQUITY

Please refer to the consolidated statement of changes in equity.

## DONATIONS

For the year ended 31 December 2005, the Company made donations for charitable and other purposes amounting to RMB42.71 million.

## PROPERTY TITLE CERTIFICATE

The Company effected changes of titles of assets, e.g. land, real estates and vehicles, in accordance with its undertakings in the prospectus of H shares offering. To date, the transfer procedures for motor vehicles of the Company's headquarter and branch companies have been substantially completed. The title transfer procedures for land and real estates of the Company's headquarter and branch companies have also been substantially completed save for a few regions. At present the unfinished work is still in progress, which do not have material adverse effect on the operation of the Company.

## MAJOR CUSTOMERS AND SUPPLIERS

For the year ended 31 December 2005, the purchases from the largest equipment supplier accounted for 18.09% of the total purchases of the Group, while purchases from the five largest equipment suppliers accounted for 48%. None of the directors or supervisors of the Company, their associates, nor any shareholder, who to the knowledge of the directors own 5% or more of the Company's share capital, had any interest in the five largest equipment suppliers of the Company.



For the year ended 31 December 2005, the sales of the Group to the five largest customers accounted for not more than 30% of the total sales of the Group.

## MATERIAL LEGAL PROCEEDINGS

As of 31 December 2005, the Group was not involved in any significant litigation or arbitration save for those disclosed in note 41 to the financial statements. To the knowledge of the Group, there was no litigation or claim of material importance pending or threatening or initiated against the Company.

## CONNECTED TRANSACTIONS

The Group has entered into a number of transactions on a continuing basis with CNAHC and its associated companies (as defined under the Listing Rules) and other connected persons of the Group. Details of those connected transactions conducted in 2005, which are not exempt under Rule 14A.33 of the Listing Rules, are as follows:

### I. Continuing Connected Transactions Between Our Group and CNAHC Group

*Trademark Licensing*

Pursuant to a trademark licence agreement (the "Trademark Licence Agreement") entered into between the Company and CNAHC on 1 November 2004, and subject to the Non-competition Agreement between the two parties, the Company granted to CNAHC and its wholly-owned or controlled subsidiaries a licence to use 17 registered trademarks which the Company held in connection with the business operations of CNAHC and its wholly-owned or controlled subsidiaries but not related to the core businesses of the Company on a royalty-free basis. The Company reserves the right to use or license any independent third party to use the above trademarks, or to transfer the trademarks to any independent third party provided that the interest of the existing licensee is not prejudiced. The term of the agreement shall commence on the date of incorporation of the Company and end on 31 December 2014.

# Report of the Directors

On 28 March 2006, the Company and CNAHC entered into a Trademark Licence Supplementary Agreement, whereby the Company granted to CNAHC a licence to use trademark no. 1125894 in connection with the business operations of CNAHC and its wholly-owned or controlled subsidiaries on a royalty-free basis and on the same terms and conditions as the Trademark Licence Agreement. As such, the total number of registered trademarks licenced by the Company to CNAHC and its wholly-owned or controlled subsidiaries amounted to 18.

*Construction Project Management Services*

The Company entered into a construction project management agreement (the "Construction Project Management Agreement") with China National Aviation Construction and Development Company ("CNACD"), a wholly-owned subsidiary of CNAHC on 1 November 2004.

Pursuant to this agreement:

- CNACD will provide the Company project management services on projects involving the construction of any property or industrial plant/facility with budgeted costs of RMB20 million or above;

- in return for its project management services, the Company pay CNACD a fee of up to 2% of the construction budget if the budget is RMB1 billion or more, and up to 2.5% if the budget is below RMB1 billion;

- if CNACD is able to manage the construction projects such that the final cost falls below the budgeted amount anticipated by the Company, the Company will pay CNACD a bonus of an amount to be determined by both parties through arm's length negotiation but shall not exceed 40% of the management fee calculated on the basis of the budgeted amount of the relevant project;

- if the final cost of the project managed by CNACD is higher than the budgeted amount, CNACD will pay the Company the difference between the final cost and the budgeted amount, unless the difference is caused by (i) a change of government policies; (ii) factors attributed to the Company; or (iii) force majeure; and

- If CNACD acquires land relating to a project on the Company's behalf, the Company will pay CNACD an agency fee of up to 2% of all the fees and expenses in relation to the land acquisition (including, among other things, land acquisition fee, formality fee, labour expenses and travelling expenses, but excluding land premium).

The Construction Project Management Agreement will expire on 31 December 2006, subject to renewal.

*Properties Leasing*

The Company entered into a properties leasing framework agreement (the "Properties Leasing Framework Agreement") with CNAHC on 1 November 2004.

Pursuant to this agreement, the Company will lease from CNAHC 14 properties with an aggregate gross floor area of approximately 53,087 sq. m. for various uses, including as business premises, offices and storage facilities. The Company will also lease to CNAHC 7 properties with an aggregate gross floor area of approximately 8,262 sq. m. The rents payable under the Properties Leasing Framework Agreement are and will continue to be determined in accordance with market rates.

The Properties Leasing Framework Agreement will expire on 31 December 2006 subject to renewal.

# Report of the Directors

*Media and Advertising Services*

The Company entered into a media and advertising services framework agreement (the "Advertising Services Framework Agreement") on 1 November 2004 with China National Aviation Media and Advertisement Co., Ltd. ("CNAMC"), a wholly-owned subsidiary of CNAHC.

Pursuant to this agreement, CNAMC will have the right to procure advertisements and to retain all advertising revenues generated from such advertisements that appear:

- in the in-flight magazines, in-flight entertainment programmes, boarding passes and certain other items specified in the Advertising Services Framework Agreement (the "Specified Items"); and

- on the potential items that may be developed from time to time (the "Potential Items").

As a consideration, CNAMC will pay the Company an annual concession fee for the Specified Items and 20% of the total revenues generated from advertisements appearing on the Potential Items. CNAMC has also agreed to:

- provide the Company at nil charge the in-flight items (except for in-flight entertainment programmes) and the Potential Items (for those not owned by the Company) on which the advertisements appear or will appear;

- provide the Company with some in-flight entertainment programmes produced by it, the production cost and expense of which will be reimbursed by the Company; and

- procure contents for the Company's in-flight entertainment programmes from independent third parties on a commission-free basis.

In addition, CNAMC has the right to bid for advertisement agency and design services to the Company.

The Advertising Services Framework Agreement will expire on 31 December 2006 subject to renewal.

*Tourism Co-operation Services*

The Company entered into a tourism services cooperation agreement (the "Tourism Cooperation Agreement") on 1 November 2004 with China National Aviation Tourism Company ("CNATC").

Pursuant to this agreement, the Company has agreed to provide the following services to CNATC:

- Commercial charter flight services: the Company will provide charter services to customers procured by CNATC at market rates.

- Package tours co-operation services: the Company and CNATC will sell package tours combining (i) the Company's airline tickets with (ii) accommodation at hotels owned and operated by CNATC. For the airline tickets in such packages sold by CNATC, CNATC will pay the Company in accordance with the pricing principle under the "Sales Agency Framework Agreement" while the Company will pay CNATC for the hotel fee portion of the packages.

- Reciprocal frequent-flyer programme ("FFP") co-operation services: CNATC will join the Company's FFP under which our Companion card members are encouraged to stay at CNATC's hotels by receiving mileage credits for such stay. As consideration, CNATC will pay us the equivalent value represented by those mileage credits.

# Report of the Directors

Pursuant to the Tourism Cooperation Agreement, CNATC agreed to provide the following services to the Company:

- FFP co-operation services: Under the FFP, if our Companion card members redeem their mileage credits for free, discounted or upgraded stay at CNATC's hotels, the Company will reimburse CNATC for such redemption at a price similar to our arrangements with other FFP partners.

- Hotel accommodation services: CNATC will provide hotel accommodation services to the Company's employees on duty and passengers affected by our flight delays or cancellations, for which services the Company will pay relevant fees to CNATC at group rates.

The Tourism Co-operation Agreement will expire on 31 December 2006 subject to renewal.

*Comprehensive Services*

The Company entered into a comprehensive services agreement (the "Comprehensive Services Agreement") with CNAHC on 1 November 2004 pursuant to which:

- CNAHC will provide the Company with various ancillary services, including but not limited to:

  (i) supply of various items for in-flight services;

  (ii) manufacturing and repair of airline-related ground equipment and vehicles;

  (iii) cabin decoration and equipment;

  (iv) passenger cabin and cargo cabin ancillary parts (including seats);

  (v) warehousing services;

  (vi) cabin cleaning services; and

  (vii) printing of air tickets and other documents.

- The Company will provide certain welfare-logistics services to the retired employees of CNAHC and its subsidiaries.



The charges payable by the Company to CNAHC for the comprehensive services above, as well as the charges payable by CNAHC to the Company for the welfare-logistics services provided to its retired employees, shall be based on prevailing market rate or, if no prevailing market rate is available, fair and reasonable price determined after arm's length negotiation.

The Comprehensive Services Agreement will expire on 31 December 2006 subject to renewal.

*Line Maintenance and Other Ground Services*

The Company entered into a standard ground handling agreement (the "Standard Ground Handling Agreement") with China Aircraft Services Limited ("CASL"), a 40%-owned subsidiary of CNACG, on 17 April 2004, pursuant to which CASL would provide line maintenance and other ground services to the Company at the Hong Kong International Airport. The services are charged at market rates.

# Report of the Directors

*Financial Services*

On 1 November 2004, The Company entered into a financial services agreement (the "Financial Services Agreement") with China National Aviation Finance Co., Ltd. ("CNAF") which is owned as to 74.89% by CNAHC and 19.31% by the Company as of 31 December 2005.

Pursuant to this agreement, CNAF has agreed to provide the Company a range of financial services including the following:

- deposit services;
- loan and finance leasing services;
- negotiable instrument and letter of credit services;
- trust loan and trust investment services;
- underwriting services for debt issuances;
- intermediary and consulting services;
- guarantee services;
- settlement services;
- internet banking services; and
- any other services provided by CNAF under the approval of the China Banking Regulatory Commission ("CBRC").

The fees and charges payable by the Company to CNAF under the Financial Services Agreement are determined with reference to the applicable fees and charges specified by the People's Bank of China (the "PBOC") and the CBRC for the relevant services from time to time, and if neither the PBOC nor the CBRC has specified a fee or charge for a particular service, then the service will be provided by CNAF on terms no less favourable than terms available from commercial banks in China.

The Financial Services Agreement will expire on 31 December 2006 subject to renewal.

*Subcontracting of Charter Flight Services*

The Company entered into a charter flight service framework agreement (the "Charter Flight Service Framework Agreement") on 1 November 2004 with CNAHC.

Pursuant to this agreement, CNAHC will subcontract to the Company its obligation of government charter flight that it undertakes from the PRC government. The Company's hourly rate of the charter flight service fee will, subject to periodical adjustment, be calculated on the basis of the following formula which includes total cost and reasonable margins:

Hourly rate = Total cost per flight hour x (1 + 6.5%)

Total cost includes all direct costs and indirect costs.

The Charter Flight Service Framework Agreement will expire on 31 December 2006 subject to renewal.

# Report of the Directors

*Sales Agency Services for Airline Tickets and Cargo Space*

The Company entered into a sales agency framework agreement with CNAHC (the "Sales Agency Services Framework Agreement") on 1 November 2004.

Pursuant to this agreement, certain associates of CNAHC acting as the Company's sales agents will:

- purchase air tickets and cargo spaces from the Company at wholesale prices and resell such air tickets and cargo spaces to end-purchasers; or
- procure purchasers for the Company's air tickets and cargo spaces on a commission basis.

The Company will pay the relevant agency commission based on relevant PRC regulations or, where the regulations do not provide for a specific commission, based on market rates. Currently, the commissions prescribed for sales of air tickets are as follows:

- for domestic routes, 3% of the ticket price;
- for Hong Kong and Macau routes, 7% of the ticket price; and
- for international routes, 9% of the ticket price.

In accordance with industry practice, and subject to applicable regulations, the Company may also offer incentives to sales agents for reaching certain ticket sale targets.



The Sales Agency Services Framework Agreement will expire on 31 December 2006 subject to renewal.

## II. Continuing Connected Transactions between the Group and the Lufthansa Group

Lufthansa holds 40% equity interest in and is a substantial shareholder of Aircraft Maintenance and Engineering Corporation ("Ameco"), a subsidiary of the Company, and is therefore a connected person of the Company under the Listing Rules.

The Company has entered into various transactions with Lufthansa and its associates (collectively, the "Lufthansa Group") in the ordinary course of its business, including, among others:

- Aircraft maintenance, repair and overhaul services ("MRO Services") provided by the Company to the Lufthansa Group;
- mutual provision of catering services;
- mutual provision of ground handling services in China and Germany;
- mutual provision of ticket sales agency services;
- airline codeshare arrangement under which the actual carrier's flights can be marketed under the airline designator code of the partner carrier and revenues earned from these arrangements are allocated between the parties based on negotiated terms according to airline industry standards;

# Report of the Directors

- special prorate arrangement under which a carrier agrees to accept passengers from another carrier and receive payment directly from that carrier; and

- other airline co-operation arrangements between the Lufthansa Group and the Company.

The above transactions have been entered into on normal commercial terms based on arm's length negotiations.

## III. Continuing Connected Transactions between the Group and the Beijing Capital Airports Group

Capital Airports Holding Company holds 24% equity interest in and is a substantial shareholder of Air China Cargo, and therefore is a connected person of the Company under the Listing Rules. The Company has entered into various transactions with Capital Airports Holding Company and its associates (collectively, the "Beijing Capital Airports Group") in the ordinary course of its business, including, among others:

- provision of taking-off/landing/parking services of the Company's aircraft at airports owned by the Beijing Capital Airports Group;

- provision of passengers' waiting lounge, check-in counters and office buildings to the Company by airports owned by the Beijing Capital Airports Group;

- provision of utilities (including water, gas and electricity) to the Company at Beijing Capital International Airport by the Beijing Capital Airports Group; and

- provision of ground handling services to the Company by the Beijing Capital Airports Group.



Most of the services provided by the Beijing Capital Airports Group to the Company are charged on the pricing terms which are prescribed, approved or recommended by PRC governmental authorities.

## IV. Continuing Connected Transactions between the Group and the Cathay Pacific Group

Cathay Pacific holds 10% of the total issued share capital of the Company and therefore is a connected person of the Company under the Listing Rules. The Company has entered into various transactions with Cathay Pacific and its associates (collectively, the "Cathay Pacific Group") in the ordinary course of its business. Such transactions, which constitute an essential part of the daily operations of an airline business, include, among others:

- provision of ground handling services by the Cathay Pacific Group to the Company;

- provision of MRO Services by the Company to the Cathay Pacific Group;

- provision of catering services by the Company to the Cathay Pacific Group; and

- mutual provision of ticket sales agency services.

The above transactions have been entered into on normal commercial terms based on arm's length negotiations.

# Report of the Directors

## V. Continuing Connected Transactions between the CNAC Group and Other Connected Persons of the Group

CNAC is a non-wholly owned subsidiary of the Company. Therefore, the continuing connected transactions entered into between CNAC and its subsidiaries (collectively, the "CNAC Group") as one party and connected persons as the other party, will also constitute continuing connected transactions for the purpose of the Group under the Listing Rules. Details of such continuing connected transactions conducted in 2005, which the Company considered would not be exempted under Rule 14A.33 of the Listing Rules, are as follows:

*Provision of In-flight Catering Services by Macau Catering Services Company Limited*

For in-flight meals to its passengers, Air Macau entered into a Catering Services Agreement on 1 November 2001 with Macau Catering Services Company Limited ("MCS"). Pursuant to the Catering Services Agreement, Air Macau purchased meals from MCS, an associate of Sociedade de Turismo e Diversoes de Macau ("STDM"). Since STDM has 14% equity interest in Air Macau and MCS is an associate of STDM, MCS is a connected person of CNAC and therefore a connected person of the Company. Since MCS is the only provider of in-flight meals in Macau, Air Macau continued to purchase in-flight meals from MCS pursuant to the Agreement on normal commercial terms determined on an arm's length basis. The Catering Services Agreement will remain valid until 31 October 2006 unless otherwise terminated according to its terms and conditions.

The Board has considered and proposed that the annual cap for the values of the transactions contemplated under the Catering Services Agreement for each of the three years ending 31 December 2005, 2006 and 2007 shall be HK$65 million, HK$75 million and HK$95 million, respectively. The amount paid by Air Macau to MCS in respect of the provision of the catering services in 2005 was HK$51.49 million. For this purpose, the percentage ratio calculated according to the Listing Rules is less than 2.5% but more than 0.1%. Accordingly, for the purpose of the Company, such transactions are exempt from independent shareholders' approval requirement but are subject to the announcement requirement for connected transactions under the Listing Rules. CNAC has obtained a waiver from the Stock Exchange from strict compliance with the announcement and/or independent shareholders' approval requirements under the Listing Rules in relation to the above continuing connected transactions.



*Payment of Airport Charges and Airport Fees*

In the ordinary course of business of Air Macau, airport charges and airport fees are invoiced and collected by Administration of Airports Limited ("ADA"), an indirect subsidiary of CNACG, on behalf of Macau International Airport Company ("MIAC"), an associated company of a substantial shareholder of Air Macau. As a result, the payment of airport charges and airport fees constitutes continuing connected transactions under the Listing Rules.

On 17 March 2006, Air Macau and ADA, being the authorized agent responsible for the global management and provision of operational services to MIAC, including the collection of Airport Charges, entered into a legally binding acknowledgement pursuant to which it was acknowledged by Air Macau and ADA that certain facilities and services are provided by MIAC to Air Macau.

In respect of Air Macau's operation at the Macau International Airport, Air Macau entered into the Airport License on 9 September 2004 and the Proposed Airport License with MIAC with a term of one year (which will be automatically renewed for another year unless it is terminated by either party by way of 90 days prior written notice) and one year respectively. The current term of the Airport License will expire on 7 September 2006 and the term of the Proposed Airport License will expire on 28 February 2007. Pursuant to the Airport License and the Proposed Airport License, MIAC licensed certain floor space (including ticketing and check-in counters, operation/traffic service offices, and lounges) at the Macau International Airport to Air Macau.

The total airport charges and airport fees paid by Air Macau to ADA in 2005 was approximately HK$86.34 million. For this purpose, the percentage ratio calculated according to the Listing Rules is less than 2.5% but more than 0.1%. Accordingly, for the purpose of the Company, such transactions are exempt from independent shareholders' approval requirement but are subject to the announcement requirement for connected transactions under the Listing Rules. CNAC has obtained a waiver from the Stock Exchange from strict compliance with the announcement and/or independent shareholders' approval requirements under the Listing Rules in relation to the above continuing connected transactions.

# Report of the Directors

## VI. Waiver from Strict Compliance of the Listing Rules

The Company has obtained a waiver from the Stock Exchange expiring on 31 December 2006 from strict compliance with the announcement and/or independent shareholders' approval requirements under the Listing Rules in relation to the above continuing connected transactions (except for transactions set out under section V above). The maximum aggregate annual value ("cap") permitted by the Stock Exchange and the aggregate annual value actually occurred for each of the above continuing connected transactions for the year ended 31 December 2005 are set out below:

| Transactions | Aggregate Amount of Transactions for the Year Ended 31 December 2005<br>Cap<br>*RMB (in millions)* | <br>Actual Amount<br>*RMB (in millions)* |
|---|---|---|
| **Transactions with the CNAHC Group** | | |
| Construction project management services | **40.0** | **1.18** |
| Properties leasing | **50.0** | **29.89** |
| Media and advertising services | **24.7** | **18.70** |
| Tourism services co-operation | **35.6** | **16.16** |
| Comprehensive services | **115.0** | **91.20** |
| Line maintenance and other ground services | **45.0** | **29.15** |
| Financial services: | | |
| Payment of fees and charges | **40.0** | **14.40** |
| Maximum daily outstanding deposits with CNAF | **5,000.0** | **1047.08** |
| Maximum daily outstanding loans from CNAF | **3,000.0** | **597.47** |
| Subcontracting of charter flights | **650.0** | **407.05** |
| Sales agency service: | | |
| Aggregate sales of airline tickets and cargo space to the CNAHC Group for resale to end purchasers | **470.0** | **232.83** |
| Aggregate ticket and cargo agency commission and amount of incentives to be paid by the Company to CNAHC Group | **35.0** | **34.74** |
| **Transactions with the Lufthansa Group** | | |
| Total amount to be paid by the Company to the Lufthansa Group | **660.0** | **634.34** |
| Total amount to be paid by the Lufthansa Group to the Company | **530.0** | **466.27** |
| **Transactions with the Beijing Capital Airports Group** | | |
| Total amount to be paid by the Company to the Beijing Capital Airports Group | **900.0** | **709.82** |
| **Transactions with the Cathay Pacific Group** | | |
| Aggregate amount to be paid by the Company to the Cathay Pacific Group | **40.0** | **20.14** |

# Report of the Directors

## VII. Confirmation from Independent Non-executive Directors

The independent non-executive directors of the Company have confirmed that all connected transactions in the year ended 31 December 2005 to which the Company was a party have been entered into:

1. in the ordinary and usual course of business of the Company;

2. either:

   (i) on normal commercial terms; or

   (ii) where there was no comparable transactions to judge whether they were on normal commercial terms, on terms no less favourable to the Company than terms available to or from independent third parties, where applicable; and

3. in accordance with terms that were fair and reasonable and in the interests of the shareholders of the Company as a whole.

## VIII. Confirmation from the Auditors

Ernst & Young, the auditors of the Company, has confirmed by a letter to the Board that the above connected transactions:



1. have been approved by the Board;

2. were in line with the pricing policies as set out in the relevant agreements;

3. have been entered into in accordance with the relevant agreement governing the transactions; and

4. did not exceed the cap disclosed in the prospectus of the Company.

## CONTRACT OF SIGNIFICANCE

None of the Company or any of its subsidiaries entered into any contract of significance with the controlling shareholder or any of its subsidiaries. There is no contract of significance in relation to provision of services by the controlling shareholder or any of its subsidiaries to the Company or any of its subsidiaries. None of the shareholders entered into any arrangement to waive or agree to waive any dividend.

## AUDITORS

The Company appointed Ernst & Young and Ernst & Young Hua Ming as its international auditors and domestic auditors respectively for the year ended 31 December 2005. Ernst & Young has audited the attached financial statements prepared in accordance with the International Financial Reporting Standards. The Company has retained Ernst & Young and Ernst & Young Hua Ming since the date of its listing. A resolution in respect of the reappointment of Ernst & Young and Ernst & Young Hua Ming as the Company's international and domestic auditors respectively for the year ending 31 December 2006 will be proposed at the Annual General Meeting of the Company to be held on 12 June 2006.

By Order of the Board
**Li Jiaxiang**
*Chairman*

Beijing, PRC
18 April 2006

# Report of the Supervisory Committee

To all shareholders,

The supervisory committee of the Company ("Supervisory Committee") has carried out its duties in accordance with the Company's articles of association and relevant requirements in 2005. Members of the Supervisory Committee attended Board meetings, inspected relevant documents and conducted seminars, exercising effective supervision over the conduct and decision-making process of Board meetings and enforcement of resolutions for compliance with the relevant laws and regulations and the Company's articles of association, with the aim of safeguarding the interests of the Company and shareholders as a whole.

The Supervisory Committee is of the opinion that the decision-making process of the Company complied with the relevant laws and regulations, and the Company's articles of association and was well-regulated. The directors and senior management of the Company observed their fiduciary duties and worked diligently and legally. The Supervisory Committee is not aware that the directors and senior management of the Company acted in breach of the laws and regulations and the articles of association of the Company or against the interests of the Company.

The Supervisory Committee considers that the Company's 2005 financial statements reflected a true and fair view of the financial position and operating results of the Company. The unqualified opinion expressed in the auditors' report issued by Ernst & Young is objective and fair. In the opinion of the Supervisory Committee, the Company has achieved satisfactory results in 2005, which represented a remarkable accomplishment given the continued rise in jet fuel price. It is expected that the Company will continue to exercise robust cost control and risk management.

The Supervisory Committee is of the opinion that the connected transactions between the Company and its connected persons were conducted at fair market price without prejudice to the interests of the Company and its minority Shareholders. The use of proceeds from the Company's initial public offering conformed to the relevant purposes disclosed in the Company's prospectus and such proceeds were not used for other purposes.

In 2006, the Supervisory Committee will continue to perform its duties in safeguarding the interests of the shareholders of the Company in strict adherence to the Company's articles of associations and relevant requirements.

By Order of the Supervisory Committee

**Zhang Xianlin**
*Chairman of the Supervisory Committee*

Beijing, PRC
17 April 2006

# Profile of Directors, Supervisors and Senior Management

## Directors

**Mr. Li Jiaxiang**, aged 56, is the Chairman of the Board and a Non-executive Director of the Company. Mr. Li graduated from Shandong Coal Technology Institute in 1969 and studied in Northwest University from 1999 to 2001 majoring in international economic law. Mr. Li had previously served in the China Air Force, People's Liberation Army of China since 1969 and served in various positions including as a Major General in the Air Force. After the restructuring of CAAC in October 2002, he served as the President of Air China International Corporation and Deputy General Manager of CNAHC. He was then promoted to the position of General Manager of CNAHC in August 2004, a post he continues to hold.

**Mr. Kong Dong**, aged 57, is a Vice Chairman of the Board and a Non-executive Director, of the Company. Mr. Kong graduated from Jiangxi Technology University in 1977 majoring in mechanical engineering and is a senior economist. Mr. Kong was Deputy General Manager of China Ocean Helicopter Company, General Manager of Shenzhen Airport Group, Director-General in charge of the expansion project of the Beijing Capital International Airport, General Manager of China National Aviation Corporation and President of CNAC, and Vice Chairman and President of CNACG. After the restructuring of CAAC in October 2002, he joined CNAHC as Deputy General Manager, a post he continues to hold since on August 2004.

**Mr. Wang Shixiang**, aged 56, is a Vice Chairman of the Board and a Non-executive Director of the Company. Mr. Wang graduated from the China Civil Aviation Advanced School in 1968 majoring in aviation and is a qualified First-Class Pilot. Mr. Wang was appointed as the President of the Civil Aviation Flight Academy of China in 1995, and General Manager of China Southwest Airlines in 1999. After the restructuring of CAAC in October 2002, he joined CNAHC as Deputy General Manager, a post he continues to hold.



**Mr. Yao Weiting**, aged 58, is a Non-executive Director of the Company. Mr. Yao graduated from Zhejiang Institute of Economics and Management and the China Central Party University in 1967 majoring in industrial accounting and economic management, respectively. He is also a senior accountant and senior economist. Mr. Yao was appointed as the Deputy Director of Economic Adjustment Bureau of China Metallurgical Ministry in 1997 and Assistant to the State Council Investigation Special Commissioner in 1998, and was the Chief Accountant of Air China International Corporation from 2000 to 2002. After the restructuring of CAAC in October 2002, he joined CNAHC as Deputy General Manager, and assumed the position of Chief Accountant of CNAHC in December 2004, a post he continues to hold.

**Mr. Ma Xulun**, aged 41, is an Executive Director and President of the Company. Mr. Ma graduated from Shanxi Finance University in 1984 with a Bachelor's Degree of Economics and is a certified public accountant. Mr. Ma was appointed as Deputy General Manager of China Commodities Storing and Transportation Corporation in 1995, Deputy Director General of Finance Department of CAAC in 1997, Vice President of Air China International Corporation in December 1998, and Deputy Director General of Air China International Corporation after the restructuring of CAAC in 2002. In September 2004, he was promoted to the President of Air China Limited, a post he continues to hold.

**Mr. Cai Jianjiang**, aged 42, is an Executive Director and Vice President of the Company. Mr. Cai graduated from China Civil Aviation Institute in 1983. Mr. Cai was appointed as General Manager of Shenzhen Airlines Company Limited in 1999. He joined Air China International Corporation in 2001 as a General Manager of its Shanghai Branch, and subsequently as Assistant to the President and Manager of the Marketing Department of Air China International Corporation. After the restructuring of CAAC in October 2002, he was appointed as the Vice President of Air China International Corporation, and has served as Vice President of Air China Limited since September 2004.

# Profile of Directors, Supervisors and Senior Management

**Mr. Fan Cheng**, aged 50, is an Executive Director and the Chief Financial Officer of the Company. Mr. Fan graduated from Nanjing Institute of Chemistry and Chemical Engineering in 1982 with a major in organic fertilizer and graduated from Guanghua School of Management, Beijing University in 2000 with an MBA degree. Mr. Fan is a senior accountant, senior engineer and certified public accountant. Mr. Fan was appointed as Deputy General Manager of China New Technology Venture Capital Company in 1996. He joined CAAC in 2001, and served as General Manager of Corporate Management Department and Assets Management Department of CNAHC from October 2002 to October 2004. He has been the Chief Financial Officer of Air China Limited since September 2004 and the Vice Chairman of the Board of Shenzhen Airlines Company Limited since January 2005.

**Mr. Hu Hung Lick, Henry**, aged 86, is an Independent Non-executive Director of the Company. Mr. Hu is currently the president of Shue Yan College in Hong Kong.. He graduated from the University of Paris with a Docteur-en-Droit degree. Mr. Hu was a member of Preparatory Committee and Selection Committee for the First Government of the Hong Kong Special Administrative Region, China, and was a member of the Standing Committee of the 8th and 9th Chinese People's Political Consultative Conference. He has been serving as an independent non-executive director of CNAC since April 1997.

**Mr. Wu Zhipan**, aged 49, is an Independent Non-executive Director of the Company. Mr. Wu holds a Doctor in Laws Degree from School of Law, Peking University, in 1988, and was a visiting scholar at Harvard Law School from 1991 to 1992. Mr. Wu is currently the Vice Chancellor of Beijing University. He is also an expert consultant of the Supreme People's Court of China and Consultant of the Drafting Group of the Banking Law in China. Mr. Wu is also an independent non-executive director of China Minsheng Banking, Corp., Ltd., Henan Zhongfu Industry, Co., Ltd. and Fortune SGAM Fund Management Co., Ltd., and an independent supervisor of PetroChina Company Limited.

**Mr. Zhang Ke**, aged 52, is an Independent Non-executive Director of the Company. Mr. Zhang graduated from Renmin University of China in 1982 with a Bachelor's degree of economics. He is a certified public accountant and senior accountant. Mr. Zhang is experienced in the fields of investment, managerial consultancy, finance and auditing, and is currently Chairman and chief partner of ShineWing Certified Public Accountants. Mr. Zhang is also a member of the Standing Council of CICPA, a member of CPA Examination Committee of the Ministry of Finance, and a part-time professor in the Renmin University of China and the Chinese Academy of Sciences.



## Supervisors

**Mr. Zhang Xianlin**, aged 52, is the Chairman of the Supervisory Committee. Mr. Zhang graduated from Huazhong University of Science and Technology with a Doctorate's degree in engineering and is a senior accountant. Mr. Zhang joined CAAC in 1974, and had served in the Finance Department of CAAC's Northern Administration Bureau and Deputy Director General of the Finance Department of CAAC. Mr. Zhang joined CNACG in 1997 as Vice President and has been promoted to Standing Vice President since 2001.

**Mr. Liao Wei**, aged 41, is a Supervisor of the Company. Mr. Liao graduated from China Southwest Finance University in 1986 majoring in accounting and is a senior accountant. Mr. Liao served as the Deputy Director of CAAC's Finance Department, the Director of Human Resources Administration of Air Macau, Deputy General Manager and General Manager of CNACG's investment department. Mr. Liao joined CNAHC in December 2002 as Deputy General Manager of CNAHC's finance department and has been promoted to General Manager since September 2003.

**Ms. Zhang Huilan**, aged 45, is a Supervisor of the Company. Ms. Zhang graduated from China Civil Aviation Institute in 1982 and from Asia (Macau) International Public University with an MBA degree in 2000. She is a senior accountant. Ms. Zhang holds IATA diploma in airline accounting and finance. Ms. Zhang joined CAAC in 1982, and had served as the financial controller of CNAC (Macau) and General Manager of finance department of CNAC (PRC). She had been the Deputy General Manager , Deputy General Manager of the Financial Department and the Asset Management Department of CNAHC since October 2002.

**Mr. Liu Feng**, aged 47, is a Supervisor of the Company and is the representative of the employees on the Supervisory Committee. Mr. Liu graduated from the China Central Party University. He joined Air China International Corporation in 1992 as Secretary to the Labour Union and has been serving as the Deputy Director of the Labour Union Office of Air China International Corporation since December 1995.

# Profile of Directors, Supervisors and Senior Management

**Mr. Liu Guo Qing**, aged 43, is a Supervisor of the Company and the representative of the employees on the Supervisory Committee and a committee member of the Labour Union. Mr. Liu graduated from the Beijing University of Technology majoring in automation, and is an assistant economist. He joined Air China International Corporation in December 1988 and worked in its Beijing ticketing and seat reservation centre until 1994, when he was transferred to the marketing department and market development department.

## Other Senior Management Personnel

**Mr. Cheng Yiru**, aged 57, graduated from China Civil Aviation Advanced School in 1971 majoring in aviation and is a First-Class Pilot. Mr. Cheng joined CAAC in 1968, and had served as the Deputy Commander and the Chief Commander of Chongqing Flight Team, Chengdu CAAC, as well as Deputy General Manager of China Southwest Airlines.. After the restructuring of CAAC in October 2002, he served as Vice President and General Manager of the southwest branch of Air China International Corporation, and has served the post of Vice President in Air China Limited since September 2004. As the Vice President, Mr. Cheng is mainly responsible for the fleet, aviation safety supervision, flying technique management and operation quality of the Company.

**Mr. Sun Yude**, aged 52, graduated from China Civil Aviation Institute in 1986 majoring in economic management. He joined CAAC in 1972, and served as the deputy head of CAAC Taiyuan Terminal and head of Ningbo Terminal, as well as General Manager of CNAC Zhejiang Airlines. After the restructuring of CAAC in October 2002, Mr. Sun joined Air China International Corporation as Vice President and General Manager of Zhejiang branch, and has served as Vice President of Air China Limited since September 2004. From December 2005 onwards, Mr. Sun has been serving as Chairman and President of Shandong Aviation Group. As the Vice President, Mr. Sun is mainly responsible for the planning and development department and information technology work of the Company.



**Mr. Ma Kuiliang**, aged 59, graduated from China Aviation Mechanics Vocational School in 1968 majoring in repair and maintenance of aircraft engine, and is a senior engineer. Mr. Ma joined CAAC in 1965, and had served as Deputy Chief Engineer of Air China International Corporation, General Manager of AMECO Beijing, and Assistant to President of Air China International Corporation. He became Vice President of Air China International Corporation after the restructuring of CAAC in October 2002, he became Vice President, and has served as Vice President of Air China Limited since September 2004. As the Vice President, Mr. Ma is mainly responsible for the aircraft engineering work of the Company.

**Ms. Yang Lihua**, aged 50, graduated from Beijing Languages University in 1977 majoring in French, and is a senior stewardess. She joined CAAC in 1973 and had served in Air China International Corporation as manager of Cabin Service Department, Deputy Chief of the Main Flight Team, and as General Manager of Passenger Service Department. Ms. Yang served as Vice President of Air China International Corporation after the restructuring of CAAC in October 2002, and has served as Vice President of Air China Limited since September 2004. As the Vice President, Ms. Yang is mainly responsible for cabin services, ground services and services quality of the Company.

**Mr. Gao Dianbang,** aged 57, graduated from China Civil Aviation Advanced School in 1969 and is a First-Class Pilot. He had served Air China International Corporation as Captain, Deputy Commander, Deputy Chief and Chief of the Main Flight Team, and was appointed as Assistant to President of Air China International Corporation in 2001. After the restructuring of CAAC in 2002, Mr. Gao served as the Chief Pilot of Air China International Corporation, and has served as the Chief Pilot of Air China Limited since September 2004. As the Chief Pilot, Mr. Gao is mainly responsible for overall flight operation management of the Company.

# Profile of Directors, Supervisors and Senior Management

**Mr. Zheng Baoan**, aged 42, graduated from the School of Business Management, Shangdong Economic University in 1985 with a Bachelor's degree in economics, and then graduated from Dalian University of Technology with a Master's degree in engineering in 1990 majoring in management engineering. Mr. Zheng was appointed as Section Manager of Shandong Qilu Securities Brokerage Co., Ltd. in 1994. In 2002, he was the Board Secretary and the Chief of Securities Department , and in 2002 the Deputy General Manager, Board Secretary and Chief of Securities Department of Shandong Airlines Co., Ltd. Mr. Zheng then joined Air China International Corporation in 2004 as a key officer participating in the overseas listing of the Company. Mr. Zheng has served as the Board Secretary, the Joint Company Secretary of Air China Limited since 2005, holding certifications of qualification in relation to Board Secretary issued by the Hong Kong Institute of Chartered Secretaries and Shenzhen Stock Exchange. He has served as a Supervisor of Shenzhen Airlines Company Limited since January 2005.

## Joint Company Secretaries

**Mr. Zheng Baoan**, his biographical details are set out in the section headed "Other Senior Management Personnel" above.

**Mr. Li Man Kit**, aged 49, is a Joint Company Secretary of the Company. He has been the Company Secretary of CNAC and CNACG since December 2000. Mr. Li graduated from the University of East Asia, Macau in business administration and also holds both a Bachelor's degree in Chinese Law and a Master's degree in International Law from Peking University. He is an associate member of the Institute of Chartered Secretaries and Administrators, UK and the Hong Kong Institute of Chartered Secretaries. Prior to joining the CNAC Group, Mr. Li was the company secretary of a shipping group of companies whose shares were listed in both Hong Kong and London. Mr. Li has many years of experience in para-legal, corporate reorganisation, administrative and personnel management and company secretarial work.



## Qualified Accountant

**Mr. David Tze-kin Ng**, aged 56, is a member of Hong Kong Institute of Certified Public Accountants. Mr. Ng graduated from Macquarie University in Australia, and has obtained various international professional accounting qualifications, including as a Certified Practising Accountant in Australia, Chartered Certified Accountant in the UK, fellow member of the Institute of Chartered Secretaries and Administrators, member of The Institute of Internal Auditors and member of the Association of International Accountants. Mr. Ng has 30 years of experience in the accounting profession. He had served in PricewaterhouseCoopers for eight years, responsible for auditing and taxation matters. Mr. Ng is currently the Director and the Chief Accountant of Hong Kong Great Wall Certified Public Accountants Limited, and has been appointed by the Hong Kong government as a committee member of Insider Dealing Tribunal.

# Report of the Independent Auditors

ERNST & YOUNG
安永會計師事務所

To the members
**Air China Limited**
*(Incorporated in the People's Republic of China with limited liability)*

We have audited the accompanying financial statements of Air China Limited (the "Company"), its subsidiaries and joint ventures (collectively the "Group"), which comprise the Company's and consolidated balance sheets as at 31 December 2005 and the consolidated income statement, consolidated statement of changes in equity and consolidated cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes, set out on pages 55 to 135 which have been prepared in accordance with International Financial Reporting Standards. These financial statements are the responsibility of the Company's Directors. Our responsibility is to express an opinion on these financial statements based on our audit. This report is made solely to you, as a body, and for no other purpose. We do not assume responsibility towards or accept liability to any other person for the contents of this report.

We conducted our audit in accordance with International Standards on Auditing. Those standards require that we plan and perform the audit to obtain reasonable assurance as to whether the financial statements are free from material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the Company's Directors, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.



In our opinion, the financial statements give a true and fair view of the financial position of the Company and of the Group as of 31 December 2005, and of the financial performance and cash flows of the Group for the year then ended in accordance with International Financial Reporting Standards and have been properly prepared in accordance with the disclosure requirements of the Hong Kong Companies Ordinance.

**Ernst & Young**
*Certified Public Accountants*

Hong Kong
18 April 2006

# Consolidated Income Statement

Year ended 31 December 2005

| | Notes | 2005 RMB'000 | 2004 RMB'000 |
|---|---|---|---|
| **Air traffic revenue** | 4 | **35,300,826** | 30,834,822 |
| **Other operating revenue** | 5 | **2,990,140** | 2,685,935 |
| **Turnover** | | **38,290,966** | 33,520,757 |
| **Operating expenses** | | | |
| Jet fuel | | **(11,777,129)** | (8,353,752) |
| Take-off, landing and depot charges | | **(4,442,585)** | (4,230,349) |
| Depreciation | | **(4,512,680)** | (3,463,252) |
| Aircraft maintenance, repair and overhaul | | **(1,341,773)** | (2,835,648) |
| Employee compensation costs | 7 | **(3,406,825)** | (2,921,322) |
| Air catering charges | | **(1,242,933)** | (1,171,784) |
| Aircraft and engine operating lease expenses | | **(1,530,754)** | (1,071,256) |
| Other operating lease expenses | | **(211,177)** | (187,471) |
| Other flight operation expenses | | **(3,744,977)** | (2,698,234) |
| Selling and marketing expenses | | **(1,775,026)** | (1,387,088) |
| General and administrative expenses | | **(631,291)** | (715,350) |
| **Total operating expenses** | | **(34,617,150)** | (29,035,506) |
| **Profit from operations** | 6 | **3,673,816** | 4,485,251 |
| **Finance revenue** | 8 | **1,248,607** | 79,361 |
| **Finance costs** | 8 | **(1,773,099)** | (1,879,234) |
| **Dilution gains on investments** | 9 | **–** | 410,137 |
| **Share of profits less losses from associates** | 19 | **224,930** | 464,044 |
| **Profit before tax** | | **3,374,254** | 3,559,559 |
| **Tax** | 12 | **(903,874)** | (1,010,864) |
| **Profit for the year** | | **2,470,380** | 2,548,695 |
| **Attributable to:** | | | |
| **Equity holders of the parent** | | **2,406,256** | 2,385,964 |
| **Minority interests** | | **64,124** | 162,731 |
| | | **2,470,380** | 2,548,695 |
| **Dividend** | 13 | | |
| **Interim** | | **–** | – |
| **Proposed final** | | **224,793** | – |
| | | **224,793** | – |
| **Earnings per share attributable to equity holders of the parent** | 14 | | |
| **Basic** | | **25.5 cents** | 36.0 cents |
| **Diluted** | | **N/A** | 36.0 cents |

# Consolidated Balance Sheet

31 December 2005

| | Notes | 2005 RMB'000 | 2004 RMB'000 |
|---|---|---|---|
| **NON-CURRENT ASSETS** | | | |
| Property, plant and equipment | 15 | **47,190,728** | 43,441,637 |
| Lease prepayments | 16 | **1,072,066** | 933,898 |
| Interests in associates | 19 | **3,793,957** | 4,001,521 |
| Advance payments for aircraft and related equipment | | **7,329,322** | 2,825,612 |
| Due from CNAHC | 20 | **531,813** | 631,813 |
| Deposits for aircraft under operating leases | | **222,945** | 137,583 |
| Available-for-sale investments | 21 | **22,266** | 21,666 |
| Deferred tax assets | 22 | **498,371** | 776,084 |
| | | **60,661,468** | 52,769,814 |
| **CURRENT ASSETS** | | | |
| Financial assets | 44(c) | **127,659** | – |
| Trade receivables | 23 | **2,764,475** | 2,364,816 |
| Inventories | 24 | **851,315** | 743,288 |
| Prepayments, deposits and other receivables | 25 | **762,435** | 915,130 |
| Pledged deposits | 26 | **176,575** | 117,231 |
| Non-pledged deposits with maturity of more than three months when acquired | 26 | **97,375** | 320,850 |
| Cash and cash equivalents | 26 | **2,248,386** | 9,413,224 |
| Due from CNAHC | 34 | **474,216** | – |
| Due from other CNAHC group companies | 27 | **38,039** | 44,916 |
| | | **7,540,475** | 13,919,455 |
| **TOTAL ASSETS** | | **68,201,943** | 66,689,269 |
| **CURRENT LIABILITIES** | | | |
| Financial liabilities | 44(c) | **(1,791)** | – |
| Trade payables | 28 | **(4,601,364)** | (4,443,608) |
| Bills payable | 29 | **(327,937)** | (362,033) |
| Other payables and accruals | 30 | **(4,168,435)** | (3,920,287) |
| Provision for major overhauls | 31 | **(18,721)** | (28,130) |
| Air traffic liabilities | | **(1,476,619)** | (1,215,770) |
| Tax payable | | **(421,077)** | (186,055) |
| Obligations under finance leases | 32 | **(1,954,873)** | (1,705,146) |
| Bank and other loans | 33 | **(10,401,170)** | (8,806,051) |
| Due to CNAHC and CNACG | 34 | **(133,680)** | (2,256,117) |
| Due to other CNAHC group companies | 27 | **(40,471)** | (49,617) |
| | | **(23,546,138)** | (22,972,814) |
| **NET CURRENT LIABILITIES** | | **(16,005,663)** | (9,053,359) |
| **TOTAL ASSETS LESS CURRENT LIABILITIES** | | **44,655,805** | 43,716,455 |

# Consolidated Balance Sheet

31 December 2005

| | Notes | 2005<br>RMB'000 | 2004<br>RMB'000 |
|---|---|---|---|
| **NON-CURRENT LIABILITIES** | | | |
| Obligations under finance leases | 32 | **(8,078,671)** | (10,576,241) |
| Bank and other loans | 33 | **(12,822,879)** | (12,896,622) |
| Long term payables | 35 | **(352,880)** | (446,311) |
| Deferred income | 36 | **(1,025,910)** | (1,102,853) |
| Provision for major overhauls | 31 | **(635,718)** | (470,698) |
| Provision for early retirement benefits obligations | | **(189,141)** | (195,188) |
| | | **(23,105,199)** | (25,687,913) |
| **NET ASSETS** | | **21,550,606** | 18,028,542 |
| **Represented by:** | | | |
| **EQUITY ATTRIBUTABLE TO EQUITY HOLDERS OF THE PARENT** | | | |
| Issued share capital | 37 | **9,433,211** | 9,050,618 |
| Reserves | 38 | **10,659,030** | 7,497,637 |
| | | **20,092,241** | 16,548,255 |
| **MINORITY INTERESTS** | | **1,458,365** | 1,480,287 |
| **TOTAL EQUITY** | | **21,550,606** | 18,028,542 |

**Ma Xulun**
*Director*

**Fan Cheng**
*Director*

# Consolidated Statement of Changes in Equity

Year ended 31 December 2005

| | Attributable to equity holders of the parent | | | | | | | | Minority interests RMB'000 | Total equity RMB'000 |
|---|---|---|---|---|---|---|---|---|---|---|
| | Owners' equity RMB'000 | Issued share capital RMB'000 | Capital reserve RMB'000 | Reserve funds RMB'000 | Retained earnings RMB'000 | Foreign exchange translation reserve RMB'000 | Proposed final dividend RMB'000 | Total RMB'000 | | |
| As at 1 January 2004 | 6,892,869 | – | – | – | – | – | – | 6,892,869 | 1,422,380 | 8,315,249 |
| Capital contribution of cash *(note a)* | 560,782 | – | – | – | – | – | – | 560,782 | – | 560,782 |
| Capital contribution of land use rights *(note b)* | 885,626 | – | – | – | – | – | – | 885,626 | – | 885,626 |
| Capitalisation of amount payable to CNAHC *(note c)* | 17,965 | – | – | – | – | – | – | 17,965 | – | 17,965 |
| Deferred taxation *(note 22)* | 793,755 | – | – | – | – | – | – | 793,755 | – | 793,755 |
| Profit from 1 January 2004 to 30 September 2004 | 1,758,879 | – | – | – | – | – | – | 1,758,879 | 117,506 | 1,876,385 |
| Dividend paid | (29,074) | – | – | – | – | – | – | (29,074) | (24,909) | (53,983) |
| Distributions *(note d)* | (2,182,921) | – | – | – | – | – | – | (2,182,921) | – | (2,182,921) |
| Capitalisation upon reorganisation of the Company | (8,697,881) | 6,500,000 | 1,892,201 | – | 305,680 | – | – | – | – | – |
| Profit from 1 October 2004 to 31 December 2004 | – | – | – | – | 627,085 | – | – | 627,085 | 45,225 | 672,310 |
| Distributions *(note e)* | – | – | – | – | (377,550) | – | – | (377,550) | – | (377,550) |
| Dilution of interest *(note 9(b))* | – | – | – | – | – | – | – | – | (79,915) | (79,915) |
| Transfer to reserve funds *(note 13)* | – | – | – | 93,020 | (93,020) | – | – | – | – | – |
| Issue of new shares upon listing *(note 37(e))* | – | 2,550,618 | 5,536,678 | – | – | – | – | 8,087,296 | – | 8,087,296 |
| Share issue expenses *(note 37(e))* | – | – | (486,457) | – | – | – | – | (486,457) | – | (486,457) |
| As at 31 December 2004 and 1 January 2005 | – | 9,050,618 | 6,942,422 | 93,020 | 462,195 | – | – | 16,548,255 | 1,480,287 | 18,028,542 |
| Profit for the year | – | – | – | – | 2,406,256 | – | – | 2,406,256 | 64,124 | 2,470,380 |
| Transfer to reserve funds *(note 13)* | – | – | – | 269,864 | (269,864) | – | – | – | – | – |
| Proposed final dividend *(note 13(d))* | – | – | – | – | (224,793) | – | 224,793 | – | – | – |
| Issue of new shares *(note 37(b))* | – | 382,593 | 830,414 | – | – | – | – | 1,213,007 | – | 1,213,007 |
| New capital contribution by a minority shareholder of a subsidiary | – | – | – | – | – | – | – | – | 2,940 | 2,940 |
| Share issue expenses *(note 37(b))* | – | – | (40,910) | – | – | – | – | (40,910) | – | (40,910) |
| Dividends paid to minority shareholders by subsidiaries | – | – | – | – | – | – | – | – | (68,611) | (68,611) |
| Exchange realignment | – | – | – | – | – | (34,367) | – | (34,367) | (20,375) | (54,742) |
| **As at 31 December 2005** | **–** | **9,433,211** | **7,731,926** | **362,884** | **2,373,794** | **(34,367)** | **224,793** | **20,092,241** | **1,458,365** | **21,550,606** |

# Consolidated Statement of Changes in Equity

Year ended 31 December 2005

*Notes:*

a. In September 2004, China National Aviation Holding Company ("CNAHC") made a cash contribution of approximately RMB561 million to the Company.

b. Upon incorporation of the Company, CNAHC effected the transfer of certain land use rights in an aggregate amount of approximately RMB885,626,000 to the Company.

c. This represented a payable of RMB17,965,000 of the Company assumed by CNAHC in 2004 which was accounted for as a capital contribution.

d. In accordance with the (財政部關於印發《企業公司制改建有關國有資本管理與財務處理的暫行規定》的通知) "Provisional Regulations Relating to Corporate Reorganisation of Enterprises and Related Management of State-owned Capital and Financial Treatment" notice issued by the Ministry of Finance (the English title is a direct translation of the Chinese title of the notice) and pursuant to the Restructuring as set out in note 1 to these financial statements, after the Company's incorporation, the Company is required to make a distribution to CNAHC and China National Aviation Corporation (Group) Limited ("CNACG" and which is a Hong Kong incorporated company wholly owned by CNAHC), details of which are set out in note 13(b) to these financial statements. The total amount of distributions made to CNAHC and CNACG pursuant to this notice is approximately RMB2,143,785,000. Details of the distributions are set out in note 13 (b) to these financial statements.

   In addition, the distributions include an amount of approximately RMB39,136,000 which represents the net assets which have been carved out and treated as deemed distribution pursuant to the Restructuring as set out in note 1 to these financial statements.

e. As a result of the completion of the BACL Agreement, SWACL Agreement and HKSACL Agreement, details of which are set out in note 13(a) to these financial statements, the Group made a payment of approximately RMB377,550,000 to CNAHC. This payment has been made to CNAHC and accounted for as a special distribution to CNAHC by the Company.

# Consolidated Cash Flow Statement

Year ended 31 December 2005

| | 2005 RMB'000 | 2004 RMB'000 |
|---|---|---|
| **CASH FLOWS FROM OPERATING ACTIVITIES** | | |
| Profit before tax | **3,374,254** | 3,559,559 |
| Adjustments for: | | |
| Exchange (gains)/losses, net | **(1,053,839)** | 161,824 |
| (Gain)/loss on disposal of property, plant and equipment, net | **(74,474)** | 33,872 |
| Loss on derecognition of property, plant and equipment | **430,010** | – |
| Gains on fuel derivatives, net | **(221,661)** | (41,036) |
| Dilution gains on investments | **–** | (410,137) |
| Depreciation | **4,512,680** | 3,463,252 |
| Amortisation of lease prepayments | **19,555** | 4,884 |
| Share of profits less losses from associates | **(224,930)** | (464,044) |
| Dividend income from available-for-sale investments | **(168)** | (4,622) |
| Interest income | **(108,481)** | (33,703) |
| Interest expense, net of interest capitalised | **1,773,099** | 1,824,392 |
| Provision/(write-back of provision) for doubtful debts, net | **14,723** | (988) |
| Write-back of provision against inventories, net | **–** | (11,508) |
| Operating profit before working capital changes | **8,440,768** | 8,081,745 |
| Increase in inventories | **(108,027)** | (19,681) |
| Increase in trade receivables | **(414,382)** | (425,080) |
| Increase in amount due from CNAHC | **(474,216)** | – |
| Increase in amount due to CNACG | **15,000** | – |
| Decrease in amounts due from other CNAHC group companies | **6,877** | 19,012 |
| (Increase)/decrease in prepayments, deposits and other receivables | **141,183** | (164,606) |
| (Increase)/decrease in deposits for aircraft under operating leases | **(73,850)** | 18,581 |
| Increase/(decrease) in amounts due to other CNAHC group companies | **(9,146)** | 16,544 |
| Increase in trade payables | **157,756** | 268,645 |
| Decrease in bills payable | **(34,096)** | (955,187) |
| Increase in other payables and accruals | **211,509** | 1,154,425 |
| Increase in provision for major overhauls | **155,611** | 93,889 |
| Increase in air traffic liabilities | **260,849** | 52,664 |
| Decrease in provision for early retirement benefits obligations | **(6,047)** | (3,409) |
| Recognition of deferred income | **(76,943)** | (70,593) |
| Cash generated from operations | **8,192,846** | 8,066,949 |
| Interest paid | **(1,754,184)** | (1,872,691) |
| Tax paid: | | |
| Mainland China enterprise income tax paid | **(378,675)** | (36,953) |
| Overseas taxes paid | **(12,464)** | (1,568) |
| **NET CASH INFLOW FROM OPERATING ACTIVITIES** | **6,047,523** | 6,155,737 |

# Consolidated Cash Flow Statement

Year ended 31 December 2005

| | 2005 RMB'000 | 2004 RMB'000 |
|---|---|---|
| **CASH FLOWS FROM INVESTING ACTIVITIES** | | |
| Purchases of property, plant and equipment | **(8,787,258)** | (5,270,777) |
| Proceeds from disposal of property, plant and equipment | **179,493** | 189,840 |
| Increase in lease prepayments | **(157,723)** | (23,349) |
| Additions of advance payments for aircraft and related equipment | **(4,503,710)** | (867,828) |
| Net cash settlements of fuel derivatives | **95,793** | 69,036 |
| Decrease in amounts due from associates | **27,894** | 4,461 |
| Increase in amounts due to associates | **14,314** | 58,796 |
| (Increase)/decrease in time deposits with original maturity of more than three months | **223,475** | (290,024) |
| (Increase)/decrease in pledged deposits | **(59,344)** | 1,128,311 |
| Interest received | **108,481** | 33,703 |
| Capital contributions to associates | **–** | (709,253) |
| Dividends received from available-for-sale investments | **168** | 4,622 |
| Dividends received from associates | **358,609** | 176,365 |
| Proceeds from disposal of available-for-sale investments | **–** | 264 |
| Purchases of available-for-sale investments | **(600)** | – |
| Net cash inflow of cash and cash equivalents in respect of the establishment of a joint venture *(note 45 (a))* | **–** | 516,491 |
| **NET CASH OUTFLOW FROM INVESTING ACTIVITIES** | **(12,500,408)** | (4,979,342) |
| **NET CASH INFLOW/(OUTFLOW) BEFORE FINANCING ACTIVITIES** | **(6,452,885)** | 1,176,395 |
| **CASH FLOWS FROM FINANCING ACTIVITIES** | | |
| New bank and other loans | **10,480,685** | 10,146,285 |
| Repayment of bank and other loans | **(8,680,857)** | (10,500,107) |
| Repayment of principal under finance lease obligations | **(1,540,238)** | (1,607,056) |
| Settlement of long-term payables | **(95,015)** | (119,946) |
| Decrease in amount due to CNAHC | **(2,037,437)** | (468,789) |
| Contributions by CNAHC | **–** | 560,782 |
| Dividends paid to minority shareholders | **(68,611)** | (24,909) |
| Receipt of government grants | **–** | 32,609 |
| Net proceeds from issuance of new shares upon listing | **1,172,097** | 7,600,839 |
| New capital contribution by a minority shareholder of a subsidiary | **2,940** | – |
| **NET CASH INFLOW/(OUTFLOW) FROM FINANCING ACTIVITIES** | **(766,436)** | 5,619,708 |
| **EFFECT OF EXCHANGE RATE CHANGES ON CASH AND CASH EQUIVALENTS** | **54,483** | 27,726 |
| **NET INCREASE/(DECREASE) IN CASH AND CASH EQUIVALENTS** | **(7,164,838)** | 6,823,829 |
| Cash and cash equivalents at beginning of year | **9,413,224** | 2,589,395 |
| **CASH AND CASH EQUIVALENTS AT END OF YEAR** | **2,248,386** | 9,413,224 |

# Balance Sheet

31 December 2005

| | Notes | 2005 RMB'000 | 2004 RMB'000 |
|---|---|---|---|
| **NON-CURRENT ASSETS** | | | |
| Property, plant and equipment | 15 | **45,025,463** | 41,908,428 |
| Lease prepayments | 16 | **1,052,493** | 919,871 |
| Interests in subsidiaries | 17 | **140,075** | 176,929 |
| Interests in joint ventures | 18 | **1,398,595** | 1,392,388 |
| Interests in associates | 19 | **723,365** | 780,837 |
| Advance payments for aircraft and related equipment | | **6,997,560** | 2,400,586 |
| Due from CNAHC | 20 | **531,813** | 631,813 |
| Deposits for aircraft under operating leases | | **146,575** | 55,831 |
| Available-for-sale investments | 21 | **816** | 816 |
| Deferred tax assets | 22 | **391,000** | 658,000 |
| | | **56,407,755** | 48,925,499 |
| **CURRENT ASSETS** | | | |
| Financial assets | 44(c) | **115,220** | – |
| Trade receivables | 23 | **2,517,384** | 2,197,293 |
| Inventories | 24 | **541,453** | 468,930 |
| Prepayments, deposits and other receivables | 25 | **651,778** | 889,037 |
| Pledged deposits | 26 | **84,048** | 80,519 |
| Non-pledged deposits with maturity of more than three months when acquired | 26 | **20,875** | 313,768 |
| Cash and cash equivalents | 26 | **891,923** | 8,108,091 |
| Due from CNAHC | 34 | **474,216** | – |
| Due from other CNAHC group companies | 27 | **12,993** | 8,801 |
| | | **5,309,890** | 12,066,439 |
| **TOTAL ASSETS** | | **61,717,645** | 60,991,938 |
| **CURRENT LIABILITIES** | | | |
| Financial liabilities | 44(c) | **(1,791)** | – |
| Trade payables | 28 | **(3,666,128)** | (3,819,353) |
| Bills payable | 29 | **(327,937)** | (362,033) |
| Other payables and accruals | 30 | **(3,568,896)** | (3,387,870) |
| Provision for major overhauls | 31 | **(18,721)** | (28,130) |
| Air traffic liabilities | | **(1,337,948)** | (1,087,838) |
| Tax payable | | **(392,984)** | (151,533) |
| Obligations under finance leases | 32 | **(1,954,873)** | (1,705,146) |
| Bank and other loans | 33 | **(10,127,847)** | (8,255,695) |
| Due to CNAHC and CNACG | 34 | **(118,680)** | (2,240,213) |
| Due to other CNAHC group companies | 27 | **(22,413)** | (12,163) |
| | | **(21,538,218)** | (21,049,974) |
| **NET CURRENT LIABILITIES** | | **(16,228,328)** | (8,983,535) |
| **TOTAL ASSETS LESS CURRENT LIABILITIES** | | **40,179,427** | 39,941,964 |

# Balance Sheet

31 December 2005

| | Notes | 2005 RMB'000 | 2004 RMB'000 |
|---|---|---|---|
| **NON-CURRENT LIABILITIES** | | | |
| Obligations under finance leases | 32 | **(8,078,671)** | (10,576,241) |
| Bank and other loans | 33 | **(12,448,067)** | (12,896,622) |
| Long term payables | 35 | **(317,379)** | (437,577) |
| Deferred income | 36 | **(1,025,910)** | (1,102,853) |
| Provision for major overhauls | 31 | **(474,571)** | (373,242) |
| Provision for early retirement benefits obligations | | **(189,141)** | (195,188) |
| | | **(22,533,739)** | (25,581,723) |
| **NET ASSETS** | | **17,645,688** | 14,360,241 |
| **Represented by:** | | | |
| Issued share capital | 37 | **9,433,211** | 9,050,618 |
| Reserves | 38 | **8,212,477** | 5,309,623 |
| **TOTAL EQUITY** | | **17,645,688** | 14,360,241 |



**Ma Xulun**
*Director*

**Fan Cheng**
*Director*

# Notes to Financial Statements

31 December 2005

## 1. GROUP REORGANISATION, PRINCIPAL ACTIVITIES AND BASIS OF PRESENTATION OF FINANCIAL STATEMENTS

Air China Limited (the "Company") was incorporated on 30 September 2004 in Beijing, the People's Republic of China (the "PRC" or "Mainland China"), as a joint stock limited company as part of the restructuring (the "Restructuring") of CNAHC, a PRC state-owned enterprise under the supervision of the State Council, in preparation for the listing of the Company's H shares on The Stock Exchange of Hong Kong Limited (the "Hong Kong Stock Exchange") and the London Stock Exchange as described below.

As disclosed in the Company's prospectus dated 3 December 2004, pursuant to the Restructuring, CNAHC and through its wholly-owned subsidiaries, effected the transfer of the following to the Company upon its incorporation:

(a) the assets, liabilities and undertakings which principally relate to airline operations (the "Relevant Businesses"); and

(b) the shareholding interests in certain subsidiaries, joint ventures and associates which principally engage in airline operations, the provision of aircraft engineering services, air catering services, airport ground handling services and other airline-related businesses (the "Relevant Companies").

The principal activities of the Company, its subsidiaries and joint ventures (collectively the "Group") and associates are airline and airline-related services, including aircraft engineering services, air catering services and airport ground handling services conducted mainly in Mainland China, Hong Kong and Macau.



The registered office of the Company is located at 9th Floor, Blue Sky Mansion, 28 Tianzhu Road, Zone A, Tianzhu Airport Industrial Zone, Shunyi District, Beijing 101312, the PRC.

In the opinion of the Directors, the Company's parent and ultimate holding company is CNAHC.

As CNAHC controlled the Relevant Businesses and the Relevant Companies before the Restructuring and continues to control the Company after the Restructuring, the consolidated financial statements of the Group prior to the incorporation of the Company on 30 September 2004 had been prepared as a reorganisation of companies under common control in a manner similar to a pooling-of-interests.

The consolidated results and consolidated cash flows for the year ended 31 December 2004 include the Group's results of operations and cash flows as if the Relevant Businesses and interests in the Relevant Companies had been transferred to the Group at 1 January 2001, which is the earliest date for the preparation of the financial information in relation to the listing of the Company's H shares. The Company's Directors are of the opinion that the consolidated income statement and consolidated cash flow statement prepared on this basis present fairly the consolidated results and consolidated cash flows of the Group as a whole.

# Notes to Financial Statements

Year ended 31 December 2005

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### Basis of preparation

The consolidated financial statements of the Group have been prepared in accordance with International Financial Reporting Standards ("IFRSs") which comprise standards and interpretations approved by the International Accounting Standards Board, and International Accounting Standards ("IAS") and Standing Interpretations Committee interpretations approved by the International Accounting Standards Committee that remain in effect. The consolidated financial statements are presented in Renminbi ("RMB") and all values are rounded to the nearest thousand (RMB'000) except when otherwise indicated.

The consolidated financial statements of the Group have been prepared on a historical cost basis, except for the measurement at fair value of financial instruments in accordance with IAS 39 (amended 2004) *Financial Instruments: Recognition and Measurement*.

The principal accounting policies used in the preparation of the consolidated financial statements of the Group are consistent with those used in the annual audited financial statements of the Group for the year ended 31 December 2004, except that the Group has adopted the following new/revised standards mandatory for financial years beginning on or after 1 January 2005.

(a) IFRS 2 *Share-based Payment* requires the Group to recognise share-based payment transactions in its financial statements, including transactions with employees or other parties to be settled in cash, other assets, or equity instruments of the Group. For equity-settled share-based payment transactions, IFRS 2 requires an entity to measure the goods or services received, and the corresponding increase in equity, directly, at the fair value of the goods or services received, unless that fair value cannot be estimated reliably. If the Group cannot estimate reliably the fair value of the goods or services received, the Group is required to measure their value, and the corresponding increase in equity, indirectly, by reference to the fair value of the equity instruments granted. For cash-settled share-based payment transactions, IFRS 2 requires an entity to measure the goods or services acquired and the liability incurred at the fair value of the liability. Until the liability is settled, the Group is required to re-measure the fair value of the liability at each reporting date and at the date of settlement, with any changes in value recognised in the income statement for the period. For share-based payment transactions in which the terms of the arrangement provide either the Group or the supplier of goods or services with a choice of whether the Group settles the transaction in cash or by issuing equity instruments, the Group is required to account for that transaction, or the components of that transaction, as a cash-settled share-based payment transaction if, and to the extent that, the Group has incurred a liability to settle in cash (or other assets), or as an equity settled share-based payment transaction if, and to the extent that, no such liability has been incurred. The provisions of IFRS 2 apply to grants of shares, share options or other equity instruments that were granted after 7 November 2002 and had not yet vested on or after 1 January 2005. The adoption of IFRS 2 did not give rise to any adjustment to the opening balances of retained earnings of the current and prior years or to any change in comparatives.

# Notes to Financial Statements

Year ended 31 December 2005

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### Basis of preparation (Continued)

(b) IAS 16 (amended 2004) *Property, Plant and Equipment* replaces IAS 16 (revised 1998), *Property, Plant and Equipment*. There are a number of differences between the amended standard and the previous version. Firstly, the amended standard requires an entity to evaluate under the general recognition principle all property, plant and equipment costs at the time they are incurred. Those costs include costs incurred initially to acquire or construct an item of property, plant and equipment and costs incurred subsequently to add to, replace part of, or service an item. The previous version of IAS 16 contained specific recognition principles for the accounting of subsequent costs. Secondly, the amended standard requires that the cost of an item of property, plant and equipment includes the costs of its dismantlement, removal or restoration, and the obligation for which an entity incurs as a consequence of installing the item. Its cost also includes the costs of its dismantlement, removal or restoration, and the obligation for which an entity incurs as a consequence of using the item during a particular period for purposes other than to produce inventories during that period. The previous version of the standard included within its scope only the costs incurred as a consequence of installing the item. Thirdly, under the amended standard an entity is required to determine the depreciation charge separately for each significant part of an item of property, plant and equipment, a requirement which was not clearly set out in the previous version. In addition, under the amended standard, an entity is required to measure the residual value of an item of property, plant and equipment as the amount that it estimates it would currently receive for the asset if the asset was already of the age and in the condition expected at the end of its useful life. The previous version of IAS 16 did not specify whether the residual value was to be this amount or the amount, inclusive of the effects of inflation, that an entity expected to receive at the asset's actual retirement date. Furthermore, the amended standard requires major inspection and overhaul costs to be recognised in the carrying amount of an item of property, plant and equipment when such services are performed.



The adoption of the revised treatment of IAS 16 (amended 2004) has been accounted for prospectively, which resulted in the following:

(i) In prior years, the aircraft were depreciated over their estimated useful lives of 20 years. With effect from 1 January 2005, the estimated useful lives of certain components within the aircraft which are subject to replacement during major overhauls have been reduced to the life of the overhaul cycle. The change in accounting estimate has increased the Group's depreciation charge for the year ended 31 December 2005 by approximately RMB899 million. As a result, the profit after tax of the Group for the year ended 31 December 2005 has decreased by approximately RMB604 million.

(ii) Major overhaul costs incurred for the year ended 31 December 2005 of approximately RMB1,639 million have been capitalised and depreciated over the life of the overhaul cycle. Prior to 1 January 2005, such costs have been charged to the income statement on an incurred basis. In this respect, the costs of aircraft maintenance, repair and overhaul of the Group charged to the income statement for the year ended 31 December 2005 decreased by RMB1,639 million. In addition, the Group has derecognised and charged to the income statement for the year ended 31 December 2005 the carrying amount of certain components of approximately RMB430 million which have been replaced during the major overhaul. As a result, the profit after tax of the Group for the year ended 31 December 2005 has increased by approximately RMB824 million.

(c) IAS 24 (revised 2003) *Related Party Disclosures* replaces IAS 24 *Related Party Disclosures* (reformatted in 1994). The main objective of such revision was to provide additional guidance and clarity in the scope of IAS 24 for the definition and the disclosures for related parties. The wording of IAS 24's objective was amended to clarify that the Group's financial statements should contain the disclosures necessary to draw attention to the possibility that the financial position and the income statement may have been affected by the existence of related parties and by transactions and outstanding balances with them. Since IAS 24 is a standard for disclosure requirements only, there is no material effect on the Group's results of operations and financial position upon adoption.

# Notes to Financial Statements

Year ended 31 December 2005

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### Basis of preparation (Continued)

*IFRSs and International Financial Reporting Interpretation Committee Interpretations ("IFRIC Interpretations") not yet effective*

The Group has not applied the following new and revised IFRSs and IFRIC interpretations that have been issued but are not yet effective in these financial statements:

| | |
|---|---|
| IAS 1 Amendment | *Capital Disclosures* |
| IAS 19 Amendment | *Actuarial Gains and Losses, Group Plans and Disclosures* |
| IAS 39 Amendment | *Cash Flow Hedge Accounting of Forecast Intragroup Transactions* |
| IAS 39 Amendment | *The Fair Value Option* |
| IAS 39 and IFRS 4 Amendments | *Financial Guarantee Contracts* |
| IFRS 1 and IFRS 6 Amendments | *First-time Adoption of International Financial Reporting Standards and Exploration for and Evaluation of Mineral Resources* |
| IFRS 6 | *Exploration for and Evaluation of Mineral Resources* |
| IFRS 7 | *Financial Instruments: Disclosures* |
| IFRIC – Int 4 | *Determining whether an Arrangement contains a Lease* |
| IFRIC – Int 5 | *Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds* |
| IFRIC – Int 6 | *Liabilities arising from Participating in a Specific Market – Waste Electrical and Electronic Equipment* |



The above standards and interpretations are required to be applied for annual periods beginning on or after 1 January 2006.

The IAS 1 Amendment shall be applied for annual periods beginning on or after 1 January 2007. The revised standard will affect the disclosures about qualitative information about the Group's objective, policies and procedures for managing capital; quantitative data about what the Company regards as capital and compliance with any capital requirements and the consequences of any non-compliance.

IFRS 7 will replace IAS 32 and has modified the disclosure requirements of IAS 32 relating to financial instruments. The IFRS shall be applied for annual periods beginning on or after 1 January 2007.

In accordance with the amendments to IAS 39 and IFRS 4 regarding financial guarantee contracts, financial guarantee contracts are initially recognised at fair value and are subsequently measured at the higher of (i) the amount determined in accordance with IAS 37 and (ii) the amount initially recognised less cumulative amortisation, when appropriate, recognised in accordance with IAS 18.

The IAS 19 Amendment, IAS 39 Amendments regarding cash flow hedge accounting of forecast intragroup transactions and the fair value option, IFRSs 1 and 6 Amendments, IFRS 6, IFRIC-Int 4, IFRIC-Int 5 and IFRIC-Int 6 do not apply to the activities of the Group. IFRIC-Int 6 shall be applied for annual periods beginning on or after 1 December 2005.

Except as stated above, the Group expects that the adoption of the other pronouncements listed above will not have any significant impact on the Group's financial statements in the period of initial application.

# Notes to Financial Statements

Year ended 31 December 2005

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### Basis of consolidation

The consolidated financial statements comprise the financial statements of the Company and its subsidiaries. The financial statements of the subsidiaries are prepared for the same reporting year as the parent company, using consistent accounting policies. Adjustments are made to bring into line any dissimilar accounting policies that may exist.

Subsidiaries are fully consolidated from the date on which control is transferred to the Group and cease to be consolidated from the date on which control is transferred out of the Group. This control is normally evidenced when the Group owns, either directly or indirectly, more than 50% of the voting rights of a company's share or registered capital, is able to govern the financial and operating policies of an enterprise so as to benefit from its activities. All significant inter-company transactions and balances within the Group are eliminated on consolidation.

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

### Foreign currency translation



The consolidated financial statements are presented in RMB, which is the Company's functional and presentation currency. Each entity in the Group determines its own functional currency and items included in the financial statements of each entity are measured using that functional currency. Transactions in foreign currencies are initially recorded in the functional currency rate ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are retranslated at the functional currency rate of exchange ruling at the balance sheet date. All differences are taken to the income statement. Non-monetary items that are measured in terms of historical cost in a foreign currency are translated using the exchange rates as at the dates of the initial transactions. Non-monetary items measured at fair value in a foreign currency are translated using the exchange rates at the date when the fair value was determined.

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

### Subsidiaries

A subsidiary is a company whose financial and operating policies the Company controls, directly or indirectly, so as to obtain benefits from its activities. A subsidiary is consolidated from the date the Company obtains control until such time as control ceases.

The results of subsidiaries are included in the Company's income statement to the extent of dividends received and receivable. In the Company's balance sheet, the Company's interests in subsidiaries are stated at cost less any impairment losses.

### Interests in joint ventures

The Group has interests in certain joint ventures which are jointly-controlled entities. A joint venture is a contractual arrangement whereby two or more parties undertake an economic activity that is subject to joint control, and a jointly-controlled entity is a joint venture that involves the establishment of a separate entity in which each venturer has an interest.

# Notes to Financial Statements

Year ended 31 December 2005

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### Interests in joint ventures (Continued)

The Group recognises its interests in the joint ventures using proportionate consolidation. The Group combines its share of each of the assets, liabilities, income and expenses of the joint ventures with the similar items, line by line, in its consolidated financial statements. The financial statements of the joint ventures are prepared for the same reporting year as the parent, using consistent accounting policies. Adjustments are made to bring into line any dissimilar accounting policies that may exist.

When the Group contributes or sells assets to the joint ventures, any portion of gain or loss from the transaction is recognised based on the substance of the transaction. When the Group purchases assets from the joint ventures, the Group does not recognise its share of the profits of the joint ventures from the transaction until it resells the assets to an independent party.

The joint ventures are proportionately consolidated until the date on which the Group ceases to have joint control over the joint ventures.

### Interests in associates

The Group's interests in its associates is accounted for under the equity method of accounting. An associate is an entity in which the Group has significant influence and which is neither a subsidiary nor a joint venture of the Group.

Under the equity method, the interests in associates are carried in the consolidated balance sheet at cost plus post-acquisition changes in the Group's share of net assets of the associates. Goodwill relating to the associates is included in the carrying amount of the investment and is not amortised. After application of the equity method, the Group determines whether it is necessary to recognise any additional impairment loss with respect to the Group's net investment in the associates. The consolidated income statement reflects the share of the results of operations of the associates. Where there has been a change recognised directly in the equity of the associates, the Group recognises its share of any changes and disclose this, when applicable, in the consolidated statement of changes in equity.



The reporting dates of the associates and the Group are identical and the associates' accounting policies conform to those used by the Group for like transactions and events in similar circumstances. Adjustments are made to bring into line any dissimilar accounting policies that may exist.

In the Company's balance sheet, the investments in associates are stated at cost less any impairment losses. The results of associates are accounted for by the Company on the basis of dividends received and receivable.

### Property, plant and equipment

Property, plant and equipment, other than construction in progress ("CIP"), are stated at cost, excluding the costs of day-to-day servicing, less accumulated depreciation and accumulated impairment in value. Such costs include the costs of replacing part of such property, plant and equipment when the costs are incurred if the recognition criteria are met.

CIP represents office buildings and various infrastructure projects under construction and equipment pending installation in the aircraft and is stated at cost less any impairment losses, and is not depreciated. Costs comprise the direct costs of construction, the cost of equipment as well as finance charges from borrowings used to finance these assets during the construction or installation period. CIP is reclassified to the appropriate categories of property, plant and equipment when completed and ready for use.

# Notes to Financial Statements

Year ended 31 December 2005

## 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### Property, plant and equipment (Continued)

Depreciation is calculated on a straight-line basis over the useful life of the asset, after taking into account its estimated residual value, as follows:

| | Depreciation life | Residual value |
|---|---|---|
| Aircraft and flight equipment | 4 to 20 years | Nil-5% |
| Buildings | 15 to 35 years | 5% |
| Machinery, transportation equipment and office equipment | 4 to 20 years | 5% |

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

The carrying values of property, plant and equipment are reviewed for impairment when events or changes in circumstances indicate that the carrying value may not be recoverable. The asset's residual value, useful life and methods are reviewed, and adjusted if appropriate, at each year end.



When each major inspection is performed, its cost is recognised in the carrying amount of the property, plant and equipment as a replacement if the recognition criteria are satisfied.

### Lease prepayments

Lease prepayments represent acquisition costs of land use rights less accumulated amortisation and impairment losses.

### Leases

The determination of whether an arrangement is, or contains, a lease is based on the substance of the arrangement and requires an assessment of whether the fulfillment of the arrangement is dependent on the use of a specific asset or assets and the arrangement conveys a right to use the asset.

Finance leases, which transfer to the Group substantially all the risks and benefits incidental to ownership of the leased item, are capitalised at the inception of the lease at the fair value of the leased asset or, if lower, at the present value of the minimum lease payments. Lease payments are apportioned between the finance charges and reduction of the lease liability so as to achieve a constant rate of interest on the remaining balance of the liability. Finance charges are charged directly against income.

Capitalised leased assets are depreciated over the shorter of the estimated useful life of the asset and the lease term, if there is no reasonable certainty that the Group will obtain ownership by the end of the lease term.

Leases where the lessor retains substantially all the risks and benefits of ownership of the asset are classified as operating leases. Where the Group is the lessor, assets leased by the Group under operating leases are included in non-current assets and rentals receivables under the operating leases are credited to the income statement on the straight-line basis over the lease terms. Where the Group is the lessee, rentals payable under the operating leases are charged to the income statement on the straight-line basis over the lease terms.

# Notes to Financial Statements

Year ended 31 December 2005

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### Goodwill

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

For the purpose of impairment testing, goodwill acquired in a business combination is, from the acquisition date, allocated to each of the Group's cash-generating units, or groups of cash-generating units, that are expected to benefit from the synergies of the combination, irrespective of whether other assets or liabilities of the Group are assigned to those units or groups of units. Each unit or group of units to which the goodwill is so allocated:

- represents the lowest level within the Group at which the goodwill is monitored for internal management purposes; and
- is not larger than a segment based on either the Group's primary or the Group's secondary reporting format determined in accordance with IAS 14 *Segment Reporting*.

Impairment is determined by assessing the recoverable amount of the cash-generating unit (group of cash-generating units), to which the goodwill relates. Where the recoverable amount of the cash-generating unit (group of cash-generating units) is less than the carrying amount, an impairment loss is recognised. Where goodwill forms part of a cash-generating unit (group of cash-generating units) and part of the operation within that unit is disposed of, the goodwill associated with the operation disposed of is included in the carrying amount of the operation when determining the gain or loss on disposal of the operation. Goodwill disposed of in this circumstance is measured based on the relative values of the operation disposed of and the portion of the cash-generating unit retained.



### Advance payments for aircraft and related equipment

Advance contract payments to aircraft manufacturers to secure deliveries of aircraft and related equipment in future years, including attributable finance costs, are included in assets. The advances are accounted for as part of the costs of property, plant and equipment upon delivery of the aircraft.

### Investments and other financial assets

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

All regular way purchases and sales of financial assets are recognised on the trade date i.e. the date that the Group commits to purchase the asset. Regular way purchases or sales are purchases or sales of financial assets that require delivery of assets within the period generally established by regulation or convention in the marketplace.

# Notes to Financial Statements

Year ended 31 December 2005

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### Investments and other financial assets (Continued)

*Financial assets at fair value through profit or loss*

Financial assets classified as held for trading are included in the category "financial assets at fair value through profit or loss". Financial assets are classified as held for trading if they are acquired for the purpose of selling in the near term. Derivatives are also classified as held for trading unless they are designated and effective hedging instruments. Gains or losses on investments held for trading are recognised in income.

*Held-to-maturity investments*

Non-derivative financial assets with fixed or determinable payments and fixed maturity are classified as held-to-maturity when the Group has the positive intention and ability to hold to maturity. Investments intended to be held for an undefined period are not included in this classification. Other long-term investments that are intended to be held-to-maturity, such as bonds, are subsequently measured at amortised cost. This cost is computed as the amount initially recognised minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between the initially recognised amount and the maturity amount. This calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate, transaction costs and all other premiums and discounts. For investments carried at amortised cost, gains and losses are recognised in income when the investments are derecognised or impaired, as well as through the amortisation process.



*Loans and receivables*

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. Such assets are carried at amortised cost using the effective interest method. Gains and losses are recognised in income when the loans and receivables are derecognised or impaired, as well as through the amortisation process.

*Available-for-sale financial assets*

Available-for-sale financial assets are those non-derivative financial assets that are designated as available for sale or are not classified as financial assets at fair value through profit or loss, held-to-maturity investments and loans and receivables. After initial recognition, available-for-sale financial assets are measured at fair value with gains or losses being recognised as a separate component of equity until the investment is derecognised or until the investment is determined to be impaired at which time the cumulative gain or loss previously reported in equity is included in the income statement.

The fair value of investments that are actively traded in organised financial markets is determined by reference to quoted market bid prices at the close of business on the balance sheet date. For investments where there is no active market, fair value is determined using valuation techniques. Such techniques include using recent arm's length market transactions, reference to the current market value of another instrument, which is substantially the same, discounted cash flow analysis and option pricing models.

### Inventories

Inventories, which consist primarily of expendable spare parts and supplies, are stated at cost less any provision for obsolescence, and are expensed when consumed in operations. Cost is determined on the weighted average basis.

# Notes to Financial Statements

Year ended 31 December 2005

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### Inventories (Continued)

Work in progress represents material costs, labour costs and overhead costs capitalised for the provision of aircraft engineering services and is stated at the lower of cost, calculated on a weighted average basis, and net realisable value. Net realisable value is determined on the basis of anticipated sales proceeds less estimated costs to be incurred to completion and disposal.

### Cash and cash equivalents

Cash and cash equivalents in the balance sheets comprise cash at banks and on hand and short-term deposits with an original maturity of three months or less, which are not restricted as to use.

For the purpose of the consolidated cash flow statement, cash and cash equivalents consist of cash and cash equivalents as defined above.

### Manufacturers' credits

In connection with the acquisition of certain aircraft and related equipment, the Group receives various credits from the manufacturers. Such credits are deferred until the aircraft and related equipment are delivered, at which time they are applied as a reduction of the cost of acquiring the aircraft and related equipment.

### Provisions



Provisions are recognised when the Group has a present obligation (legal or constructive) as a result of a past event and it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and a reliable estimate can be made of the amount of the obligation. The expense relating to any provision is presented in the income statement. If the effect of the time value of money is material, provisions are discounted using a current pre-tax rate that reflects, where appropriate, the risks specific to the liability. Where discounting is used, the increase in the provision due to the passage of time is recognised as a borrowing cost.

### Employee benefits

*(a) Pension obligations*

The full-time employees of the Group are covered by various government-sponsored pension plans under which the employees are entitled to a monthly pension based on certain formulae. Certain government agencies are responsible for the pension liability to these retired employees. The Group contributes on a monthly basis to these pension plans. Under these plans, the Group has no legal or constructive obligation for retirement benefits beyond the contributions made. Contributions to these plans are expensed as incurred.

*(b) Termination and early retirement benefits*

Termination benefits are payable whenever an employee's employment is voluntary terminated before the normal retirement date or whenever an employee accepts voluntary redundancy in exchange for these benefits. The Group recognises termination benefits when it is demonstrably committed to either terminating the employment of current employees according to a detailed formal plan without possibility of withdrawal or to providing termination benefits as a result of an offer made to encourage voluntary redundancy.

# Notes to Financial Statements

Year ended 31 December 2005

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### Employee benefits (Continued)

*(c) Housing benefits*

In prior years, the Group sold staff quarters to its employees, subject to a number of eligibility requirements, at below market prices. When staff quarters are identified as being subject to sale under these arrangements, the carrying value of the staff quarters is written down to the net recoverable amount. Upon sale, any difference between sales proceeds and the carrying amount of the staff quarters is charged to the income statement. The above staff quarters' allocation scheme was phased out before the incorporation of the Company in accordance with the policies of the PRC government.

In 1998, the State Council of the PRC issued a circular, which stipulated that the sale of quarters to employees at preferential prices should be withdrawn. In 2000, the State Council further issued a circular stating that cash subsidies should be made to the employees following the withdrawal of allocation of staff quarters. However, the specific timetable and procedures to implement these policies are to be determined by the individual provincial or municipal government based on the particular situation of the province or municipality.

Based on the relevant detailed local government regulations promulgated, certain entities within the Group have adopted cash housing subsidy plans, whereby, for those eligible employees who have not been allocated with any quarters or who have not been allocated with quarters up to the prescribed standards before the staff quarters' allocation scheme was terminated, the Group will pay them one-off cash housing subsidies based on their years of service, position and other criteria. These cash housing subsidies are charged to the income statement in the year in which it was determined that the payment of such subsidies is probable and the amounts can be reasonably estimated.



In addition, all full-time employees of the Group are entitled to participate in various government-sponsored housing funds. The Group contributes on a monthly basis to these funds based on certain percentages of the salaries of the employees. The Group's liability in respect of these funds is limited to the contributions payable in each year.

### Maintenance and overhaul costs

In respect of aircraft and engines under operating leases, the Group has the responsibility to fulfil certain return conditions under the relevant operating leases. In order to fulfil these return conditions, major overhauls are required to be conducted on a regular basis. Accordingly, estimated costs of major overhauls for aircraft and engines under operating leases are accrued and charged to the income statement over the estimated period between overhauls using the ratios of actual flying hours/cycles and estimated flying hours/cycles between overhauls. The costs of major overhauls comprise mainly labour and materials. Differences between the estimated costs and the actual costs of overhauls are included in the income statement in the period of overhaul.

In respect of aircraft and engines owned by the Group or held under finance leases, costs of major overhauls are recognised in the carrying amount of the property, plant and equipment as a replacement if the recognition criteria are satisfied.

All other routine repair and maintenance costs incurred in restoring such property, plant and equipment to their normal working condition are charged to the income statement as and when incurred.

# Notes to Financial Statements

Year ended 31 December 2005

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### Frequent flyer programme

For Air China Companion Club member accounts that have sufficient mileage credits to claim the lowest level of free travel, the Group records a liability for the estimated incremental costs associated with providing travel awards that are expected to be redeemed. Incremental costs include the costs of incremental fuel, meals and insurance but do not include any costs for aircraft ownership, maintenance, labour or overhead allocation. The liability is adjusted periodically based on awards earned, awards redeemed, changes in the incremental costs and changes in the Air China Companion Club programme, and is included in the balance sheet as a current liability.

### Revenue recognition

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

*(a)* *Provision of airline and airline-related services*

Passenger revenue is recognised either when transportation services are provided or when a ticket expires unused rather than when a ticket is sold. Unused tickets generally expire one year from the date the ticket was sold, or for partially used tickets, the date of first flight. Ticket sales for transportation not yet provided are included in current liabilities as air traffic liabilities. In addition, the Group has code-sharing agreements with other airlines under which a carrier's flights can be marketed under the two-letter airline designator code of another carrier. Revenue earned under these arrangements are allocated between the code share partners based on existing contractual agreements and airline industry standard pro-ratio formulae and are recognised as passenger revenue when the transportation services are provided.

Cargo and mail revenue is recognised when transportation services are provided.

Revenue from airline-related services is recognised when services are rendered.

Revenue is stated net of business tax.

*(b)* *Sale of goods*

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

*(c)* *Trading of investments*

Revenue is recognised on a trade date basis.

*(d)* *Interest income*

Revenue is recognised on a time proportion basis taking into account the principal outstanding and the effective rate of interest applicable.

*(e)* *Dividends*

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

*(f)* *Rental income and aircraft and related equipment lease income*

Revenue is recognised on a time proportion basis over the terms of the respective leases.

# Notes to Financial Statements

Year ended 31 December 2005

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### Government grants

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

### Related parties

Parties are considered to be related if one party has the ability, directly or indirectly, to control the other party or exercise significant influence over the other party in making financial and operating decisions. Parties are also considered to be related if they are subject to common control or common significant influence. Related parties may be individuals or corporate entities.

### Taxes

*Current tax*

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



*Deferred tax*

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

Deferred income tax liabilities are recognised for all taxable temporary differences, except:

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

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

Deferred income tax assets are recognised for all deductible temporary differences, carry-forward of unused tax assets and unused tax losses, to the extent that it is probable that taxable profit will be available against which the deductible temporary differences, and the carry-forward of unused tax credits and unused tax losses can be utilised, except:

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

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

# Notes to Financial Statements

Year ended 31 December 2005

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### Taxes (Continued)

*Deferred tax* (Continued)

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

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

Income tax relating to items recognised directly in equity is recognised in equity and not in the income statement.

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

### Trade and other receivables



Trade receivables, which generally have terms of 30 to 90 days, are recognised and carried at original invoice amount less an allowance for any uncollectible amounts. Provision is made when there is objective evidence that the Group will not be able to collect the debts. Bad debts are written off when identified.

Other receivables are recognised and carried at cost less allowances for any uncollectible amounts.

### Derivative financial instruments and hedging

The Group uses derivative financial instruments to hedge its exposure to jet fuel prices. Such derivative financial instruments are initially recognised at fair value on the date on which a derivative contract is entered into and are subsequently re-measured at fair value. Derivatives are carried as assets when the fair value is positive and as liabilities when the fair value is negative.

Any gains or losses arising from changes in fair value on derivatives that do not qualify for hedge accounting are taken directly to the income statement for the year.

For the purposes of hedge accounting, hedges are classified as follows:

- fair value hedges, when hedging the exposure to changes in the fair value of a recognised asset or liability;
- cash flow hedges, when hedging exposure to variability in cash flows that is either attributable to a particular risk associated with a recognised asset or liability or a forecast transaction; or
- hedges of a net investment in a foreign operation.

Hedges which meet the strict criteria for hedge accounting are accounted for as follows:

# Notes to Financial Statements

Year ended 31 December 2005

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### Derivative financial instruments and hedging (Continued)

*Fair value hedges*

Fair value hedges are hedges of the Group's exposure to changes in the fair value of a recognised asset or liability or an unrecognised firm commitment, or an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect profit or loss. For fair value hedges, the carrying amount of the hedged item is adjusted for gains and losses attributable to the risk being hedged, the derivative is re-measured at fair value and gains and losses from both are taken to profit or loss.

For fair value hedges relating to items carried at amortised cost, the adjustment to carrying value is amortised through profit or loss over the remaining term to maturity. Any adjustment to the carrying amount of a hedged financial instrument for which the effective interest method is used is amortised to profit or loss.

Amortisation may begin as soon as an adjustment exists and shall begin no later than when the hedged item ceases to be adjusted for changes in its fair value attributable to the risk being hedged.

When an unrecognised firm commitment is designated as a hedged item, the subsequent cumulative change in the fair value of the firm commitment attributable to the hedged risk is recognised as an asset or liability with the corresponding gain or loss recognised in profit or loss. The changes in the fair value of the hedging instrument are also recognised in profit or loss.



The Group discontinues fair value hedge accounting if the hedging instrument expires or is sold, terminated or exercised; the hedge no longer meets the criteria for hedge accounting; or the Group revokes the designation. Any adjustment to the carrying amount of a hedged financial instrument for which the effective interest method is used is amortised to profit or loss. Amortisation may begin as soon as an adjustment exists and shall begin no later than when the hedged item ceases to be adjusted for changes in its fair value attributable to the risk being hedged.

*Cash flow hedges*

Cash flow hedges are a hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with a recognised asset or liability or a highly probable forecast transaction and could affect profit or loss. The effective portion of the gain or loss on the hedging instrument is recognised directly in equity, while the ineffective portion is recognised in profit or loss.

Amounts taken to equity are transferred to the income statement when the hedged transaction affects profit or loss, such as when hedged financial income or financial expense is recognised or when a forecast sale or purchase occurs. Where the hedged item is the cost of a non-financial asset or liability, the amounts taken to equity are transferred to the initial carrying amount of the non-financial asset or liability.

If the forecast transaction is no longer expected to occur, amounts previously recognised in equity are transferred to the profit or loss. If the hedging instrument expires or is sold, terminated or exercised without replacement or rollover, or if its designation as a hedge is revoked, amounts previously recognised in equity will remain in equity until the forecast transaction occurs. If the related transaction is not expected to occur, the amount is taken to profit or loss.

# Notes to Financial Statements

Year ended 31 December 2005

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### Derivative financial instruments and hedging (Continued)

*Hedges of a net investment*

Hedges of a net investment in a foreign operation, including a hedge of a monetary item that is accounted for as part of the net investment, are accounted for in a way similar to cash flow hedges. Gains or losses on the hedging instrument relating to the effective portion of the hedge are recognised directly in equity while any gains or losses relating to the ineffective portion are recognised in profit or loss. On disposal of the foreign operation, the cumulative value of any such gains or losses recognised directly in equity is transferred to profit or loss.

### Borrowing costs

Borrowing costs directly attributable to the acquisition of aircraft, construction or production of qualifying assets, i.e. assets that necessarily take a substantial period of time to get ready for their intended use, are capitalised as part of the costs of those assets. The capitalisation of aircraft borrowing costs ceases when the aircraft is placed into revenue earning services and the capitalisation of other assets' borrowing costs ceases when the assets are substantially ready for their intended use or sale.

Where funds have been borrowed generally, and used for the purpose of obtaining qualifying assets, a capitalisation rate of 4.5% (2004: ranging between 5.6% and 5.8%) has been applied to the expenditure on the individual asset.



All other borrowing costs are recognised as an expense when incurred.

### Interest-bearing loans and borrowings

All loans and borrowings are initially recognised at the fair value of the consideration received less directly attributable transaction costs.

After initial recognition, interest-bearing loans and borrowings are subsequently measured at amortised cost using the effective interest rate method.

Gains and losses are recognised in the income statement when the liabilities are derecognised as well as through the amortisation process.

### Impairment of assets

The Group assesses at each reporting date whether there is an indication that an asset may be impaired. If any such indication exists, or when annual impairment testing for an asset is required, the Group makes an estimate of the asset's recoverable amount. An asset's recoverable amount is the higher of an asset's or cash-generating unit's fair value less costs to sell and its value in use, and is determined for an individual asset, unless the asset does not generate cash inflows that are largely independent of those from other assets or groups of assets. Where the carrying amount of an asset exceeds its recoverable amount, the asset is considered impaired and is written down to its recoverable amount. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset. Impairment losses of continuing operations are recognised in the income statement in those expense categories consistent with the function of the impaired asset.

# Notes to Financial Statements

Year ended 31 December 2005

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### Impairment of assets (Continued)

An assessment is made at each reporting date as to whether there is any indication that previously recognised impairment losses may no longer exist or may have decreased. If such indication exists, the recoverable amount is estimated. A previously recognised impairment loss is reversed only if there has been a change in the estimates used to determine the asset's recoverable amount since the last impairment loss was recognised. If that is the case the carrying amount of the asset is increased to its recoverable amount. That increased amount cannot exceed the carrying amount that would have been determined, net of depreciation, had no impairment loss been recognised for the asset in prior years. Such reversal is recognised in profit or loss. After such a reversal the depreciation charge is adjusted in future periods to allocate the asset's revised carrying amount, less any residual value, on a systematic basis over its remaining useful life.

### Derecognition of financial assets and liabilities

*Financial assets*

A financial asset (or, where applicable a part of a financial asset or part of a group of similar financial assets) is derecognised where:

- the rights to receive cash flows from the asset have expired;
- the Group retains the right to receive cash flows from the asset, but has assumed an obligation to pay them in full without material delay to a third party under a "pass-through" arrangement; or
- the Group has transferred its rights to receive cash flows from the asset and either (a) has transferred substantially all the risks and rewards of the asset, or (b) has neither transferred nor retained substantially all the risks and rewards of the asset, but has transferred control of the asset.

Where the Group has transferred its rights to receive cash flows from an asset and has neither transferred nor retained substantially all the risks and rewards of the asset nor transferred control of the asset, the asset is recognised to the extent of the Group's continuing involvement in the asset. Continuing involvement that takes the form of a guarantee over the transferred asset is measured at the lower of the original carrying amount of the asset and the maximum amount of consideration that the Group could be required to repay.

Where continuing involvement takes the form of a written and/or purchased option (including a cash-settled option or similar provision) on the transferred asset, the extent of the Group's continuing involvement is the amount of the transferred asset that the Group may repurchase, except that in the case of a written put option (including a cash-settled option or similar provision) on an asset measured at fair value, the extent of the Group's continuing involvement is limited to the lower of the fair value of the transferred asset and the option exercise price.

*Financial liabilities*

A financial liability is derecognised when the obligation under the liability is discharged or cancelled or expires.

Where an existing financial liability is replaced by another from the same lender on substantially different terms, or the terms of an existing liability are substantially modified, such an exchange or modification is treated as a derecognition of the original liability and the recognition of a new liability, and the difference in the respective carrying amounts is recognised in profit or loss.

# Notes to Financial Statements

Year ended 31 December 2005

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### Impairment of financial assets

The Group assesses at each balance sheet date whether a financial asset or group of financial assets is impaired.

*Available-for-sale financial assets*

If an available-for-sale asset is impaired, an amount comprising the difference between its cost (net of any principal payment and amortisation) and its current fair value, less any impairment loss previously recognised in profit or loss, is transferred from equity to the income statement. Reversals of impairment loss in respect of equity instruments classified as available-for-sale are not recognised in profit or loss. Reversals of impairment losses on debt instruments are reversed through profit or loss, if the increase in fair value of the instruments can be objectively related to an event occurring after the impairment loss was recognised in profit or loss.

### Significant accounting estimates

*Estimation uncertainty*

The key assumptions concerning the future and other key sources of estimation uncertainty at the balance sheet date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next year are discussed below.

(a) Impairment of goodwill

The Group determines whether goodwill is impaired at least on an annual basis. This requires an estimation of the value in use of the cash-generating units to which the goodwill is allocated. Estimating the value in use requires the Group to make an estimate of the expected future cash flows from the cash-generating unit and also to choose a suitable discount rate in order to calculate the present value of those cash flows. The carrying amount of goodwill at 31 December 2005 was RMB1,444 million (2004: RMB1,405 million). More details are given in note 19 to these financial statements.

# Notes to Financial Statements

Year ended 31 December 2005

## 3. SEGMENT INFORMATION

Segment information of the Group is presented by way of two segment formats: (i) on a primary segment reporting basis, by business segment; and (ii) on a secondary segment reporting basis, by geographical segment.

The Group's operating businesses are structured and managed separately, according to the nature of their operations and the services they provide. Each of the Group's business segments represents a strategic business unit that offers services which are subject to risks and returns that are different from those of the other business segments.

Currently, the Group's business segment information is divided into the following four business segments:

(a) the airline operations segment comprises the provision of air passenger and air cargo services;

(b) the engineering services segment comprises the provision of aircraft engineering services which include aircraft maintenance, repair and overhaul services;

(c) the airport terminal services segment comprises the provision of ground services which include check-in service, boarding service, premium class lounge service, ramp service, luggage handling service, loading and unloading services, cabin cleaning and transit services; and

(d) the "others" segment comprises the provision of air catering services and other airline-related services.



The profit before tax of a segment represents revenue less expenses directly attributable to a segment and the relevant portion of enterprise revenue less expenses that can be allocated on a reasonable basis to a segment, whether from external transactions or from transactions with other segments of the Group.

Segment assets and liabilities mainly comprise operating assets and liabilities that are directly attributable to the segment or can be allocated to the segment on a reasonable basis.

In determining the Group's geographical segments, revenue is attributed to the segments based on the origin and destination of each flight segment. Assets, which consist principally of aircraft and ground equipment, supporting the entire worldwide transportation system, are mainly located in Mainland China. An analysis of assets and capital expenditure of the Group by geographical distribution has therefore not been included.

Intersegment sales and transfers are transacted with reference to the selling prices used for sales made to third parties at the then prevailing market prices.

# Notes to Financial Statements

Year ended 31 December 2005

## 3. SEGMENT INFORMATION (Continued)

### Business segments

The following tables present revenue, profit and certain asset, liability and expenditure information for the Group's business segments for the years ended 31 December 2005 and 2004:

**For the year ended 31 December 2005**

| | Airline operations RMB'000 | Engineering services RMB'000 | Airport terminal services RMB'000 | Others RMB'000 | Eliminations RMB'000 | Total RMB'000 |
|---|---|---|---|---|---|---|
| **REVENUE** | | | | | | |
| Sales to external customers | 37,380,669 | 376,437 | 320,477 | 213,383 | – | 38,290,966 |
| Intersegment sales | – | 619,098 | – | 108,873 | (727,971) | – |
| Total revenue | 37,380,669 | 995,535 | 320,477 | 322,256 | (727,971) | 38,290,966 |
| **PROFIT FROM OPERATIONS** | | | | | | |
| Segment results | 3,367,949 | 772,877 | 123,679 | 137,282 | (727,971) | 3,673,816 |
| Finance revenue | 1,231,986 | 8,512 | 37 | 8,072 | – | 1,248,607 |
| Finance costs | (1,762,481) | (7,504) | (2,320) | (794) | – | (1,773,099) |
| Share of profits less losses from associates | 81,645 | (8,628) | 148,096 | 3,817 | – | 224,930 |
| Profit before tax | 2,919,099 | 765,257 | 269,492 | 148,377 | (727,971) | 3,374,254 |
| Tax | | | | | | (903,874) |
| Minority interests | | | | | | (64,124) |
| Net profit attributable to equity holders of the parent | | | | | | 2,406,256 |
| **ASSETS** | | | | | | |
| Segment assets | 63,703,084 | 1,046,799 | 122,474 | 668,200 | (1,630,942) | 63,909,615 |
| Interests in associates | 3,312,608 | 18,700 | 192,084 | 270,565 | – | 3,793,957 |
| Unallocated assets | | | | | | 498,371 |
| Total assets | | | | | | 68,201,943 |
| **LIABILITIES** | | | | | | |
| Segment liabilities | (46,191,851) | (489,320) | (404,229) | (775,802) | 1,630,942 | (46,230,260) |
| Unallocated liabilities | | | | | | (421,077) |
| Total liabilities | | | | | | (46,651,337) |
| **OTHER INFORMATION** | | | | | | |
| Capital expenditures | | | | | | |
| – property, plant and equipment | 13,222,058 | 37,219 | 855 | 30,836 | – | 13,290,968 |
| Depreciation of property, plant and equipment | 4,409,021 | 38,381 | 61,303 | 3,975 | – | 4,512,680 |
| Amortisation of lease prepayments | 19,555 | – | – | – | – | 19,555 |
| Increase in fair value of financial assets, net | (125,868) | – | – | – | – | (125,868) |
| Provision/(write-back of provision) for doubtful debts, net | 14,836 | 118 | – | (231) | – | 14,723 |

# Notes to Financial Statements

Year ended 31 December 2005

## 3. SEGMENT INFORMATION (Continued)

### Business segments (Continued)

For the year ended 31 December 2004

| | Airline operations RMB'000 | Engineering services RMB'000 | Airport terminal services RMB'000 | Others RMB'000 | Eliminations RMB'000 | Total RMB'000 |
|---|---|---|---|---|---|---|
| **REVENUE** | | | | | | |
| Sales to external customers | 32,766,164 | 296,775 | 287,905 | 169,913 | – | 33,520,757 |
| Intersegment sales | – | 731,589 | – | 131,299 | (862,888) | – |
| Total revenue | 32,766,164 | 1,028,364 | 287,905 | 301,212 | (862,888) | 33,520,757 |
| **PROFIT FROM OPERATIONS** | | | | | | |
| Segment results | 4,146,402 | 824,858 | 203,133 | 173,746 | (862,888) | 4,485,251 |
| Finance revenue | 73,943 | 278 | – | 5,140 | – | 79,361 |
| Finance costs | (1,859,139) | (14,819) | (1,978) | (3,298) | – | (1,879,234) |
| Dilution gains on investments | 330,222 | – | – | 79,915 | – | 410,137 |
| Share of profits less losses from associates | 331,530 | (5,083) | 130,661 | 6,936 | – | 464,044 |
| Profit before tax | 3,022,958 | 805,234 | 331,816 | 262,439 | (862,888) | 3,559,559 |
| Tax | | | | | | (1,010,864) |
| Minority interests | | | | | | (162,731) |
| Net profit attributable to equity holders of the parent | | | | | | 2,385,964 |
| **ASSETS** | | | | | | |
| Segment assets | 62,308,593 | 1,077,748 | 160,087 | 379,390 | (2,014,154) | 61,911,664 |
| Interests in associates | 3,589,574 | 25,539 | 186,056 | 200,352 | – | 4,001,521 |
| Unallocated assets | | | | | | 776,084 |
| Total assets | | | | | | 66,689,269 |
| **LIABILITIES** | | | | | | |
| Segment liabilities | (48,845,870) | (652,749) | (312,765) | (677,442) | 2,014,154 | (48,474,672) |
| Unallocated liabilities | | | | | | (186,055) |
| Total liabilities | | | | | | (48,660,727) |
| **OTHER INFORMATION** | | | | | | |
| Capital expenditures – property, plant and equipment | 6,046,355 | 32,697 | 25,912 | 33,641 | – | 6,138,605 |
| Depreciation of property, plant and equipment | 3,395,049 | 35,797 | 19,247 | 13,159 | – | 3,463,252 |
| Amortisation of lease prepayments | 4,884 | – | – | – | – | 4,884 |
| Decrease in fair value of financial assets, net | 28,000 | – | – | – | – | 28,000 |
| Provision/(write-back of provision) for doubtful debts, net | (4,483) | 2,642 | – | 853 | – | (988) |
| Provision/(write-back of provision) against inventories, net | 12,492 | (24,000) | – | – | – | (11,508) |

# Notes to Financial Statements

Year ended 31 December 2005

## 3. SEGMENT INFORMATION (Continued)

### Geographical segments

The following tables present consolidated revenue by geographical segments for the years ended 31 December 2005 and 2004:

| For the year ended 31 December 2005 | Domestic | HK/ Macau | Europe | North America | Japan/ Korea | Asia Pacific, others | Total |
|---|---|---|---|---|---|---|---|
| | *RMB'000* | *RMB'000* | *RMB'000* | *RMB'000* | *RMB'000* | *RMB'000* | *RMB'000* |
| **REVENUE** | | | | | | | |
| Sales to external customers and total revenue | **20,490,055** | **2,269,256** | **5,081,774** | **2,964,247** | **4,250,255** | **3,235,379** | **38,290,966** |

| For the year ended 31 December 2004 | Domestic | HK/ Macau | Europe | North America | Japan/ Korea | Asia Pacific, others | Total |
|---|---|---|---|---|---|---|---|
| | *RMB'000* | *RMB'000* | *RMB'000* | *RMB'000* | *RMB'000* | *RMB'000* | *RMB'000* |
| **REVENUE** | | | | | | | |
| Sales to external customers and total revenue | 18,482,949 | 1,744,590 | 4,232,489 | 2,477,214 | 3,846,973 | 2,736,542 | 33,520,757 |

## 4. AIR TRAFFIC REVENUE



Air traffic revenue comprises revenue from the airline operations business and is stated net of business tax. An analysis of air traffic revenue is as follows:

| | Group | |
|---|---|---|
| | **2005** | 2004 |
| | ***RMB'000*** | *RMB'000* |
| Passenger | **31,584,426** | 27,665,018 |
| Cargo and mail | **3,716,400** | 3,169,804 |
| | **35,300,826** | 30,834,822 |

Pursuant to various PRC business tax rules and regulations, the Group is required to pay business tax to the local tax bureaus at the following rates:

| Type of revenue | Applicable business tax rate |
|---|---|
| Air traffic revenue | 3% of air traffic revenue (all inbound international and Hong Kong and Macau regional flights are exempted from business tax) |
| Other operating revenue *(note 5)* | 3% to 5% of other operating revenue |

PRC business tax incurred for the years ended 31 December 2005 and 2004, netted against air traffic revenue, amounted to approximately RMB846 million and RMB711 million, respectively.

# Notes to Financial Statements

Year ended 31 December 2005

## 5. OTHER OPERATING REVENUE

| | Group | |
|---|---|---|
| | **2005** | 2004 |
| | ***RMB'000*** | *RMB'000* |
| Bellyhold income from a joint venture *(note 46)* | **1,496,302** | 1,384,457 |
| Aircraft engineering income | **376,437** | 296,775 |
| Ground services income | **320,477** | 287,905 |
| General aviation income | **155,521** | 159,990 |
| Air catering income | **109,591** | 118,140 |
| Government grants: | | |
| (i) Recognition of deferred income *(note 36)* | **76,943** | 70,593 |
| (ii) Fixed cash subsidy | **–** | 37,500 |
| (iii) Others | **41,250** | 44,853 |
| Service charges on return of unused flight tickets | **97,951** | 63,821 |
| Cargo handling service income | **67,822** | 49,850 |
| Sale of materials | **11,899** | 33,008 |
| Import and export service income | **12,311** | 29,767 |
| Training service income | **19,029** | 23,761 |
| Aircraft and related equipment lease income | **7,072** | 11,516 |
| Gain on disposal of property, plant and equipment, net | **74,474** | – |
| Others | **123,061** | 73,999 |
| | **2,990,140** | 2,685,935 |



## 6. PROFIT FROM OPERATIONS

The Group's profit from operations is arrived at after charging/(crediting):

| | Group | |
|---|---|---|
| | **2005** | 2004 |
| | ***RMB'000*** | *RMB'000* |
| Repair and maintenance costs | **2,078,382** | 3,608,348 |
| Depreciation *(note 15)* | **4,512,680** | 3,463,252 |
| Amortisation of lease prepayments *(note 16)* | **19,555** | 4,884 |
| Employee compensation costs *(note 7)* | **3,406,825** | 2,921,322 |
| Minimum lease payments under operating leases: | | |
| Aircraft and engines | **1,530,754** | 1,071,256 |
| Land and buildings | **211,177** | 187,471 |
| (Gain)/loss on disposal of property, plant and equipment, net | **(74,474)** | 33,872 |
| Loss on derecognition of property, plant and equipment *(note 2 (b) (ii))* | **430,010** | – |
| Auditors' remuneration | **11,029** | 7,206 |
| Provision/(write-back of provision) for doubtful debts, net | **14,723** | (988) |
| Write-back of provision against inventories, net | **–** | (11,508) |

# Notes to Financial Statements

Year ended 31 December 2005

## 7. EMPLOYEE COMPENSATION COSTS

| | Group | |
|---|---|---|
| | **2005** | 2004 |
| | ***RMB'000*** | *RMB'000* |
| Employee compensation costs (including Directors', supervisors' and management's emoluments): | | |
| Wages, salaries and social security costs | **3,200,391** | 2,732,927 |
| Retirement benefit costs *(note 11)* | **206,434** | 188,395 |
| | **3,406,825** | 2,921,322 |

## 8. FINANCE REVENUE AND FINANCE COSTS

### Finance revenue

| | Group | |
|---|---|---|
| | **2005** | 2004 |
| | ***RMB'000*** | *RMB'000* |
| Exchange gains, net | **918,297** | – |
| Interest income | **108,481** | 33,703 |
| Gains on fuel derivatives, net | **221,661** | 41,036 |
| Dividend income from available-for-sale investments | **168** | 4,622 |
| | **1,248,607** | 79,361 |



### Finance costs

| | Group | |
|---|---|---|
| | **2005** | 2004 |
| | ***RMB'000*** | *RMB'000* |
| Interest expense | **1,792,408** | 1,827,002 |
| Less: Interest capitalised | **(19,309)** | (2,610) |
| | **1,773,099** | 1,824,392 |
| Exchange losses, net | **–** | 54,842 |
| | **1,773,099** | 1,879,234 |

The interest capitalisation rate represents the cost of capital from raising the related borrowings and is approximately 4.5% (2004: ranging from 5.6% to 5.8%) per annum.

# Notes to Financial Statements

Year ended 31 December 2005

## 9. DILUTION GAINS ON INVESTMENTS

| | Group | |
|---|---|---|
| | **2005** | 2004 |
| | ***RMB'000*** | *RMB'000* |
| Dilution gain on investment in Air Cargo Business *(note 9(a))* | – | 330,222 |
| Dilution gains on investments in BACL and SWACL *(note 9(b))* | – | 79,915 |
| | – | 410,137 |

*Notes:*

(a) Pursuant to the Restructuring, the air cargo business and relevant air cargo assets and liabilities (the "Air Cargo Business") were operated and owned solely by the Group as if it had been directly held by the Group prior to 1 January 2004 in accordance with the basis of presentation as set out in note 1 to these financial statements. In 2004, the entire Air Cargo Business was transferred to Air China Cargo Co., Ltd. ("Air China Cargo"), a 51% owned joint venture of the Company, in the form of the Company's capital contribution and advance to Air China Cargo. Subsequent to the transfer of Air Cargo Business to Air China Cargo, the Group's effective interest in the Air Cargo Business was diluted from 100% to 51% and, accordingly, a gain on dilution of the investment in Air Cargo Business of approximately RMB330 million arose.

(b) In accordance with the basis of presentation as set out in note 1 to these financial statements, a 60% shareholding interest in Beijing Air Catering Co., Ltd. ("BACL") and a 75% shareholding interest in Southwest Air Catering Company Limited ("SWACL") were deemed to be held by the Group prior to being transferred during 2004.



During 2004, the Group transferred its entire 60% shareholding interest in BACL and a 60% shareholding interest in SWACL to Fly Top Limited, a wholly-owned subsidiary of China National Aviation Company Limited ("CNAC"), a subsidiary of the Company, for considerations of RMB294 million and RMB67 million, respectively.

In addition to the above, the Group transferred its remaining 15% shareholding interest in SWACL to Hongkong Southwest Air Catering Limited ("HKSACL"), the minority shareholder of SWACL, for a consideration of approximately RMB17 million.

Subsequent to the completion of the above transactions, the Group's effective shareholding interests in BACL and SWACL were diluted from 60% and 75%, respectively, to 41% and accordingly gains on dilution of investments in BACL and SWACL in aggregate of approximately RMB80 million arose.

# Notes to Financial Statements

Year ended 31 December 2005

## 10. DIRECTORS', SUPERVISORS' AND SENIOR MANAGEMENT'S EMOLUMENTS

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

| | Group | |
|---|---|---|
| | **2005** | 2004 |
| | ***RMB'000*** | *RMB'000* |
| Fees | **150** | 29 |
| Basic salaries, housing benefits, other allowances and benefits in kind | **4,443** | 4,279 |
| Discretionary bonuses | **787** | 636 |
| Retirement benefits | **69** | 43 |
| | **5,449** | 4,987 |

| | **Fees** | **Basic salaries, housing benefits, other allowances and benefits in kind** | **Discretionary bonuses** | **Retirement benefits** | **Total emoluments** |
|---|---|---|---|---|---|
| | ***RMB'000*** | ***RMB'000*** | ***RMB'000*** | ***RMB'000*** | ***RMB'000*** |
| **Year ended 31 December 2005** | | | | | |
| **Directors** | | | | | |
| Mr. Li Jiaxiang | – | – | – | – | – |
| Mr. Kong Dong | – | 2,132 | – | – | 2,132 |
| Mr. Wang Shixiang | – | – | – | – | – |
| Mr. Yao Weiting | – | – | – | – | – |
| Mr. Ma Xulun | – | 124 | 245 | 16 | 385 |
| Mr. Cai Jianjiang | – | 124 | 232 | 16 | 372 |
| Mr. Fan Cheng | – | 113 | 153 | 16 | 282 |
| Dr. Hu Hung Lick, Henry | 50 | 63 | – | – | 113 |
| Mr. Wu Zhipan | 50 | – | – | – | 50 |
| Mr. Zhang Ke | 50 | – | – | – | 50 |
| Mr. David Turnbill | – | – | – | – | – |
| | 150 | 2,556 | 630 | 48 | 3,384 |
| **Supervisors** | | | | | |
| Mr. Zhang Xianlin | – | 1,770 | – | – | 1,770 |
| Mr. Liao Wei | – | – | – | – | – |
| Ms. Zhang Huilan | – | – | – | – | – |
| Mr. Liu Feng | – | 93 | 132 | 16 | 241 |
| Mr. Liu Guoqing | – | 24 | 25 | 5 | 54 |
| | – | 1,887 | 157 | 21 | 2,065 |
| | 150 | 4,443 | 787 | 69 | 5,449 |

# Notes to Financial Statements

Year ended 31 December 2005

## 10. DIRECTORS', SUPERVISORS' AND SENIOR MANAGEMENT'S EMOLUMENTS (Continued)

| | Fees RMB'000 | Basic salaries, housing benefits, other allowances and benefits in kind RMB'000 | Discretionary bonuses RMB'000 | Retirement benefits RMB'000 | Total emoluments RMB'000 |
|---|---|---|---|---|---|
| **Year ended 31 December 2004** | | | | | |
| **Directors** | | | | | |
| Mr. Li Jiaxiang | – | – | – | – | – |
| Mr. Kong Dong | – | 2,172 | – | – | 2,172 |
| Mr. Wang Shixiang | – | – | – | – | – |
| Mr. Yao Weiting | – | – | – | – | – |
| Mr. Ma Xulun | – | 103 | 259 | 14 | 376 |
| Mr. Cai Jianjiang | – | 101 | 240 | 14 | 355 |
| Mr. Fan Cheng | – | 16 | 45 | 1 | 62 |
| Dr. Hu Hung Lick, Henry | 4 | – | – | – | 4 |
| Mr. Wu Zhipan | 13 | – | – | – | 13 |
| Mr. Zhang Ke | 12 | – | – | – | 12 |
| | 29 | 2,392 | 544 | 29 | 2,994 |
| **Supervisors** | | | | | |
| Mr. Zhang Xianlin | – | 1,804 | – | – | 1,804 |
| Mr. Liao Wei | – | – | – | – | – |
| Ms. Zhang Huilan | – | – | – | – | – |
| Mr. Liu Feng | – | 83 | 92 | 14 | 189 |
| | – | 1,887 | 92 | 14 | 1,993 |
| | 29 | 4,279 | 636 | 43 | 4,987 |



Fees of approximately RMB150,000 (2004: RMB29,000) are wholly payable to the independent non-executive Directors. Except for other emoluments of RMB63,000 paid to Dr. Hu Hung Lick, Henry, there were no other emoluments payable to other independent non-executive Directors during the year (2004: Nil).

An analysis of the five individuals whose remuneration were the highest in the Group is as follows:

| | Group | |
|---|---|---|
| | **2005** *Number of individuals* | 2004 *Number of individuals* |
| Director | **1** | 1 |
| Supervisor | **1** | 1 |
| Employees | **3** | 3 |

# Notes to Financial Statements

Year ended 31 December 2005

## 10. DIRECTORS', SUPERVISORS' AND SENIOR MANAGEMENT'S EMOLUMENTS (Continued)

The emoluments paid to the three non-director, non-supervisor and highest paid individuals are as follows:

| | Group | |
|---|---|---|
| | **2005** | 2004 |
| | ***RMB'000*** | *RMB'000* |
| Basic salaries, housing benefits, other allowances and benefits in kind | **4,729** | 5,360 |
| Discretionary bonuses | **–** | – |
| Retirement benefits | **216** | 164 |
| | **4,945** | 5,524 |

The remuneration of these three highest paid individuals for the year fell within the following bands:

| | Group | |
|---|---|---|
| | **2005** | 2004 |
| | ***Number of individuals*** | *Number of individuals* |
| HK$1,000,001 to HK$1,500,000 (equivalent to RMB1,051,701 to RMB1,575,550) | **2** | 1 |
| HK$1,500,001 to HK$2,000,000 (equivalent to RMB1,575,551 to RMB2,103,400) | **1** | 2 |
| | **3** | 3 |

There was no arrangement under which a Director or a supervisor or any of the five highest paid individuals waived or agreed to waive any remuneration during the year (2004: Nil).

There was no emolument paid by the Group to any of the Directors or supervisors or any of the five highest paid individuals as an inducement to join or upon joining the Group or as compensation for loss of office during the year (2004: Nil).

# Notes to Financial Statements

Year ended 31 December 2005

## 11. RETIREMENT BENEFITS

All of the Group's full-time employees in Mainland China are covered by a government-regulated defined contribution retirement scheme, and are entitled to an annual pension determined by their basic salaries upon their retirement. The PRC government is responsible for the pension liabilities to these retired employees. The Group is required to make annual contributions to the government-regulated defined contribution retirement scheme at rates ranging from 15% to 20% of the employees' basic salaries during the year and has no further obligation for post-retirement benefits in respect of the above. This defined contribution plan continues to be available to the Group's employees after the Restructuring. The related pension costs are expensed as incurred.

Prior to the Restructuring, the Group also paid certain supplementary pension benefits (the "Supplementary Pension Benefits") to its employees who retired before the incorporation of the Company. Pursuant to the Restructuring, CNAHC has agreed to assume past payments and future liabilities in respect of the Supplementary Pension Benefits for those employees who retired before the incorporation of the Company for nil consideration. The pension payments relating to the Supplementary Pension Benefits borne by CNAHC was approximately RMB39 million for the year ended 31 December 2004 *(note 46 (d))*. These pension payments were relating to the period from 1 January 2004 to the date immediately before the incorporation of the Company. The Group's employees who retire after the incorporation of the Company are not entitled to the Supplementary Pension Benefits. CNAHC has agreed to indemnify the Group against losses from any claims for the Supplementary Pension Benefits.

Besides, the Group also implemented an early retirement plan for certain employees in addition to the benefits under the government-regulated defined contribution retirement scheme described above. The benefits of the early retirement plan are calculated based on factors including the remaining number of years of services from the date of early retirement to the normal retirement date and the salary amount on the date of early retirement of the employees. The costs of early retirement benefits were recognised in the period when employees opted for early retirement. Where the effect of discounting is material, the amount recognised for early retirement benefits is the present value at the balance sheet date of the future cash flows expected to be required to settle the obligation. The increase in the discounted present value amount arising from the passage of time is included in finance costs in the income statement.

The expenses attributed to the PRC government-regulated defined contribution retirement scheme and the early retirement benefits are as follows:

| | Group | |
|---|---|---|
| | **2005** | 2004 |
| | ***RMB'000*** | *RMB'000* |
| Contributions to PRC government-regulated defined contribution retirement scheme | **202,535** | 179,740 |
| Early retirement benefits | **3,899** | 8,655 |
| Total *(note 7)* | **206,434** | 188,395 |

Forfeited contributions totalling RMB1,633,000 (2004: RMB1,579,000) was utilised during the year. At 31 December 2005, the Group had no forfeited contributions available to reduce its contributions to the pension scheme in future years (2004: Nil).

# Notes to Financial Statements

Year ended 31 December 2005

## 12. TAX

According to the PRC Enterprise Income Tax Law, the Company, its subsidiaries, joint ventures and associates established in the PRC are subject to enterprise income tax at rates ranging from 15% to 33% (2004: 15% to 33%) on their taxable income.

Hong Kong profits tax has been provided at the rate of 17.5% (2004: 17.5%) on the estimated assessable profits arising in Hong Kong during the year.

The Group is subject to income tax on an entity basis on profits arising in or derived from the jurisdictions in which members of the Group are domiciled and operate. In accordance with an approval document issued by the relevant tax authorities, the filing of tax returns of the Relevant Businesses and all wholly-owned PRC-established subsidiaries of the Company prior to its incorporation on 30 September 2004 was handled by CNAHC on a consolidated group basis. The share of the income tax liability of the Relevant Businesses and all wholly-owned PRC-established subsidiaries of the Company prior to its incorporation was calculated at the applicable tax rates on their profits determined in accordance with PRC accounting principles and after the relevant adjustments made under the prevailing PRC Enterprise Income Tax Law as applicable to domestic enterprises. Such tax was payable to CNAHC which in turn would settle the tax liability with the relevant tax bureau. Similarly, the net profit attributable to CNAHC for the period from 1 January 2004 to 30 September 2004 (the date of incorporation of the Company) referred to in note 13(b) to these financial statements was calculated after deducting the amount of income tax payable to CNAHC, which in turn would settle any tax liability on profits arising during that period with the relevant tax bureau.

Following the incorporation of the Company, the Company will settle its tax liability by itself with the respective tax bureau.



In accordance with the PRC Enterprise Income Tax Law and an approval document issued by the relevant tax bureau on 28 November 2005 (the "Approval Document"), Air China Cargo was approved to be subject to a enterprise income tax rate of 24% on its taxable income as reported in its statutory financial statements for the year ended 31 December 2005 and was fully exempted from corporate income tax for the year ended 31 December 2005 and followed by a 3-year 50% reduction in corporate income tax in the period between 1 January 2006 and 31 December 2008. In addition, pursuant to the Approval Document, Air China Cargo has been granted a 4-year local income tax exemption in the period between 1 January 2005 and 31 December 2008 and followed by a 5-year 50% reduction in local income tax in the period between 1 January 2009 and 31 December 2013.

# Notes to Financial Statements

Year ended 31 December 2005

## 12. TAX (Continued)

The determination of current and deferred income tax was based on enacted tax rates. Major components of income tax charge are as follows:

| | | Group | |
|---|---|---|---|
| | | **2005** | 2004 |
| | | ***RMB'000*** | *RMB'000* |
| *Current income tax* | | | |
| Current income tax charge | – Mainland China | **614,313** | 398,944 |
| | – Hong Kong | **11,848** | 4,096 |
| *Deferred income tax* | | | |
| Relating to origination and reversal of temporary differences *(note 22)* | | **277,713** | 607,824 |
| Income tax charge for the year | | **903,874** | 1,010,864 |

Share of tax attributable to associates amounting to RMB33,640,000 (2004: RMB96,974,000) is included in the "Share of profit less losses from associates" on the face of the consolidated income statement.

A reconciliation of income tax expense applicable to profit before income tax at the statutory income tax rates in Mainland China to income tax expense at the Group's effective income tax rate, and a reconciliation of the applicable rate (i.e., the statutory tax rate) to the effective tax rate, are as follows:



| | Group | | | |
|---|---|---|---|---|
| | **2005** | | 2004 | |
| | ***RMB'000*** | ***%*** | *RMB'000* | *%* |
| Profit before income tax | **3,374,254** | | 3,559,559 | |
| At statutory income tax rate of 33% | **1,113,504** | **33.0** | 1,174,654 | 33.0 |
| Profits and losses attributable to associates | **(74,227)** | **(2.2)** | (153,135) | (4.3) |
| Lower income tax rates of other territories | **(15,024)** | **(0.5)** | (20,455) | (0.6) |
| Tax exemption | **(49,558)** | **(1.4)** | – | – |
| Income not subject to tax | **(115,131)** | **(3.4)** | (211,035) | (5.9) |
| Expenses not deductible for tax purposes | **26,941** | **0.8** | 220,835 | 6.2 |
| Tax losses not recognised | **12,537** | **0.4** | – | – |
| Effect on opening deferred income tax assets due to decrease in other territories' income tax rates | **4,832** | **0.1** | – | – |
| Tax charge at Group's effective income tax rate | **903,874** | **26.8** | 1,010,864 | 28.4 |

At 31 December 2005, there was no significant unrecognised deferred tax liability (2004: Nil) for taxes that would be payable on the unremitted earnings of certain of the Group's subsidiaries and joint ventures as the Directors of the Company do not have intention to remit any significant amount of earnings to the Company in the foreseeable future.

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

# Notes to Financial Statements

Year ended 31 December 2005

## 13. APPROPRIATIONS

Set out below are the details of distributions made by the Company for the two years ended 31 December 2005:

| | Group | |
|---|---|---|
| | **2005** | 2004 |
| | ***RMB'000*** | *RMB'000* |
| ***Declared during the year*** | | |
| Carved-out of net assets *(note 13(c))* | – | 39,136 |
| Dividend paid *(note 13(c))* | – | 29,074 |
| Distribution to CNAHC *(note 13(a))* | – | 377,550 |
| Distribution to CNAHC *(note 13(b))* | – | 2,025,105 |
| Distribution to CNACG *(note 13(b))* | – | 118,680 |
| Total | – | 2,589,545 |
| ***Proposed for approval (not recognised as a liability as at 31 December)*** | | |
| Final dividend for 2005: RMB0.2383 (2004: Nil) per 10 shares *(note 13(d))* | **224,793** | – |

(a) On 21 April 2004, Fly Top Limited, a wholly-owned subsidiary of CNAC, entered into the following acquisition agreements which were supplemented on 26 April 2004:

(i) a share purchase agreement with Air China International Corporation in relation to the acquisition of 60% of the equity interest in BACL (the "BACL Agreement") for a consideration of RMB294 million; and

(ii) a share purchase agreement with Air China International Corporation in relation to the acquisition of 60% of the equity interest in SWACL (the "SWACL Agreement") for a consideration of RMB67 million.

On 12 November 2004, all the pre-completion undertakings of the BACL Agreement and the SWACL Agreement were completed and these two acquisition agreements were effective on that date accordingly.

On 20 April 2004, Air China International Corporation entered into a stock transfer agreement with HKSACL (the "HKSACL Agreement"), the minority shareholder of SWACL, pursuant to which, Air China International Corporation disposed of 15% of the equity interest in SWACL to HKSACL for a consideration of approximately RMB17 million. On 12 November 2004, all the pre-completion undertakings of the HKSACL Agreement were completed and this agreement was effective on that date accordingly.

Immediately after the completion of the BACL Agreement, SWACL Agreement and HKSACL Agreement, the Group's effective shareholding interests in BACL and SWACL were diluted from 60% and 75%, respectively, to approximately 41%.

As a result of the completion of the BACL Agreement, SWACL Agreement and HKSACL Agreement, the Group made a payment of approximately RMB378 million to CNAHC, representing the total consideration payable by CNAC and HKSACL for the acquisitions of the entire shareholding interests held by the Group in BACL and SWACL pursuant to the Restructuring as set out in note 1 to these financial statements. This payment has been made to CNAHC and accounted for as a special distribution to CNAHC by the Company.

# Notes to Financial Statements

Year ended 31 December 2005

## 13. APPROPRIATIONS (Continued)

(b) In accordance with the (財政部關于印發《企業公司制改建有關國有資本管理与財務處理的暫行規定》的通知) "Provisional Regulations Relating to Corporate Reorganisation of Enterprises and Related Management of State-owned Capital and Financial Treatment" notice issued by the Ministry of Finance, which became effective from 27 August 2002, and pursuant to the Restructuring, after the Company's incorporation, the Company is required to make a distribution to CNAHC, which represents an amount equal to the net profit attributable to shareholders, as determined based on the audited accounts prepared in accordance with the accounting principles and the financial regulations applicable in the PRC ("PRC GAAP"), generated during the period from 1 January 2004 to 30 September 2004 (the date of incorporation of the Company) by the businesses and operations (excluding those of CNAC) contributed to the Group by CNAHC after giving effect to relevant necessary adjustments. The net profit attributable to shareholders mentioned above for the said period is calculated after deducting the amount of income tax payable to CNAHC of approximately RMB191,721,000 which in turn will settle the tax liability on profit arisen during that period with the relevant tax bureau as detailed in note 12 to these financial statements.

In addition, in accordance with (財政部關于印發《企業公司制改建有關國有資本管理与財務處理的暫行規定》的通知) "Provisional Regulations Relating to Corporate Reorganisation of Enterprises and Related Management of State-owned Capital and Financial Treatment" notice issued by the Ministry of Finance and pursuant to the Restructuring, after the Company's incorporation, the Company is required to make a distribution to CNACG, which represents an amount equal to the net profit attributable to shareholders, as determined based on audited accounts prepared in accordance with PRC GAAP, generated during the period from 1 January 2004 to 30 September 2004 (the date of incorporation of the Company) by the businesses and operations (excluding those directly contributed by CNAHC) contributed to the Group by the CNAC group, less the 2003 final dividend and 2004 interim dividend amounts already paid by CNAC to CNACG.



(c) The profit distributions made prior to the incorporation of the Company represent the net assets which have been carved out and treated as deemed distributions pursuant to the Restructuring set out in note 1 to these financial statements and the dividends paid during that period.

The rates of dividend and the number of shares ranking for dividends for the year ended 31 December 2004 are not presented in this footnote for those profit distributions made prior to the incorporation of the Company as such information is not considered meaningful.

(d) The proposed final dividend of RMB0.2383 per 10 shares for the year ended 31 December 2005 is subject to the approval of the Company's shareholders at the forthcoming annual general meeting.

Cash dividends to shareholders in Hong Kong will be paid in Hong Kong dollars.

Following the incorporation of the Company, under the PRC Company Law and the Company's articles of association, net profit after tax as reported in the PRC statutory financial statements can only be distributed as dividends after allowance has been made for the following:

(i) Making up prior years' cumulative losses, if any;

(ii) Allocations to the statutory common reserve fund of at least 10% of after-tax profit, until the fund aggregates 50% of the Company's registered capital. For the purpose of calculating the transfer to reserves, the profit after tax shall be the amount determined under the PRC GAAP. The transfer to this reserve must be made before any distribution of dividends to shareholders.

The statutory common reserve fund can be used to offset previous years' losses, if any, and part of the statutory common reserve fund can be capitalised as the Company's share capital provided that the amount of such reserve remaining after the capitalisation shall not be less than 25% of the share capital of the Company;

# Notes to Financial Statements

Year ended 31 December 2005

## 13. APPROPRIATIONS (Continued)

(iii) Allocations of 5% to 10% of after-tax profit, as determined under PRC GAAP, to the Company's statutory public welfare fund, which will be established for the purpose of providing for the Company's employees collective welfare benefits such as the construction of dormitories, canteens and other staff welfare facilities. The fund forms part of the shareholders' equity as only individual employees can use these facilities, while the title of such facilities is held by the Company. The transfer to this fund must be made before any distribution of dividends to shareholders; and

(iv) Allocations to the discretionary common reserve if approved by the shareholders.

The above reserves cannot be used for purposes other than those for which they are created and are not distributable as cash dividends.

In accordance with the articles of association of the Company, the net profit after tax of the Company for the purpose of dividends payment is based on the lesser of (i) the net profit determined in accordance with PRC GAAP; and (ii) the net profit determined in accordance with IFRSs.

Prior to the incorporation of the Company on 30 September 2004, no profit appropriations to the aforesaid reserve funds were required.

## 14. EARNINGS PER SHARE ATTRIBUTABLE TO EQUITY HOLDERS OF THE PARENT



The calculation of basic earnings per share for the year ended 31 December 2005 is based on the net profit attributable to equity holders of the parent for the year ended 31 December 2005 of approximately RMB2,406,256,000, and the weighted average number of approximately 9,422,728,916 ordinary shares in issue during the year, as adjusted to reflect the new issue of 382,592,727 H shares on the exercise of the over-allotment options granted to international underwriters to subscribe for the Company's H shares during the year.

The calculation of basic earnings per share for the year ended 31 December 2004 is based on the net profit attributable to equity holders of the parent for the year ended 31 December 2004 of approximately RMB2,385,964,000, and the weighted average number of approximately 6,618,795,915 ordinary shares in issue during the year on the assumption that the 6,500,000,000 shares issued as at 30 September 2004 had been in issue throughout the year ended 31 December 2004, and as adjusted to reflect the new issue of 2,550,618,182 H shares by way of placing and public offering in connection with the public listing of the Company's H shares on 15 December 2004.

Diluted earnings per share for the year ended 31 December 2005 has not been disclosed because no diluting events existed during 2005.

The calculation of diluted earnings per share for the year ended 31 December 2004 was based on the net profit attributable to equity holders of the parent for the year ended 31 December 2004 of approximately RMB2,385,964,000. The weighted average number of ordinary shares used in the calculation is the weighted average number of 6,618,795,915 ordinary shares in issue during the year, as used in the basic earnings per share calculation and the weighted average of 556,132 ordinary shares assumed to have been issued at no consideration on the deemed exercise of all over-allotment options granted to international underwriters to subscribe for the Company's H shares during the year.

# Notes to Financial Statements

Year ended 31 December 2005

## 15. PROPERTY, PLANT AND EQUIPMENT

### Group

| | Aircraft and flight equipment RMB'000 | Buildings RMB'000 | Machinery RMB'000 | Transportation equipment RMB'000 | Office equipment RMB'000 | Construction in progress RMB'000 | Total RMB'000 |
|---|---|---|---|---|---|---|---|
| At 1 January 2004, net of accumulated depreciation | 37,789,877 | 2,715,540 | 1,051,602 | 293,144 | 90,268 | 483,489 | 42,423,920 |
| Establishment of a joint venture *(note 45 (a))* | (267,119) | (186,169) | (86,932) | (21,673) | – | (3,947) | (565,840) |
| Additions | 4,479,459 | 42,515 | 109,019 | 135,909 | 77,244 | 734,028 | 5,578,174 |
| Disposals | (424,064) | (49,111) | (28,705) | (7,170) | (22,315) | – | (531,365) |
| Transfer from CIP | 164,788 | 285,156 | 91,393 | 5,177 | 206 | (546,720) | – |
| Depreciation charge for the year | (3,024,078) | (123,071) | (172,910) | (89,845) | (53,348) | – | (3,463,252) |
| At 31 December 2004 and 1 January 2005, net of accumulated depreciation | 38,718,863 | 2,684,860 | 963,467 | 315,542 | 92,055 | 666,850 | 43,441,637 |
| Additions | 7,185,603 | 10,022 | 112,533 | 72,122 | 32,270 | 1,394,017 | 8,806,567 |
| Disposals | (469,378) | (44,861) | (4,542) | (15,975) | (273) | – | (535,029) |
| Transfer from CIP | 467,440 | 71,898 | 67,571 | 5,147 | 22,724 | (634,780) | – |
| Exchange adjustment | (6,542) | (1,826) | – | (1,399) | – | – | (9,767) |
| Depreciation charge for the year | (4,128,357) | (147,542) | (156,489) | (56,501) | (23,791) | – | (4,512,680) |
| **At 31 December 2005, net of accumulated depreciation** | **41,767,629** | **2,572,551** | **982,540** | **318,936** | **122,985** | **1,426,087** | **47,190,728** |
| At 31 December 2004 and 1 January 2005 | | | | | | | |
| Cost | 63,813,626 | 3,674,146 | 2,045,002 | 1,068,502 | 223,531 | 666,850 | 71,491,657 |
| Accumulated depreciation | (25,094,763) | (989,286) | (1,081,535) | (752,960) | (131,476) | – | (28,050,020) |
| Net carrying amount | 38,718,863 | 2,684,860 | 963,467 | 315,542 | 92,055 | 666,850 | 43,441,637 |
| **At 31 December 2005** | | | | | | | |
| **Cost** | **70,705,988** | **3,698,597** | **2,192,095** | **1,076,728** | **276,239** | **1,426,087** | **79,375,734** |
| **Accumulated depreciation** | **(28,938,359)** | **(1,126,046)** | **(1,209,555)** | **(757,792)** | **(153,254)** | **–** | **(32,185,006)** |
| **Net carrying amount** | **41,767,629** | **2,572,551** | **982,540** | **318,936** | **122,985** | **1,426,087** | **47,190,728** |

# Notes to Financial Statements

Year ended 31 December 2005

## 15. PROPERTY, PLANT AND EQUIPMENT (Continued)

### Company

| | Aircraft and flight equipment RMB'000 | Buildings RMB'000 | Machinery RMB'000 | Transportation equipment RMB'000 | Office equipment RMB'000 | Construction in progress RMB'000 | Total RMB'000 |
|---|---|---|---|---|---|---|---|
| Transferred to the Company upon its incorporation *(note 1)* | 38,595,577 | 1,858,577 | 784,743 | 182,711 | 76,724 | 583,635 | 42,081,967 |
| Additions | 372,799 | – | 25,547 | 42,916 | 27,182 | 308,493 | 776,937 |
| Disposals | (9,216) | (32) | (31,158) | (1,650) | (148) | – | (42,204) |
| Transfer from CIP | – | 219,934 | 17,770 | 176 | – | (237,880) | – |
| Depreciation charge for the period | (804,864) | (23,307) | (29,053) | (20,021) | (31,027) | – | (908,272) |
| At 31 December 2004 and 1 January 2005, net of accumulated depreciation | 38,154,296 | 2,055,172 | 767,849 | 204,132 | 72,731 | 654,248 | 41,908,428 |
| Additions | 6,444,967 | 2,209 | 85,229 | 46,376 | 20,404 | 1,347,614 | 7,946,799 |
| Disposals | (460,726) | (39,100) | (1,898) | (15,096) | (197) | – | (517,017) |
| Transfer from CIP | 467,440 | 63,320 | 57,033 | 5,147 | 22,706 | (615,646) | – |
| Depreciation charge for the year | (3,997,538) | (130,020) | (129,145) | (36,615) | (19,429) | – | (4,312,747) |
| **At 31 December 2005, net of accumulated depreciation** | **40,608,439** | **1,951,581** | **779,068** | **203,944** | **96,215** | **1,386,216** | **45,025,463** |
| At 31 December 2004 and 1 January 2005 | | | | | | | |
| Cost | 61,842,914 | 2,820,374 | 1,520,769 | 830,178 | 131,321 | 654,248 | 67,799,804 |
| Accumulated depreciation | (23,688,618) | (765,202) | (752,920) | (626,046) | (58,590) | – | (25,891,376) |
| Net carrying amount | 38,154,296 | 2,055,172 | 767,849 | 204,132 | 72,731 | 654,248 | 41,908,428 |
| **At 31 December 2005** | | | | | | | |
| **Cost** | **68,020,677** | **2,839,822** | **1,649,825** | **823,159** | **172,910** | **1,386,216** | **74,892,609** |
| **Accumulated depreciation** | **(27,412,238)** | **(888,241)** | **(870,757)** | **(619,215)** | **(76,695)** | **–** | **(29,867,146)** |
| **Net carrying amount** | **40,608,439** | **1,951,581** | **779,068** | **203,944** | **96,215** | **1,386,216** | **45,025,463** |

Certain of the Group's and the Company's bank loans are secured by certain of the Group's and the Company's aircraft which had an aggregate carrying amount of approximately RMB16,471 million as at 31 December 2005 (2004: RMB16,586 million) *(note 33(a))*.

The carrying amount of aircraft held under finance leases as at 31 December 2005 is approximately RMB10,487 million (2004: RMB11,999 million) *(note 32(a))*. Leased assets are pledged as security for the related finance lease liabilities.

As at 31 December 2005, the Group is in the process of applying to obtain the title certificates of certain of its buildings with an aggregate carrying amount of approximately RMB270 million (2004: RMB2,178 million). The Directors of the Company are of the view that the Group is entitled to lawfully and validly occupy and use the above-mentioned buildings. The Directors of the Company are of the opinion that the aforesaid matter will not have any significant impact on the Group's financial position as at 31 December 2005.

# Notes to Financial Statements

Year ended 31 December 2005

## 16. LEASE PREPAYMENTS

| | Group | | Company | |
|---|---|---|---|---|
| | **2005** | 2004 | **2005** | 2004 |
| | ***RMB'000*** | *RMB'000* | ***RMB'000*** | *RMB'000* |
| **Cost** | | | | |
| At 1 January | **938,992** | 30,017 | **924,895** | – |
| Transferred to the Company upon its incorporation *(note 1)* | **–** | – | **–** | 924,895 |
| Additions | **157,723** | 908,975 | **151,955** | – |
| At 31 December | **1,096,715** | 938,992 | **1,076,850** | 924,895 |
| **Accumulated amortisation** | | | | |
| At 1 January | **5,094** | 210 | **5,024** | – |
| Transferred to the Company upon its incorporation *(note 1)* | **–** | – | **–** | 411 |
| Amortisation for the year | **19,555** | 4,884 | **19,333** | 4,613 |
| At 31 December | **24,649** | 5,094 | **24,357** | 5,024 |
| **Net book value** | | | | |
| At 31 December | **1,072,066** | 933,898 | **1,052,493** | 919,871 |



## 17. INTERESTS IN SUBSIDIARIES

| | Company | |
|---|---|---|
| | **2005** | 2004 |
| | ***RMB'000*** | *RMB'000* |
| Listed shares in Hong Kong, at cost | **579,472** | 579,472 |
| Unlisted investments, at cost | **137,707** | 134,647 |
| Due from subsidiaries | **11,519** | 22,513 |
| Due to subsidiaries | **(588,623)** | (559,703) |
| | **140,075** | 176,929 |
| Market value of listed shares | **2,893,811** | 3,161,997 |

The balances with the subsidiaries are unsecured, interest-free and have no fixed terms of repayment.

As at 31 December 2005, the Group is in the process of applying to register the already transferred equity interests in certain subsidiaries with an aggregate cost of approximately RMB504,000 (2004: RMB134 million) from Air China International Corporation into the Company's name. The Directors of the Company are of the view that the Company owns the aforesaid equity interests and that the aforesaid matter will not have any significant impact on the Group's financial position as at 31 December 2005.

# Notes to Financial Statements

Year ended 31 December 2005

## 17. INTERESTS IN SUBSIDIARIES (Continued)

Particulars of the principal subsidiaries at 31 December 2005 are as follows:

| Company name | Place of incorporation/ establishment and operations | Legal status | Nominal value of paid-up capital (in thousands) | Percentage of equity interests attributable to the Company Direct | Indirect | Principal activities |
|---|---|---|---|---|---|---|
| **Subsidiaries** | | | | | | |
| CNAC (中航興業有限公司) | Hong Kong | Limited liability company | HK$331,268 | 69 | – | Investment holding |
| Air Macau Company Limited ("Air Macau") * (澳門航空股份有限公司) | Macau | Limited liability company | MOP400,000 | – | 35 | Airline operator |
| Air China Group Import and Export Trading Co. ("AIE") (國航集團進出口貿易公司) | PRC/ Mainland China | Limited liability company | RMB90,000 | 100 | – | Import and exportt rading |
| 浙江航空服務有限公司 (Zhejiang Air Services Co., Ltd.) ** | PRC/ Mainland China | Limited liability company | RMB20,000 | 100 | – | Provision of airline catering and shuttle bus services |
| Beijing Aviation Passenger Service Corporation (北京航空旅客服務公司) | PRC/ Mainland China | Limited liability company | RMB3,000 | 100 | – | Provision of passenger transportation services |
| Air China Shantou Industrial Development Company (中國民航航空汕頭實業發展公司) | PRC/ Mainland China | Limited liability company | RMB18,000 | 51 | – | Manufacture and retail of aircraft supplies |
| China National Aviation Air Passenger and Cargo Services Agency Company (中國民航客貨運輸銷售代理公司) | PRC/ Mainland China | Limited liability company | RMB6,980 | 100 | – | Provision of travel agency and freight forwarding services |
| Beijing Air China Engineering Technology Development Centre (北京國航工程技術發展中心) | PRC/ Mainland China | Limited liability company | RMB1,500 | 100 | – | Provision of engineering consultancy services |
| Beijing Civil Aviation Blue Sky Air Travel Services Company (北京民航藍天空運服務公司) | PRC/ Mainland China | Limited liability company | RMB5,533 | 100 | – | Provision of travel agency services |
| Air China Development Corporation (Hong Kong) Limited (國航香港發展有限公司) | Hong Kong | Limited liability company | HK$500 | 95 | – | Provision of air ticketing services |
| 上海國航基地開發中心 (Shanghai Air China Base Development Centre) ** | PRC/ Mainland China | Limited liability company | RMB2,000 | 100 | – | Provision of ground services, air passenger, cargo and consultancy services |

* Air Macau is a 51%-owned subsidiary of CNAC.

** The English names are direct translations of the company's Chinese names.

The above table lists the subsidiaries of the Company which, in the opinion of the Directors, principally affected the results for the year ended 31 December 2005 or formed a substantial portion of the net assets of the Group at 31 December 2005. To give details of other subsidiaries would, in the opinion of the Directors, result in particulars of excessive length.

# Notes to Financial Statements

Year ended 31 December 2005

## 18. INTERESTS IN JOINT VENTURES

| | Company 2005 RMB'000 | Company 2004 RMB'000 |
|---|---|---|
| Unlisted investments, at cost | **1,398,595** | 1,392,388 |

Particulars of the joint ventures of the Group at 31 December 2005 are as follows:

| Company name | Place of incorporation/ establishment and operations | Legal status | Nominal value of paid-up capital *(in thousands)* | Percentage of equity interests attributable to the Group Direct | Percentage of equity interests attributable to the Group Indirect | Principal activities |
|---|---|---|---|---|---|---|
| **Joint ventures** | | | | | | |
| Aircraft Maintenance and Engineering Corporation, Beijing (北京飛机維修工程有限公司) | PRC/ Mainland China | Limited liability company | US$112,533 | 60 | – | Provision of aircraft overhaul and maintenance services |
| Air China Cargo (中國國際貨運航空有限公司) | PRC/ Mainland China | Limited liability company | RMB2,200,000 | 51 | – | Provision of cargo carriage services |
| BACL (北京航空食品有限公司) | PRC/ Mainland China | Limited liability company | US$8,000 | – | 41 | Provision of airline catering services |
| SWACL (西南航空食品有限公司) | PRC/ Mainland China | Limited liability company | RMB70,000 | – | 41 | Provision of airline catering services |



As at the balance sheet date and for the two years ended 31 December 2005, the Group's proportionate share of the assets, liabilities, and the Group's proportionate share of the revenue and expenses of the joint ventures are as follows:

| | Group 2005 RMB'000 | Group 2004 RMB'000 |
|---|---|---|
| Current assets | **1,654,865** | 1,606,903 |
| Non-current assets | **2,147,711** | 1,706,734 |
| Total assets | **3,802,576** | 3,313,637 |
| Current liabilities | **(1,349,440)** | (1,578,665) |
| Non-current liabilities | **(444,475)** | (8,734) |
| Net assets attributable to the Group | **2,008,661** | 1,726,238 |
| Revenue | **4,248,167** | 3,944,633 |
| Operating expenses | **(3,929,313)** | (3,748,389) |
| Finance revenue | **10,616** | 5,720 |
| Finance costs | **(25,460)** | (21,857) |
| Share of profits less losses from associates | **–** | 1,006 |
| Profit before tax | **304,010** | 181,113 |
| Tax | **(35,767)** | (51,976) |
| Net profit attributable to the Group | **268,243** | 129,137 |

# Notes to Financial Statements

Year ended 31 December 2005

## 19. INTEREST IN ASSOCIATES

| | Group | | Company | |
|---|---|---|---|---|
| | **2005** | 2004 | **2005** | 2004 |
| | ***RMB'000*** | *RMB'000* | ***RMB'000*** | *RMB'000* |
| Listed shares in Mainland China, at cost | **–** | – | **163,477** | 168,949 |
| Unlisted investments, at cost | **–** | – | **673,879** | 676,692 |
| Share of net assets | **2,382,547** | 2,587,304 | **–** | – |
| Goodwill | **1,444,367** | 1,404,966 | **–** | – |
| Due from associates | **62,948** | 90,842 | **15,419** | 17,305 |
| Due to associates | **(95,905)** | (81,591) | **(129,410)** | (82,109) |
| | **3,793,957** | 4,001,521 | **723,365** | 780,837 |
| Market value of listed shares | **–** | – | **124,032** | 288,192 |

The balances with the associates are unsecured, interest-free and have no fixed terms of repayment.

As at 31 December 2005, the Group is in the process of applying to register the already transferred equity interests in certain associates with an aggregate cost of approximately RMB101 million (2004: RMB846 million) from Air China International Corporation into the Company's name. The Directors of the Company are of the view that the Company owns the aforesaid equity interests and that the aforesaid matter will not have any significant impact on the Group's financial position as at 31 December 2005.

# Notes to Financial Statements

Year ended 31 December 2005

## 19. INTEREST IN ASSOCIATES (Continued)

Particulars of the associates at 31 December 2005 are as follows:

| Name | Place of incorporation/ establishment and operations | Registered/ issued share capital | Percentage of equity interests attributable to the Group | Principal activities |
|---|---|---|---|---|
| Shenzhen Airlines (深圳航空有限責任公司) | PRC/ Mainland China | RMB300,000,000 | 25 | Airline operator |
| Hong Kong Dragon Airlines Limited ("Dragonair") # (港龍航空有限公司) | Hong Kong | HK$500,000,000 | 29.9 | Airline operator |
| Shandong Aviation Group Corporation ("Shandong Aviation") (山東航空集團有限公司) | PRC/ Mainland China | RMB580,000,000 | 48 | Investment holding |
| Shandong Airlines Co., Ltd. ("Shandong Airlines") (山東航空股份有限公司) | PRC/ Mainland China | RMB400,000,000 | 22.8 | Airline operator |
| Sichuan SNECMA Aeroengine Maintenance Co., Ltd. (四川斯拉克瑪航空發動機机維修有限公司) | PRC/ Mainland China | US$21,000,0000 | 40.3 | Provision of maintenance and repair services for aircraft engines |
| Chengdu Falcon Aircraft Engineering Service Co., Ltd. (成都富凱飛机工程服務有限公司) | PRC/ Mainland China | RMB16,474,293 | 35.6 | Provision of maintenance and repair services for aircraft engines |
| Yunnan Airport Aircraft Maintenance Services Co., Ltd. (云南空港飛机維修服務公司) | PRC/ Mainland China | RMB10,000,000 | 40 | Provision of maintenance and repair services |
| Macau Aircraft Repair and Conversion Company Limited # (澳門飛机維修工程有限公司) | Macau | MOP100,000 | 17.3 | Provision of aircraft repair and conversion services |
| Jardine Airport Services Limited # (怡中航空服務有限公司) | Hong Kong | HK$10,000 | 34.5 | Provision of airport ground handling services |
| Menzies Macau Airport Services Limited # (明捷澳門机場服務有限公司) | Macau | MOP10,000,000 | 23.2 | Provision of airport ground handling services |

# Notes to Financial Statements

Year ended 31 December 2005

## 19. INTEREST IN ASSOCIATES (Continued)

| Name | Place of incorporation/ establishment and operations | Registered/ issued share capital | Percentage of equity interests attributable to the Group | Principal activities |
|---|---|---|---|---|
| Guangzhou Baiyun International Airport Ground Handling Service Company Limited (廣州白云國際机場地勤服務有限公司) | PRC/ Mainland China | RMB100,000,000 | 21 | Provision of airport ground handling services |
| 三亞世貿發展有限公司 (Sanya World Trade Development Company Limited) * | PRC/ Mainland China | RMB5,000,000 | 40 | Provision of airport ground handling services |
| CAAC Data Communications Co., Ltd. (民航數據通信有限責任公司) | PRC/ Mainland China | RMB10,800,000 | 23.2 | Provision of aviation data communication services |
| CAAC Cares Chongqing Co., Ltd. (重慶民航凱亞信息技術有限公司) | PRC/ Mainland China | RMB9,800,000 | 24.5 | Provision of airline-related information system services |
| 成都民航西南凱亞有限責任公司 (Chengdu CAAC Southwest Cares Co., Ltd.) * | PRC/ Mainland China | RMB2,000,000 | 35 | Provision of airline-related information system services |
| Tradeport Hong Kong Limited # (香港商貿港有限公司) | Hong Kong | HK$400 | 17.3 | Provision of services for developing and operating logistics centre |
| LSG Lufthansa Service Hong Kong Limited ("LSGHK") # (德國漢莎航空膳食服務(香港)有限公司) | Hong Kong | HK$501 | 13.9 | Provision of airline catering services |
| China National Aviation Finance Co., Ltd. ("CNAF") (中國航空集團財務有限責任公司) ** | PRC/ Mainland China | RMB505,269,500 | 23.5 | Provision of financial services |

# Shareholding interests of these associates are held indirectly through subsidiaries of the Company.

* The English names are direct translations of the company's Chinese names.

** 19.3% of the Group's equity interests in CNAF is held directly by the Company, while the remaining 4.2% is held indirectly through subsidiaries of the Company.

# Notes to Financial Statements

Year ended 31 December 2005

## 19. INTEREST IN ASSOCIATES (Continued)

Summarised financial information of the Group's associates is as follows:

| | Group | |
|---|---|---|
| | **2005** | 2004 |
| | ***RMB'000*** | *RMB'000* |
| Aggregate of associates' financial position: | | |
| Total assets | **32,096,859** | 27,767,944 |
| Total liabilities | **(25,497,576)** | (20,747,807) |
| Aggregate of associates' results: | | |
| Revenue | **21,026,538** | 16,770,072 |
| Net profit | **745,230** | 1,330,066 |
| Share of profits less losses after tax from associates: | | |
| Dragonair | **139,824** | 279,801 |
| Others | **85,106** | 184,243 |
| | **224,930** | 464,044 |



Movements of goodwill are as follows:

| | Group | |
|---|---|---|
| | **2005** | 2004 |
| | ***RMB'000*** | *RMB'000* |
| Goodwill at beginning of the year *(note 19(a))* | **1,404,966** | 1,205,390 |
| Adjustment to opening goodwill *(note 19(b))* | **40,445** | – |
| Additions *(note 19(b))* | **–** | 199,576 |
| Exchange adjustment | **(1,044)** | – |
| Goodwill at end of the year | **1,444,367** | 1,404,966 |
| Accumulated impairment | **–** | – |

*Notes:*

(a) The goodwill brought forward from 2003 related to the acquisition of shareholding interests of 35.86% and 7.43% in Dragonair by CNACG and its then wholly-owned subsidiary, CNAC, in June 1996 and October 1997, respectively. The aggregate goodwill arising from these two acquisitions was approximately RMB2,130 million and subsequently reduced to approximately RMB1,205 million through deemed disposal upon the initial public offering of CNAC and the accumulated amortisation on the straight-line basis over a period of 20 years until 1 January 2001 (the date of adoption of IFRS 3 by the Group).

(b) The goodwill arose in 2004 related to the acquisitions of effective shareholding interests of 48.0% in Shandong Aviation, 22.8% in Shandong Airlines and 13.9% in LSGHK by the Group, resulting in an aggregate goodwill amount of approximately RMB200 million.

During the year, Shandong Aviation and Shandong Airlines restated their retained earnings as at 31 December 2004 and as such the goodwill, being calculated as the excess of the cost of the business combination over the Group's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities of Shandong Aviation and Shandong Airlines arising on the acquisitions of shareholding interests in these two companies, were adjusted accordingly.

# Notes to Financial Statements

Year ended 31 December 2005

## 19. INTEREST IN ASSOCIATES (Continued)

### Impairment testing of goodwill attributable to Dragonair, Shandong Airlines and Shandong Aviation

Goodwill acquired through the business combination in relation to the acquisition of shareholding interests in Dragonair, Shandong Airlines and Shandong Aviation has been allocated to the cash-generating unit, Dragonair, Shandong Airlines and Shandong Aviation, within the airline operations segment.

The recoverable amount of Dragonair has been determined based on a value in use calculation. To calculate this, cash flow projections are based on financial budgets approved by management covering a one-year period. The discount rate applied to the cash flow projections beyond the one-year period is 5.0% (2004: 5.0%). No growth has been projected beyond the one-year period.

### Key assumptions used in the value in use calculation of Dragonair, Shandong Airlines and Shandong Aviation

The following describes each key assumption on which management has based its cash flow projections when undertaking the impairment testing of goodwill attributable to Dragonair, Shandong Airlines and Shandong Aviation:

*Passenger revenue* – the bases used to determine the value assigned to the budgeted passenger revenue are available seat kilometers, passenger traffic, passenger load factor and passenger yield. Values assigned to the key assumptions reflect past experience and are consistent with external information sources.



*Operating expenses* – the bases used to determine the values assigned are staff headcount, scheduled flight hours, passenger traffic and jet fuel consumption. Values assigned to the key assumptions reflect past experience and are consistent with external information sources.

## 20. LONG TERM RECEIVABLE FROM CNAHC

On 30 September 2004, the Company entered into an agreement with CNAHC whereby CNAHC agreed to assume the obligation to settle an aggregate amount of approximately RMB757 million, which was recorded by the Group as government grant receivable as at 31 December 2003 of RMB842 million, consisting of long term portion and short term portion of RMB764 million and RMB78 million, respectively. This receivable from CNAHC is unsecured, interest-free and repayable over eight years commencing from 31 December 2004 by 16 semi-annual instalments to be made by 30 June and 31 December each year. Pursuant to the relevant agreement, the first instalment amount of RMB25 million was settled by 31 December 2004 and the final instalment amount of approximately RMB32 million shall be settled by 30 June 2012, with the remaining 14 semi-annual instalment amounts of RMB50 million each to be settled by 30 June and 31 December each year between 30 June 2005 and 31 December 2011.

## 21. AVAILABLE-FOR-SALE INVESTMENTS

Available-for-sale investments consist of unlisted equity investments.

# Notes to Financial Statements

Year ended 31 December 2005

## 22. DEFERRED TAX ASSETS

| | Group | | Company | |
|---|---|---|---|---|
| | **2005** | 2004 | **2005** | 2004 |
| | ***RMB'000*** | *RMB'000* | ***RMB'000*** | *RMB'000* |
| Balance at beginning of year | **776,084** | 590,153 | **658,000** | – |
| Transferred to the Company upon its incorporation *(note 1)* | **–** | – | **–** | 660,349 |
| Charge for the year *(note 12)* | **(277,713)** | (607,824) | **(267,000)** | (2,349) |
| Credited to equity | **–** | 793,755 | **–** | – |
| Balance at end of year | **498,371** | 776,084 | **391,000** | 658,000 |

The principal components of the Group's and the Company's deferred income tax assets are as follows:

| | Group | | Company | |
|---|---|---|---|---|
| | **2005** | 2004 | **2005** | 2004 |
| | ***RMB'000*** | *RMB'000* | ***RMB'000*** | *RMB'000* |
| Deferred income tax liabilities: | | | | |
| Accelerated depreciation for tax purposes | **(447,186)** | (441,441) | **(456,000)** | (426,000) |
| Other deferred income tax liabilities | **(72,000)** | (47,000) | **(72,000)** | (47,000) |
| Gross deferred income tax liabilities | **(519,186)** | (488,441) | **(528,000)** | (473,000) |
| Deferred income tax assets: | | | | |
| Additional tax deduction on revaluation surplus arising from the Restructuring | **528,000** | 714,000 | **434,000** | 606,000 |
| Provisions and accruals | **341,070** | 384,000 | **329,000** | 381,000 |
| Losses available for offset against future taxable income | **10,487** | 20,525 | **–** | – |
| Other deferred income tax assets | **138,000** | 146,000 | **156,000** | 144,000 |
| Gross deferred income tax assets | **1,017,557** | 1,264,525 | **919,000** | 1,131,000 |
| Net deferred income tax assets | **498,371** | 776,084 | **391,000** | 658,000 |

There was no material unprovided deferred income tax during the year (2004: Nil).

# Notes to Financial Statements

Year ended 31 December 2005

## 23. TRADE RECEIVABLES

The Group normally allows a credit period ranging from 30 days to 90 days to its sales agents and other customers. An aged analysis of the trade receivables, net of provision for doubtful debts, of the Group and the Company is analysed as follows:

| | Group | | Company | |
|---|---|---|---|---|
| | **2005** | 2004 | **2005** | 2004 |
| | ***RMB'000*** | *RMB'000* | ***RMB'000*** | *RMB'000* |
| Within 30 days | **1,770,628** | 1,838,756 | **1,511,371** | 2,067,875 |
| 31 to 60 days | **458,454** | 280,382 | **503,590** | 102,938 |
| 61 to 90 days | **177,587** | 152,548 | **245,168** | 14,949 |
| Over 90 days | **357,806** | 93,130 | **257,255** | 11,531 |
| At end of year | **2,764,475** | 2,364,816 | **2,517,384** | 2,197,293 |

Included in the Group's and the Company's trade receivables was the following amount due from a joint venture:

| | Group | | Company | |
|---|---|---|---|---|
| | **2005** | 2004 | **2005** | 2004 |
| | ***RMB'000*** | *RMB'000* | ***RMB'000*** | *RMB'000* |
| Joint venture | **451,965** | 412,539 | **922,378** | 841,916 |



## 24. INVENTORIES

Inventories primarily consist of materials and supplies.

Set out below is the breakdown of materials and supplies:

| | Group | | Company | |
|---|---|---|---|---|
| | **2005** | 2004 | **2005** | 2004 |
| | ***RMB'000*** | *RMB'000* | ***RMB'000*** | *RMB'000* |
| Flight equipment spare parts | **745,411** | 680,039 | **516,320** | 454,220 |
| Work in progress | **72,664** | 38,061 | **3,586** | 1,621 |
| Catering supplies | **33,240** | 25,188 | **21,547** | 13,089 |
| | **851,315** | 743,288 | **541,453** | 468,930 |

## 25. PREPAYMENTS, DEPOSITS AND OTHER RECEIVABLES

Set out below is the breakdown of prepayments, deposits and other receivables:

| | Group | | Company | |
|---|---|---|---|---|
| | **2005** | 2004 | **2005** | 2004 |
| | ***RMB'000*** | *RMB'000* | ***RMB'000*** | *RMB'000* |
| Advances and others | **457,568** | 324,655 | **379,258** | 322,047 |
| Manufacturers' credits on aircraft acquisition receivables | **62,930** | 74,518 | **62,930** | 74,518 |
| Prepaid aircraft operating lease rentals | **110,472** | 95,681 | **91,608** | 79,260 |
| Receivables from the sale of staff quarters | **4,333** | 24,681 | **4,333** | 24,681 |
| Miscellaneous deposits | **127,132** | 395,595 | **113,649** | 388,531 |
| | **762,435** | 915,130 | **651,778** | 889,037 |

# Notes to Financial Statements

Year ended 31 December 2005

## 26. DEPOSITS AND CASH AND CASH EQUIVALENTS

| | Group | | Company | |
|---|---|---|---|---|
| | **2005** | 2004 | **2005** | 2004 |
| | ***RMB'000*** | *RMB'000* | ***RMB'000*** | *RMB'000* |
| Cash and bank balances | **1,092,900** | 8,635,653 | **439,803** | 7,888,436 |
| Cash placed with CNAF | **67,567** | 261,904 | **37,570** | 219,655 |
| | **1,160,467** | 8,897,557 | **477,373** | 8,108,091 |
| Time deposits placed with banks | **958,573** | 648,667 | **141,677** | 94,287 |
| Time deposits placed with CNAF | **403,296** | 305,081 | **377,796** | 300,000 |
| | **1,361,869** | 953,748 | **519,473** | 394,287 |
| Less: Pledged deposits against: | | | | |
| Bank loans *(note 33)* | **81,598** | 64,242 | **81,598** | 64,242 |
| Finance leases *(note 32)* | **–** | 16,277 | **–** | 16,277 |
| Others * | **94,977** | 36,712 | **2,450** | – |
| Pledged deposits | **176,575** | 117,231 | **84,048** | 80,519 |
| Less: Non-pledged deposits with maturity of more than three months when acquired | **97,375** | 320,850 | **20,875** | 313,768 |
| Cash and cash equivalents | **2,248,386** | 9,413,224 | **891,923** | 8,108,091 |

* Including deposits pledged against the Group's aircraft operating leases and financial derivatives.

At the balance sheet date, the cash and cash equivalents balances of the Group denominated in RMB amounted to RMB992,468,000 (2004: RMB8,549,508,000). The RMB is not freely convertible into other currencies, however, under Mainland China's Foreign Exchange Control Regulations and Administration of Settlement, Sale and Payment of Foreign Exchange Regulations, the Group is permitted to exchange RMB for other currencies through banks authorised to conduct foreign exchange business.

Cash at banks earns interest at floating rates based on daily bank deposit rates. Time deposits are made for terms of between three days and one year depending on the immediate cash requirements of the Group and the Company, and earn interest at the respective time deposit rates.

## 27. BALANCES WITH OTHER CNAHC GROUP COMPANIES

The balances with other CNAHC group companies are unsecured, interest-free and have no fixed terms of repayment.

# Notes to Financial Statements

Year ended 31 December 2005

## 28. TRADE PAYABLES

An aged analysis of the trade payables is as follows:

| | Group | | Company | |
|---|---|---|---|---|
| | **2005** | 2004 | **2005** | 2004 |
| | ***RMB'000*** | *RMB'000* | ***RMB'000*** | *RMB'000* |
| Within 30 days | **3,247,501** | 3,108,028 | **2,549,447** | 2,740,974 |
| 31 to 60 days | **603,010** | 805,858 | **468,948** | 673,690 |
| 61 to 90 days | **293,407** | 304,943 | **253,482** | 243,448 |
| Over 90 days | **457,446** | 224,779 | **394,251** | 161,241 |
| At end of year | **4,601,364** | 4,443,608 | **3,666,128** | 3,819,353 |

Included in the Group's and the Company's trade payables was the following amount due to a joint venture:

| | Group | | Company | |
|---|---|---|---|---|
| | **2005** | 2004 | **2005** | 2004 |
| | ***RMB'000*** | *RMB'000* | ***RMB'000*** | *RMB'000* |
| Joint venture | **115,435** | 179,934 | **288,588** | 449,835 |



## 29. BILLS PAYABLE

An aged analysis of the bills payable is as follows:

| | Group and Company | |
|---|---|---|
| | **2005** | 2004 |
| | ***RMB'000*** | *RMB'000* |
| Over 90 days | **327,937** | 362,033 |
| At end of year | **327,937** | 362,033 |

Included in the Group's and the Company's bills payable was the following amount due to CNAF:

| | Group and Company | |
|---|---|---|
| | **2005** | 2004 |
| | ***RMB'000*** | *RMB'000* |
| CNAF | **103,426** | – |

# Notes to Financial Statements

Year ended 31 December 2005

## 30. OTHER PAYABLES AND ACCRUALS

Set out below is a breakdown of other payables and accruals:

| | Group | | Company | |
|---|---|---|---|---|
| | **2005** | 2004 | **2005** | 2004 |
| | ***RMB'000*** | *RMB'000* | ***RMB'000*** | *RMB'000* |
| Provision for staff housing benefits | **135,381** | 469,617 | **112,372** | 448,694 |
| Accrued salaries, wages and benefits | **894,052** | 692,510 | **732,240** | 562,493 |
| Interest expense payable | **308,152** | 269,928 | **298,330** | 255,977 |
| Accruals for share issue expenses | **–** | 208,644 | **–** | 208,644 |
| Custom duties and levies payable | **982,819** | 742,201 | **900,544** | 665,986 |
| Current portion of long term payables *(note 35)* | **100,218** | 101,802 | **100,218** | 101,802 |
| Current portion of deferred income *(note 36)* | **76,943** | 76,943 | **76,943** | 76,943 |
| Advances from customers | **259,965** | 294,798 | **163,608** | 224,321 |
| Accrued operating expenses | **1,038,995** | 716,548 | **909,260** | 611,257 |
| Others | **371,910** | 347,296 | **275,381** | 231,753 |
| | **4,168,435** | 3,920,287 | **3,568,896** | 3,387,870 |



## 31. PROVISION FOR MAJOR OVERHAULS

Set out below is the movement of provision for major overhauls in respect of aircraft and engines under operating leases for each of the two years ended 31 December 2005 and 2004.

| | Group | | Company | |
|---|---|---|---|---|
| | **2005** | 2004 | **2005** | 2004 |
| | ***RMB'000*** | *RMB'000* | ***RMB'000*** | *RMB'000* |
| At beginning of year | **498,828** | 404,939 | **401,372** | – |
| Transferred to the Company upon its incorporation *(note 1)* | **–** | – | **–** | 363,842 |
| Provision for the year | **415,513** | 221,543 | **271,550** | 61,341 |
| Utilised during the year | **(259,902)** | (127,654) | **(179,630)** | (23,811) |
| At end of year | **654,439** | 498,828 | **493,292** | 401,372 |
| Less: Portion classified as current liabilities | **(18,721)** | (28,130) | **(18,721)** | (28,130) |
| Long term portion | **635,718** | 470,698 | **474,571** | 373,242 |

# Notes to Financial Statements

Year ended 31 December 2005

## 32. OBLIGATIONS UNDER FINANCE LEASES

The Group and the Company have obligations under finance lease agreements expiring during the years from 2006 to 2011 (2004: 2005 to 2011) in respect of aircraft and related equipment. As at the balance sheet date, future minimum lease payments under these finance leases, together with the present value of the net minimum lease payments, which are principally denominated in foreign currencies, are as follows:

| | **Group and Company** | | Group and Company | |
|---|---|---|---|---|
| | **Minimum lease payments 2005** *RMB'000* | **Present value of Minimum lease payments 2005** *RMB'000* | Minimum lease payments 2004 *RMB'000* | Present value of Minimum lease payments 2004 *RMB'000* |
| Amounts repayable: | | | | |
| Within one year | **2,306,587** | **1,954,873** | 2,313,871 | 1,705,146 |
| In the second year | **2,330,192** | **1,949,802** | 2,408,481 | 1,943,630 |
| In the third to fifth years, inclusive | **6,850,768** | **6,071,492** | 7,784,209 | 6,722,448 |
| Over five years | **79,157** | **57,377** | 2,049,406 | 1,910,163 |
| Total minimum finance lease payments | **11,566,704** | **10,033,544** | 14,555,967 | 12,281,387 |
| Less: Amounts representing finance charges | **(1,533,160)** | | (2,274,580) | |
| Present value of minimum lease payments | **10,033,544** | | 12,281,387 | |
| Less: Portion classified as current liabilities | **(1,954,873)** | | (1,705,146) | |
| Long term portion | **8,078,671** | | 10,576,241 | |

Certain lease financing arrangements comprised finance leases between the Company and certain of its subsidiaries, and the corresponding borrowings between such subsidiaries and banks. The Company has guaranteed the subsidiaries' obligations under the bank borrowings and, accordingly, the aforesaid assets and obligations are recorded in the balance sheets to reflect the substance of the transactions. The future payments under these leases have therefore been presented by the Company and the Group in the amounts that reflect the payments under the bank borrowings between the subsidiaries and the banks.

At 31 December 2005, there were 21 (2004: 23) aircraft under finance lease agreements. Under the terms of the leases, the Company has the option to purchase, at the end of or during the lease terms, certain aircraft at fair market value and others at either fair market value or at the price as stipulated in the finance lease agreements. For the current year, the effective borrowing rate ranged from 1.64% to 9.84% (2004: 1.64% to 9.13%).

The Group's and the Company's finance leases were secured by:

(a) mortgages over certain of the Group's and the Company's aircraft, which had an aggregate carrying value of approximately RMB10,487 million as at 31 December 2005 (2004: RMB11,999 million) *(note 15)*;

(b) the pledge of certain of the Group's and the Company's bank deposits amounting to approximately RMB16 million as at 31 December 2004 *(note 26)*; and

(c) guarantees by certain commercial banks in an aggregate amount of approximately RMB12,044 million (2004: RMB14,785 million).

# Notes to Financial Statements

Year ended 31 December 2005

## 32. OBLIGATIONS UNDER FINANCE LEASES (Continued)

As at 31 December 2005, certain PRC state-owned banks have provided counter-guarantees in an aggregate amount of RMB2,521 million (2004: RMB3,074 million) in respect of the commercial bank guarantee arrangements set out in note 32 (c) above. At 31 December 2004, CNAHC and CNAF, in turn, provided counter-guarantees to certain of these PRC state-owned banks in the amounts of RMB921 million and RMB3,976 million *(note 46)*, respectively. These counter-guarantees provided by CNAHC and CNAF were released during the year.

## 33. BANK AND OTHER LOANS

| | Group | | Company | |
|---|---|---|---|---|
| | **2005** | 2004 | **2005** | 2004 |
| | ***RMB'000*** | *RMB'000* | ***RMB'000*** | *RMB'000* |
| Bank loans: | | | | |
| Secured | **11,667,241** | 13,685,002 | **11,258,268** | 13,643,002 |
| Unsecured | **8,336,734** | 7,519,047 | **8,126,735** | 7,144,917 |
| | **20,003,975** | 21,204,049 | **19,385,003** | 20,787,919 |
| Other loans: | | | | |
| Secured | **50,560** | 66,667 | **50,560** | 66,667 |
| Unsecured | **169,514** | 431,957 | **140,351** | 297,731 |
| | **220,074** | 498,624 | **190,911** | 364,398 |
| Corporate bonds: | | | | |
| Unsecured | **3,000,000** | – | **3,000,000** | – |
| | **23,224,049** | 21,702,673 | **22,575,914** | 21,152,317 |
| Bank loans repayable: | | | | |
| Within one year | **10,217,210** | 8,359,280 | **9,973,050** | 7,943,149 |
| In the second year | **2,732,712** | 3,049,084 | **2,698,551** | 3,049,084 |
| In the third to fifth years, inclusive | **4,677,985** | 6,178,222 | **4,575,502** | 6,178,222 |
| Over five years | **2,376,067** | 3,617,464 | **2,137,900** | 3,617,464 |
| Other loans repayable: | | | | |
| Within one year | **183,960** | 446,771 | **154,797** | 312,546 |
| In the second year | **14,446** | 14,815 | **14,446** | 14,815 |
| In the third to fifth years, inclusive | **21,669** | 37,037 | **21,668** | 37,037 |
| Corporate bonds: | | | | |
| Over five years | **3,000,000** | – | **3,000,000** | – |
| Total bank and other loans | **23,224,049** | 21,702,673 | **22,575,914** | 21,152,317 |
| Less: Portion classified as current liabilities | **(10,401,170)** | (8,806,051) | **(10,127,847)** | (8,255,695) |
| Long term portion | **12,822,879** | 12,896,622 | **12,448,067** | 12,896,622 |

# Notes to Financial Statements

Year ended 31 December 2005

## 33. BANK AND OTHER LOANS (Continued)

Further details of bank and other loans at the balance sheet date are as follows:

| Nature | Interest rate and final maturity | Group 2005 RMB'000 | Group 2004 RMB'000 | Company 2005 RMB'000 | Company 2004 RMB'000 |
|---|---|---|---|---|---|
| **RMB denominated loans:** | | | | | |
| Loans for purchases of aircraft and related equipment | Floating interest rates ranging from 5.18% to 5.51% and 4.94% to 5.76% per annum at 31 December 2005 and 2004, respectively, with maturities through 2014 | **4,452,262** | 5,382,986 | **4,452,262** | 5,382,986 |
| Loans for working capital | Fixed interest rates ranging from 2.92% to 5.02% and 4.54% to 4.94% per annum at 31 December 2005 and 2004, respectively, with maturities through 2007 | **4,196,394** | 2,528,869 | **4,140,000** | 2,171,800 |
| **United States dollars denominated loans:** | | | | | |
| Loans for purchases of aircraft and related equipment | Fixed interest rates ranging from 5.40% to 8.33% and 5.40% to 10.17% per annum at 31 December 2005 and 2004, respectively, with maturities through 2012 | **5,837,073** | 7,155,311 | **5,837,073** | 7,155,311 |
| Loans for purchases of aircraft and related equipment | Floating interest rate at six months LIBOR + 0.4% to 0.7% per annum at 31 December 2005 and 2004 with maturities through 2014 | **1,514,147** | 1,270,236 | **1,105,174** | 1,270,236 |
| Loans for working capital | Floating interest rates at six months LIBOR + 0.5% to 0.7% and six months LIBOR + 0.6% to 0.8% per annum at 31 December 2005 and 2004, respectively, with maturities through 2007 | **4,000,508** | 5,365,271 | **3,833,345** | 5,171,984 |
| **Hong Kong dollars denominated loans:** | | | | | |
| Loans for working capital | Fixed interest rate at 4.60% per annum at 31 December 2005 with maturities through 2006 | **15,605** | – | **–** | – |
| Loans for working capital | Floating interest rate at six months LIBOR +1% per annum at 31 December 2005 with maturities through 2006 | **208,060** | – | **208,060** | – |
| **Corporate bonds** | | | | | |
| Corporate bonds for purchases of aircraft and related equipment | Fixed interest rate at 4.50% per annum at 31 December 2005 with maturity in September 2015 | **3,000,000** | – | **3,000,000** | – |
| | | **23,224,049** | 21,702,673 | **22,575,914** | 21,152,317 |
| Less: Loans due within one year classified as current liabilities | | **(10,401,170)** | (8,806,051) | **(10,127,847)** | (8,255,695) |
| Loans due after one year classified as long term portion | | **12,822,879** | 12,896,622 | **12,448,067** | 12,896,622 |

# Notes to Financial Statements

Year ended 31 December 2005

## 33. BANK AND OTHER LOANS (Continued)

The interest rates of RMB denominated loans are set and subject to change by the People's Bank of China.

The Group's and the Company's bank and other loans of approximately RMB14,718 million as at 31 December 2005 (2004: RMB13,710 million) were secured by:

(a) mortgages over certain of the Group's and the Company's aircraft and related equipment, which had an aggregate carrying value of approximately RMB16,471 million as at 31 December 2005 (2004: RMB16,586 million) *(note 15)*;

(b) the pledge of certain of the Group's and the Company's bank deposits amounting to RMB82 million as at 31 December 2005 (2004: RMB64 million) *(note 26)*; and

(c) guarantees by certain commercial banks amounting to RMB9,780 million (2004: RMB8,294 million).

As at 31 December 2005, certain PRC state-owned banks provided counter-guarantees in an aggregate amount of RMB4,891 million (2004: RMB5,943 million) to one of these commercial banks as mentioned in note 33 (c) above. At 31 December 2004, CNAHC and CNAF, in turn, provided counter-guarantees to certain of these PRC state-owned banks in the amounts of RMB1,455 million and RMB761 million *(note 46)*, respectively. These counter-guarantees provided by CNAHC and CNAF were released during the year.

## 34. DUE FROM/(TO) SHAREHOLDERS



Set out below is the breakdown of the amounts due from/(to) shareholders:

| | **Group** | | **Company** | |
|---|---|---|---|---|
| | **2005** | 2004 | **2005** | 2004 |
| | ***RMB'000*** | *RMB'000* | ***RMB'000*** | *RMB'000* |
| Due from CNAHC | **474,216** | – | **474,216** | – |
| Due to CNAHC | **–** | (2,137,437) | **–** | (2,121,533) |
| Due to CNACG | **(133,680)** | (118,680) | **(118,680)** | (118,680) |
| | **(133,680)** | (2,256,117) | **(118,680)** | (2,240,213) |

The amount due from CNAHC mainly arose from transactions as set out in notes 20 and 46(A) to the financial statements. The amount is unsecured, interest-free and repayable within one year.

The amounts due to shareholders are unsecured, interest-free and repayable within one year.

# Notes to Financial Statements

Year ended 31 December 2005

## 35. LONG-TERM PAYABLES

Long term payables mainly represent customs duties and value-added tax payable after one year to the PRC government in respect of the acquisition of aircraft and related equipment under finance leases. The customs duties and value-added tax are payable upon repayment of the corresponding finance lease installments. Set out below are details of the customs duties and value-added tax payable further analysed into non-current and current portions:

| | Group | | Company | |
|---|---|---|---|---|
| | **2005** | 2004 | **2005** | 2004 |
| | ***RMB'000*** | *RMB'000* | ***RMB'000*** | *RMB'000* |
| Customs duties and value-added tax payable | **417,339** | 539,121 | **417,339** | 539,121 |
| Others | **35,759** | 8,992 | **258** | 258 |
| | **453,098** | 548,113 | **417,597** | 539,379 |
| Less: Portion classified as current liabilities *(note 30)* | **(100,218)** | (101,802) | **(100,218)** | (101,802) |
| Long term portion | **352,880** | 446,311 | **317,379** | 437,577 |

## 36. DEFERRED INCOME

In 2000, the Group acquired an aircraft which was funded by the PRC government, and a further aircraft was injected into the Group by the PRC government during 2004. In accordance with IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*, the Group recorded these aircraft purchased in 2000 and received in 2004 as property, plant and equipment with the corresponding amounts of government grant recorded as deferred income at the respective dates of the delivery of the aircraft. As such, the government subsidies in relation to the aforesaid aircraft purchased in 2000 and the aircraft received in 2004 are recorded in deferred income of the Group in 2000 and 2004, respectively. The deferred income is recognised as income over the expected useful lives of the relevant aircraft on the straight-line basis.

# Notes to Financial Statements

Year ended 31 December 2005

## 36. DEFERRED INCOME (Continued)

The movements of deferred income as stated under current and non-current liabilities are as follows:

| | Group | | Company | |
|---|---|---|---|---|
| | **2005** | 2004 | **2005** | 2004 |
| | ***RMB'000*** | *RMB'000* | ***RMB'000*** | *RMB'000* |
| Deferred income: | | | | |
| At beginning of the year | **1,462,667** | 1,157,880 | **1,462,667** | – |
| Transferred to the Company upon its incorporation *(note 1)* | **–** | – | **–** | 1,462,667 |
| Additions during the year | **–** | 304,787 | **–** | – |
| At end of year | **1,462,667** | 1,462,667 | **1,462,667** | 1,462,667 |
| Accumulated income recognised as other operating revenue: | | | | |
| At beginning of year | **282,871** | 212,278 | **282,871** | – |
| Transferred to the Company upon its incorporation *(note 1)* | **–** | – | **–** | 263,636 |
| Credit during the year *(note 5)* | **76,943** | 70,593 | **76,943** | 19,235 |
| At end of the year | **359,814** | 282,871 | **359,814** | 282,871 |
| Net amount | **1,102,853** | 1,179,796 | **1,102,853** | 1,179,796 |
| Less: Portion classified as current liabilities *(note 30)* | **(76,943)** | (76,943) | **(76,943)** | (76,943) |
| Long term portion | **1,025,910** | 1,102,853 | **1,025,910** | 1,102,853 |

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## 37. SHARE CAPITAL

| | **Number of shares 2005** | **Nominal value 2005** | Number of shares 2004 | Nominal value 2004 |
|---|---|---|---|---|
| | | ***RMB'000*** | | *RMB'000* |
| **Company and Group** | | | | |
| Registered, issued and fully paid: | | | | |
| – State legal person shares of RMB1.00 each | **4,826,195,989** | **4,826,196** | 4,855,945,675 | 4,855,946 |
| – Non-H foreign shares of RMB1.00 each | **1,380,482,920** | **1,380,483** | 1,388,992,507 | 1,388,992 |
| – H shares of RMB1.00 each | **3,226,532,000** | **3,226,532** | 2,805,680,000 | 2,805,680 |
| | **9,433,210,909** | **9,433,211** | 9,050,618,182 | 9,050,618 |

# Notes to Financial Statements

Year ended 31 December 2005

## 37. SHARE CAPITAL (Continued)

A summary of the movements in the Company's issued share capital for the year ended 31 December 2005 is as follows:

| | Number of shares 2005 | Nominal value 2005 RMB'000 |
|---|---|---|
| At beginning of year | **9,050,618,182** | **9,050,618** |
| State legal person shares converted into H shares *(note 37(a))* | **(29,749,686)** | **(29,750)** |
| Non-H foreign shares converted into H shares *(note 37(a))* | **(8,509,587)** | **(8,509)** |
| Share placement and public offer *(note 37(b))* | **420,852,000** | **420,852** |
| | **9,433,210,909** | **9,433,211** |

A summary of the movements in the Company's issued share capital for the period from 30 September 2004 (date of incorporation of the Company) to 31 December 2004 is as follows:

| | Number of shares 2004 | Nominal value 2004 RMB'000 |
|---|---|---|
| Restructuring *(note 37(c))* | 6,500,000,000 | 6,500,000 |
| State legal person shares converted into H shares *(note 37(d))* | (198,331,240) | (198,331) |
| Non-H foreign shares converted into H shares *(note 37(d))* | (56,730,578) | (56,731) |
| Share placement and public offer *(note 37(e))* | 2,805,680,000 | 2,805,680 |
| | 9,050,618,182 | 9,050,618 |

*Notes:*

(a) In January 2005, upon the exercise of the over-allotment options granted to international underwriters, the Company issued 420,852,000 H shares, consisting of 382,592,727 new shares, 29,749,686 H shares converted from state legal person shares and 8,509,587 H shares converted from non-H foreign shares, with a par value of RMB1.00 each at HK$2.98 (equivalent to RMB3.17072) per share. The proceeds from the sale of the state legal person shares and non-H foreign shares totalling approximately RMB117 million, after deducting share issue expenses of approximately RMB4 million which were borne by the Social Security Fund in connection with the sale of the state legal person shares and non-H foreign shares, were remitted to the Social Security Fund.

(b) As referred to in note 37 (a) above, the Company issued 420,852,000 H shares upon the exercise of the over-allotment options granted to international underwriters. After deducting aggregate net proceeds of approximately RMB117 million from the sale of 29,749,686 H shares converted from state legal person shares and 8,509,587 H shares converted from non-H foreign shares, which were remitted to the Social Security Fund and share issue expenses of approximately RMB45 million (before deducting share issue expenses of approximately RMB4 million borne by the Social Security Fund), the Company raised net proceeds of approximately RMB1,172 million, of which paid-up share capital amounted to approximately RMB383 million and capital reserve amounted to approximately RMB789 million.

(c) Pursuant to the Restructuring, and the basis of presentation thereof, as discussed in note 1 to these financial statements, the owners' equity of the Company in the consolidated balance sheet as at 30 September 2004, the date of incorporation of the Company, was converted into the Company's share capital of RMB6,500 million of RMB1.00 each with the rest as capital reserve.

# Notes to Financial Statements

Year ended 31 December 2005

## 37. SHARE CAPITAL (Continued)

*Notes:* (Continued)

(d) The Company's H shares were listed on the Hong Kong Stock Exchange and the London Stock Exchange on 15 December 2004 and 2,805,680,000 H shares, consisting of 2,550,618,182 new shares, 198,331,240 shares converted from state legal person shares and 56,730,578 shares converted from non-H foreign shares, with a par value of RMB1.00 each were issued to the public by way of placement and offer at HK$2.98 (equivalent to approximately RMB3.17072) each. The proceeds from the sale of the 198,331,240 state legal person shares and 56,730,578 non-H foreign shares totalling approximately RMB759 million, after deducting the portion of share issuing expenses of approximately RMB50 million which were borne by the Social Security Fund in connection with these sales of State legal person shares and non-H foreign shares, were remitted to the Social Security Fund.

(e) As referred to in note 37 (d) above, the Company issued 2,805,680,000 H shares to the public by way of placement and offer. After deducting aggregate net proceeds of approximately RMB759 million from the sale of 198,331,240 H shares converted from state legal person shares and 56,730,578 H shares converted from non-H foreign shares which were remitted to the Social Security Fund as referred to in note 37 (d) above and share issue expenses of approximately RMB536 million (before deducting share issue expenses of approximately RMB50 million borne by the Social Security Fund as referred to in note 37 (d) above), the Company raised net proceeds of approximately RMB7,601 million, of which paid-up share capital amounted to approximately RMB2,551 million and capital reserve amounted to approximately RMB5,050 million.

The H shares rank pari passu, in all material respects, with the state legal person shares and non-H foreign shares of the Company.



## 38. RESERVES

### Group

The amounts of the Group's reserves and the movements therein for each of the two years ended 31 December 2005 are presented in the consolidated statement of changes in equity on page 58 of these financial statements.

### Company

| | Capital reserve<br>*RMB'000* | Reserve funds<br>*RMB'000* | Retained earnings<br>*RMB'000* | Proposed final dividend<br>*RMB'000* | Total<br>*RMB'000* |
|---|---|---|---|---|---|
| Upon incorporation of the Company *(note 38(a))* | (627,464) | – | 34,813 | – | (592,651) |
| Profit for the period from 1 October to 31 December 2004 | – | – | 1,229,603 | – | 1,229,603 |
| Distributions *(note 38(b))* | – | – | (377,550) | – | (377,550) |
| Transfer to reserve funds *(note 13)* | – | 51,908 | (51,908) | – | – |
| Issue of new shares upon listing *(note 37(e))* | 5,536,678 | – | – | – | 5,536,678 |
| Share issue expenses *(note 37(e))* | (486,457) | – | – | – | (486,457) |
| At 31 December 2004 and I January 2005 | 4,422,757 | 51,908 | 834,958 | – | 5,309,623 |
| Profit for the year | – | – | 2,113,350 | – | 2,113,350 |
| Transfer to statutory reserve funds *(note 13)* | – | 252,908 | (252,908) | – | – |
| Proposed final 2005 dividend *(note 13(d))* | – | – | (224,793) | 224,793 | – |
| Issue of new shares upon exercise of over-allotment options *(note 37(b))* | 830,414 | – | – | – | 830,414 |
| Share issue expenses *(note 37(b))* | (40,910) | – | – | – | (40,910) |
| **At 31 December 2005** | **5,212,261** | **304,816** | **2,470,607** | **224,793** | **8,212,477** |

# Notes to Financial Statements

Year ended 31 December 2005

## 38. RESERVES (Continued)

*Notes:*

(a) As described in note 1 to these financial statements, the financial statements of the Group for the year ended 31 December 2004 have been prepared as if the Group had been in existence throughout the year and as if the Relevant Businesses and the interests in the Relevant Companies were transferred to the Company prior to 1 January 2004. Upon incorporation of the Company on 30 September 2004, the historical net asset value of the Relevant Businesses and the interests in the Relevant Companies transferred to the Company were converted into the Company's registered capital as described in note 37 (c) to these financial statements with all the then existing reserves eliminated and the resulting difference dealt with in the capital reserve and retained earnings. Accordingly, the aggregate of the capital reserve and retained earnings amounts, being the difference between the amount of share capital issued and the historical net asset value of the Relevant Businesses and the interests in the Relevant Companies transferred to the Company as at 30 September 2004, were presented in the reserves of both the Group and the Company.

Retained earnings of the Company and the Group upon incorporation of the Company represent the amounts set aside for distributions, details of which are set out in note 13 to these financial statements. Therefore, these amounts were not capitalised by the Company and the Group upon the Company's incorporation.

(b) Details of the distributions are set out in note 13 to these financial statements.

## 39. LONG TERM COMPENSATION PLAN

The Company has adopted a long term compensation plan (the "Plan") which was approved by the shareholders on 18 October 2004 for the purpose of motivating its employees. The Plan provides for the grant of share appreciation rights ("SARs") to eligible participants, including the Company's Directors (excluding independent non-executive Directors), supervisors (excluding independent supervisors), president, vice presidents, heads of key departments in the Company's headquarters, general managers and general deputy managers of principal branches and subsidiaries as well as selected senior professionals and key specialists. In any event, SARs will be granted to no more than 200 individuals. The Plan will remain in force unless otherwise cancelled or amended.



Under the Plan, the holders of SARs are entitled the rights to receive an amount in respect of the appreciation in market value of the Company's H shares from the date of grant of SARs and the date of exercise. No shares will be issued under the Plan and therefore the Company's equity interests will not be diluted as a result of the issuance of SARs. The maximum number of unexercised SARs permitted to be granted under the Plan is, upon their exercise, limited to 2% of the Company's H shares in issue at any time during each year. The maximum number of SARs granted to eligible participants under the Plan within any 12-month period is, upon their exercise, limited to 0.4% of the Company's H shares in issue at any time during each year. The maximum number of SARs granted to any eligible participant is limited to 10% of the total number of unexercised SARs in issue at any time during each year. Any further grant of SARs in excess of the above limits is subject to shareholders' approval in general meetings.

The exercise period of all SARs commences after a vesting period and ends on a date which is not later than five years from the date of grant of the SARs. As at each of the last day of the second, third and fourth anniversary of the date of grant, the total number of SARs exercisable will not exceed 30%, 70% and 100%, respectively, of the total SARs granted to the respective eligible participants.

The exercise price of SARs will be equal to the average closing price of the Company's H shares on the Hong Kong Stock Exchange for the five consecutive trading days immediately preceding the date of the grant.

As at 31 December 2005 and 31 December 2004, no SARs had been issued under the Plan.

# Notes to Financial Statements

Year ended 31 December 2005

## 40. DISTRIBUTABLE RESERVES

As at 31 December 2005, in accordance with the PRC Company Law, an amount of approximately RMB8,505 million (2004: RMB7,704 million) standing to the credit of the Company's capital reserve account, and an amount of approximately RMB305 million (2004: RMB52 million) standing to the credit of the Company's reserve funds, as determined in accordance with PRC GAAP, were available for distribution by way of future capitalisation issue. In addition, the Company had retained earnings of approximately RMB1,641 million (2004: RMB208 million), as determined in accordance with PRC GAAP and being the lesser amount of the retained earnings determined in accordance with PRC GAAP and IFRSs, available for distribution as dividend.

## 41. CONTINGENT LIABILITIES

Pursuant to the Restructuring, the following legal matters set out in items (a) and (b) below were transferred to or assumed by the Company upon its incorporation. As at 31 December 2005, the Group had the following contingent liabilities:

(a) Pursuant to the Restructuring of CNAHC, in preparation for the listing of the Company's H shares on Hong Kong Stock Exchange and the London Stock Exchange, the Company entered into a restructuring agreement with CNAHC and CNACG on 20 November 2004 ("Restructuring Agreement"), except for liabilities constituting or arising out of or relating to business undertaken by the Company after the Restructuring, no other liabilities were assumed by the Company and the Company is not liable, whether severally, or jointly and severally, for debts and obligations incurred prior to the Restructuring by CNAHC and CNACG. The Company has also undertaken to indemnify CNAHC and CNACG in respect of any damage suffered or incurred by CNAHC and CNACG as a result of any breach by the Company of any provision of the Restructuring Agreement.

(b) On 15 April 2002, Flight CA129 crashed on approach to Gimhae International Airport, South Korea. There were 129 fatalities including 121 passengers and 8 crew members aboard the crashed aircraft. An investigation was conducted by the Chinese and the Korean civil aviation authorities, but the cause of the accident has yet to be released at the date of these financial statements. Certain injured passengers and families of the deceased passengers have commenced proceedings in Korean courts seeking damages against Air China International Corporation, the predecessor of the Company. The Group cannot predict the timing of the courts' judgements or the possible outcome of the lawsuits nor any possible appeal actions. Up to 31 December 2005, the Company, Air China International Corporation and the Company's insurer had paid an aggregate amount of approximately RMB197 million in respect of passenger liability and other auxiliary costs. Included in the RMB197 million is an amount of approximately RMB179 million borne by the Company's insurer. As part of the Restructuring, CNAHC has agreed to indemnify the Group for any liabilities relating to the crash of Flight CA129, excluding the compensation already paid up to 30 September 2004 (being the date of incorporation of the Company). The Directors of the Company believe that there will not be any material adverse impact on the Group's financial position.

# Notes to Financial Statements

Year ended 31 December 2005

## 41. CONTINGENT LIABILITIES (Continued)

(c) The Group and the Company have issued guarantees to banks in respect of the bank loans granted to the following parties:

| | Group | | Company | |
|---|---|---|---|---|
| | **2005** | 2004 | **2005** | 2004 |
| | ***RMB'000*** | *RMB'000* | ***RMB'000*** | *RMB'000* |
| Joint ventures | **91,000** | – | **–** | – |
| Associates | **149,109** | 214,002 | **128,303** | 198,102 |
| | **240,109** | 214,002 | **128,303** | 198,102 |

## 42. COMMITMENTS

### (a) Capital commitments

The Group and the Company have the following amounts of contractual commitments for the acquisition and construction of plant, property and equipment:

| | Group | | Company | |
|---|---|---|---|---|
| | **2005** | 2004 | **2005** | 2004 |
| | ***RMB'000*** | *RMB'000* | ***RMB'000*** | *RMB'000* |
| Contracted, but not provided for: | | | | |
| Aircraft and flight equipment | **31,696,796** | 8,750,195 | **31,403,107** | 7,272,969 |
| Buildings | **835,902** | 544,855 | **664,614** | 211,607 |
| Others | **22,339** | 8,426 | **22,339** | 8,426 |
| | **32,555,037** | 9,303,476 | **32,090,060** | 7,493,002 |
| Authorised, but not contracted for: | | | | |
| Aircraft and flight equipment | **3,973,095** | – | **3,564,126** | – |
| Buildings | **1,920,079** | 2,528,544 | **1,920,079** | 2,528,544 |
| Others | **65,608** | – | **–** | – |
| Total capital commitments | **38,513,819** | 11,832,020 | **37,574,265** | 10,021,546 |

### (b) Investment commitments

As at 31 December 2005, the Company is committed to make capital contributions of RMB358 million (equivalent to approximately US$45 million) (2004: RMB422 million) and RMB103 million (2004: Nil) to a joint venture and an associate, respectively.

# Notes to Financial Statements

Year ended 31 December 2005

## 42. COMMITMENTS (Continued)

### (c) Operating lease commitments

The Group and the Company lease certain of its office premises, aircraft and related equipment under operating lease arrangements. Leases for these assets are negotiated for terms ranging from 1 to 20 years.

At the balance sheet date, the Group and the Company have the following future minimum lease payments under non-cancellable operating leases:

| | Group | | Company | |
|---|---|---|---|---|
| | **2005** | 2004 | **2005** | 2004 |
| | ***RMB'000*** | *RMB'000* | ***RMB'000*** | *RMB'000* |
| Within one year | **1,507,057** | 1,140,228 | **760,230** | 748,202 |
| In the second to fifth years, inclusive | **2,862,349** | 3,215,879 | **1,657,353** | 2,111,282 |
| Over five years | **1,066,083** | 1,000,319 | **644,741** | 566,585 |
| | **5,435,489** | 5,356,426 | **3,062,324** | 3,426,069 |

## 43. FINANCIAL INSTRUMENTS



### (a) Fair value

Financial assets of the Group and the Company mainly include cash and cash equivalents, pledged deposits, trade receivables, available-for-sale investments, deposits and other receivables. Financial liabilities of the Group and the Company mainly include bank and other loans, obligations under finance leases, trade payables, other payables, bills payable and air traffic liabilities.

The carrying amounts of the Group's and the Company's financial instruments approximated their fair value as at the balance sheet date. Fair value estimates are made at a specific point in time and based on relevant market information about the financial instruments. These estimates are subjective in nature and involve uncertainties and matters of significant judgement and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

# Notes to Financial Statements

Year ended 31 December 2005

## 43. FINANCIAL INSTRUMENTS (Continued)

### (b) Interest rate risk

The following table sets out the carrying amount, by maturity, of the Group's financial instruments that are exposed to interest rate risk:

**For the year ended 31 December 2005**

*Fixed rate*

| | **Within one year** | **In the second year** | **In the third to fifth years, inclusive** | **Over five years** | **Total** |
|---|---|---|---|---|---|
| | *RMB'000* | *RMB'000* | *RMB'000* | *RMB'000* | *RMB'000* |
| Obligations under finance leases | **1,625,907** | **1,949,802** | **6,071,492** | **57,377** | **9,704,578** |
| Bank and other loans | **4,877,843** | **1,502,072** | **2,856,723** | **812,434** | **10,049,072** |
| 4.5% corporate bonds | **–** | **–** | **–** | **3,000,000** | **3,000,000** |
| Bills payable | **327,937** | **–** | **–** | **–** | **327,937** |
| Cash assets | **2,522,336** | **–** | **–** | **–** | **2,522,336** |

*Floating rate*

| | **Within one year** | **In the second year** | **In the third to fifth years, inclusive** | **Over five years** | **Total** |
|---|---|---|---|---|---|
| | *RMB'000* | *RMB'000* | *RMB'000* | *RMB'000* | *RMB'000* |
| Obligations under finance leases | **328,966** | **–** | **–** | **–** | **328,966** |
| Bank and other loans | **5,523,327** | **1,245,086** | **1,842,931** | **1,563,633** | **10,174,977** |

For the year ended 31 December 2004

*Fixed rate*

| | Within one year | In the second year | In the third to fifth years, inclusive | Over five years | Total |
|---|---|---|---|---|---|
| | *RMB'000* | *RMB'000* | *RMB'000* | *RMB'000* | *RMB'000* |
| Obligations under finance leases | 1,629,551 | 1,606,254 | 6,722,448 | 1,910,163 | 11,868,416 |
| Bank and other loans | 3,197,913 | 1,195,648 | 3,694,366 | 1,596,253 | 9,684,180 |
| Bills payable | 362,033 | – | – | – | 362,033 |
| Cash assets | 9,851,305 | – | – | – | 9,851,305 |

*Floating rate*

| | Within one year | In the second year | In the third to fifth years, inclusive | Over five years | Total |
|---|---|---|---|---|---|
| | *RMB'000* | *RMB'000* | *RMB'000* | *RMB'000* | *RMB'000* |
| Obligations under finance leases | 75,595 | 337,376 | – | – | 412,971 |
| Bank and other loans | 5,608,138 | 1,868,251 | 2,520,893 | 2,021,211 | 12,018,493 |

Interest on financial instruments classified as floating rate is repriced at intervals of less than one year. Interest on financial instruments classified as fixed rate is fixed until the maturity of the instrument. The other financial instruments of the Group that are not included in the above tables are non-interest-bearing and are therefore not subject to interest rate risk.

# Notes to Financial Statements

Year ended 31 December 2005

## 44. FINANCIAL RISK MANAGEMENT OBJECTIVES AND POLICIES

The Group's principal financial instruments, other than derivatives, comprise bank and other loans, obligations under finance leases, cash and cash equivalents and pledged deposits. The main purpose of these financial instruments is to raise finance for the Group's operations. The Group has various other financial assets and liabilities such as trade receivables and trade payables, which arise directly from its operations.

The Group also enters into derivative transactions, including principally swaps and collars contracts. The purpose is to manage the jet fuel price risk arising from the Group's operations.

It is, and has been throughout the year under review, the Group's policy that no trading in financial instruments shall be undertaken.

The Group operates globally and generates revenue in various currencies. The Group's airline operations are exposed to business risk, liquidity risk, jet fuel price risk, foreign currency risk, interest rate risk and credit risk. The Group's overall risk management approach is to moderate the effects of such volatility on its financial performance.

Financial risk management policies are periodically reviewed and approved by the Board of Directors and they are summarised below.

### (a) Business risk



The operations of the air transportation industry are substantially influenced by global political and economic development. Factors such as accidents and wars may have a material impact on the Group's operations or the industry as a whole. In addition, the Group primarily conducts its principal operations in Mainland China and accordingly is subject to special consideration and significant risks not typically associated with companies in the United States of America and Western Europe. These include risks associated with, among other things, the political, economic and legal environment, competition and influence of the CAAC in the Chinese civil aviation industry.

### (b) Liquidity risk

The Group's net current liabilities amounted to approximately RMB16,006 million at 31 December 2005 (2004: RMB9,053 million). The Group recorded a net cash inflow from operating activities of approximately RMB6,048 million for the year ended 31 December 2005 (2004: RMB6,151 million). For the same period, the Group had a net cash outflow from investing activities of approximately RMB12,500 million (2004: RMB4,979 million). The Group also recorded a net cash outflow from financing activities of approximately RMB766 million and an inflow from financing activities of approximately RMB5,620 million for the years ended 31 December 2005 and 2004, respectively. The Group has recorded a decrease in cash and cash equivalents of approximately RMB7,165 million and an increase in cash and cash equivalents of approximately RMB6,824 million for the years ended 31 December 2005 and 2004, respectively.

With regards to 2006 and thereafter, the liquidity of the Group is primarily dependent on its ability to maintain adequate cash inflow from operations to meet its debt obligations as they fall due, and on its ability to obtain external financing to meet its committed future capital expenditure. With regards to its future capital commitments and other financing requirements, the Company has already obtained several banking facilities with several PRC banks of up to an amount of RMB78,570 million as at 31 December 2005, of which an amount of approximately RMB33,476 million was utilised.

# Notes to Financial Statements

Year ended 31 December 2005

## 44. FINANCIAL RISK MANAGEMENT OBJECTIVES AND POLICIES (Continued)

### (b) Liquidity risk (Continued)

The Directors of the Company have carried out a detailed review of the cash flow forecast of the Group for the year ending 31 December 2006. Based on such forecast, the Directors have determined that adequate liquidity exists to finance the working capital and capital expenditure requirements of the Group during 2006. In preparing the cash flow forecast, the Directors have considered historical cash requirements of the Group as well as other key factors, including the availability of the above-mentioned loans financing which may impact the operations of the Group prior to the end of 2006. The Directors are of the opinion that the assumptions and sensitivities which are included in the cash flow forecast are reasonable. However, as with all assumptions in regard to future events, these are subject to inherent limitations and uncertainties and some or all of these assumptions may not be realised.

### (c) Jet fuel price risk

The Group's strategy for managing the risk on jet fuel price aims to provide the Group with protection against sudden and significant increases in prices. In meeting these objectives, the Group allows for the judicious use of approved derivative instruments such as swaps and collars with approved counter-parties and within approved limits.

Moreover, counter-party credit risk is generally restricted to any gains on changes in fair value at any time, and not the principal amount of the instrument. Therefore, the possibility of material loss arising in the event of non-performance by a counter-party is considered to be unlikely.



The fair values of derivative instruments of the Group and the Company at the balance sheet date are as follows:

| | **Group** | | Group | |
|---|---|---|---|---|
| | **2005** | **2005** | 2004 | 2004 |
| | **Assets** | **Liabilities** | Assets | Liabilities |
| | ***RMB'000*** | ***RMB'000*** | *RMB'000* | *RMB'000* |
| Swaps and collars expiring: | | | | |
| Within 6 months | **–** | **–** | – | – |
| Over 6 months to 21 months | **127,659** | **(1,791)** | – | – |
| | **127,659** | **(1,791)** | – | – |

| | **Company** | | Company | |
|---|---|---|---|---|
| | **2005** | **2005** | 2004 | 2004 |
| | **Assets** | **Liabilities** | Assets | Liabilities |
| | ***RMB'000*** | ***RMB'000*** | *RMB'000* | *RMB'000* |
| Swaps and collars expiring: | | | | |
| Within 6 months | **–** | **–** | – | – |
| Over 6 months to 21 months | **115,220** | **(1,791)** | – | – |
| | **115,220** | **(1,791)** | – | – |

Fair values of derivative instruments, denominated in United States dollars, are obtained from quoted market prices, dealer price quotations, discounted cash flow models and option pricing models, which consider current market and contractual prices for the underlying instruments, as well as time value of money, yield curve and volatility of the underlying instruments.

# Notes to Financial Statements

Year ended 31 December 2005

## 44. FINANCIAL RISK MANAGEMENT OBJECTIVES AND POLICIES (Continued)

### (d) Foreign currency risk

The Group's finance lease obligations as well as certain bank and other loans are denominated in United States dollars and Japanese yen, and certain expenses of the Group are denominated in currencies other than RMB. The Group generates foreign currency revenue from ticket sales made in overseas offices and would normally generate sufficient foreign currencies after payment of foreign currency expenses, to meet its foreign currency liabilities repayable within one year. RMB against United States dollars and Hong Kong dollars have been comparatively stable in the past. However, RMB against Japanese yen had experienced a significant level of fluctuation during the year which is the major reason for the significant exchange difference recognised by the Group for the year.

### (e) Interest rate risk

The Group's earnings are also affected by changes in interest rates due to the impact of such changes on interest income and expense from short-term deposits and other interest-bearing financial assets and liabilities. A significant portion of the Group's interest-bearing financial liabilities with maturities over one year have predominately fixed rates of interest and are denominated in United States dollars and Japanese yen.

The Group's short-term deposits and other interest-bearing financial assets and liabilities are predominately denominated in RMB, United States dollars and Hong Kong dollars.



### (f) Credit risk

The Group's cash and cash equivalents are deposited with banks in Mainland China, overseas banks and an associate. The Group has policies in place to limit the exposure to any one financial institution.

A significant portion of the Group's air tickets are sold by agents participating in the Billing and Settlements Plan ("BSP"), a clearing system between airlines and sales agents organised by the International Air Transportation Association. The balance due from BSP agents amounted to approximately RMB529 million as at 31 December 2005 (2004: RMB531 million).

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

# Notes to Financial Statements

Year ended 31 December 2005

## 45. CONSOLIDATED CASH FLOW STATEMENT

### (a) Establishment of a joint venture

For the year ended 31 December 2004, the establishment of a joint venture has been shown in the consolidated cash flow statement as a single item. The cash flow effect can be analysed as follows:

| | 2004<br>*RMB'000* |
|---|---|
| Cash and bank balances | 561,509 |
| Trade receivables | 16,844 |
| Other receivables | 2,778 |
| Property, plant and equipment *(note 15)* | 565,840 |
| Inventories | 352 |
| Trade payables | (40,018) |
| Other payables and accruals | (357,517) |
| Air traffic liabilities | (2,010) |
| Net assets attributable to the joint venture partners | 747,778 |
| Dilution gain on an investment *(note 9)* | 330,222 |
| Cash contribution from the joint venture partners | 1,078,000 |
| Less: Cash attributable to the joint venture partners | (561,509) |
| Cash flow on establishment of a joint venture, net of cash attributable to the joint venture partners | 516,491 |

### (b) Major non-cash transactions

Major non-cash transactions in 2004 were as follows:

(i) In 2004, the Group received an aircraft injected by the PRC government amounting to RMB304,787,000 *(note 36)*. This amount has been recorded in property, plant and equipment.

(ii) Upon incorporation of the Company on 30 September 2004, CNAHC effected the transfer of certain land use rights in an aggregate amount of approximately RMB885,626,000 to the Company.

# Notes to Financial Statements

Year ended 31 December 2005

## 46. RELATED PARTY TRANSACTIONS

The Group is part of a larger group of companies under CNAHC and has extensive transactions and relationships with members of CNAHC. As such, it is possible that the terms of these transactions are not the same as those that would result from transactions among wholly-unrelated parties. Related parties refer to corporations in which CNAHC is a shareholder and is able to exercise control or joint control. The transactions were made at prices and terms mutually agreed between the parties. The Directors of the Company are of the opinion that the transactions with related parties (see below) were conducted in the usual course of business.

The Group had the following significant transactions between the Group and (i) CNAHC, its subsidiaries (other than the Group) and joint ventures (collectively known as the "CNAHC Group"); (ii) its joint ventures; and (iii) its associates:

| | Group | |
|---|---|---|
| | **2005** | 2004 |
| | ***RMB'000*** | *RMB'000* |
| A. Included in air traffic revenue | | |
| Sale of air tickets | | |
| CNAHC Group | **9,836** | 17,227 |
| Associates | **1,463** | 2,154 |
| | **11,299** | 19,381 |
| Sale of cargo space | | |
| CNAHC Group | **200,273** | 213,836 |
| Government charted flights | | |
| CNAHC | **407,048** | – |
| B. Included in other operating revenue | | |
| Aircraft and related equipment lease income | | |
| CNAHC Group | **–** | 1,912 |
| Aircraft engineering income | | |
| Associates | **11,563** | 9,876 |
| Ground services income | | |
| CNAHC Group | **1,061** | – |
| Joint ventures | **23,417** | 942 |
| Associates | **34,401** | 19,849 |
| | **58,879** | 20,791 |
| Bellyhold income | | |
| Joint venture | **1,496,302** | 1,384,457 |
| Others | | |
| CNAHC Group | **22,432** | 5,734 |
| Joint ventures | **33,406** | 14,424 |
| Associates | **35,568** | 11,484 |
| | **91,406** | 31,642 |

# Notes to Financial Statements

Year ended 31 December 2005

## 46. RELATED PARTY TRANSACTIONS (Continued)

| | Group 2005 RMB'000 | Group 2004 RMB'000 |
|---|---|---|
| C. Included in finance revenue and finance costs | | |
| Interest income | | |
| Associate | **2,363** | 3,409 |
| Interest expense | | |
| Associate | **14,532** | 21,843 |
| D. Included in operating expenses | | |
| Airport ground services, take-off, landing and depot expenses | | |
| CNAHC Group | **92,836** | 97,183 |
| Associates | **248,128** | 210,103 |
| | **340,964** | 307,286 |
| Air catering charges | | |
| CNAHC Group | **49,695** | 43,241 |
| Joint ventures | **115,116** | 85,874 |
| Associates | **7,496** | 5,123 |
| | **172,307** | 134,238 |
| Repair and maintenance costs | | |
| Joint ventures | **363,181** | 472,378 |
| Associates | **125,717** | 107,508 |
| | **488,898** | 579,886 |
| Sale commission expenses | | |
| CNAHC Group | **7,571** | 25,913 |
| Associates | **6,119** | – |
| | **13,690** | 25,913 |
| Management fees | | |
| CNAHC Group | **10,096** | 44,080 |
| Aircraft leasing fees | | |
| Associate | **201,388** | – |
| Others | | |
| CNAHC Group | **79,197** | 71,729 |
| Associates | **7,517** | 9,050 |
| | **86,714** | 80,779 |

# Notes to Financial Statements

Year ended 31 December 2005

## 46. RELATED PARTY TRANSACTIONS (Continued)

| | Group | | Company | |
|---|---|---|---|---|
| | **2005** | 2004 | **2005** | 2004 |
| | **RMB'000** | RMB'000 | **RMB'000** | RMB'000 |
| E. Deposits, loans and bills payable | | | | |
| Deposits placed with an associate | **470,863** | 566,985 | **415,366** | 519,655 |
| Loans from an associate | **203,016** | 481,132 | **190,910** | 364,400 |
| Bills payable to an associate | **103,426** | – | **103,426** | – |
| F. Outstanding balance with related parties | | | | |
| Due from CNAHC (long term) | **531,813** | 631,813 | **531,813** | 631,813 |
| Due from other CNAHC group companies | **38,039** | 44,916 | **12,993** | 8,801 |
| Due from associates | **62,948** | 90,842 | **15,419** | 17,305 |
| Due to associates | **(95,905)** | (81,591) | **(129,410)** | (82,109) |
| Due from a joint venture | **451,965** | 412,539 | **922,378** | 841,916 |
| Due to CNAHC and CNACG | **(133,680)** | (2,256,117) | **(118,680)** | (2,240,213) |
| Due to other CNAHC group companies | **(40,471)** | (49,617) | **(22,413)** | (12,163) |
| Due to a joint venture | **(115,435)** | (179,934) | **(288,588)** | (449,835) |
| Due from CNAHC | **474,216** | – | **474,216** | – |
| Due from subsidiaries | **–** | – | **11,519** | 22,513 |
| Due to subsidiaries | **–** | – | **(588,623)** | (559,703) |



The long term amount due from CNAHC is unsecured, interest-free and is not repayable within one year from the balance sheet date. Except for the long term amount due from CNAHC, the outstanding balances with related parties are unsecured, interest-free and repayable within one year.

| | Group | |
|---|---|---|
| | **2005** | 2004 |
| | **RMB'000** | RMB'000 |
| G. Compensation of key management personnel of the Group | | |
| Short term employee benefits | **5,501** | 5,002 |
| Post-employment benefits | **142** | 93 |
| Total compensation paid to key management personnel | **5,643** | 5,095 |

Further details of directors' emoluments are included in note 10 to the financial statements.

| | Group | |
|---|---|---|
| | **2005** | 2004 |
| | **RMB'000** | RMB'000 |
| H. Disposal of a long term investment to CNAHC Group | **20,737** | – |

On 30 September 2005, Beijing Catering Co. Ltd., a 60% joint venture of the Group, sold its shares in CNAF to CNAHC for a total consideration of approximately RMB34 million.

# Notes to Financial Statements

Year ended 31 December 2005

## 46. RELATED PARTY TRANSACTIONS (Continued)

(a) In addition to the above, on 18 October 1997, CNAC entered into a licence agreement with China National Aviation Corporation ("CNAC (PRC)") pursuant to which CNAC (PRC) had agreed to grant a licence to CNAC, free of royalty, for the right to use certain trademarks in Hong Kong, the Taiwan region and Macau so long as CNAC is a subsidiary of CNACG.

On 25 August 2004, CNAC (PRC) entered into two assignment agreements with CNACG pursuant to which CNAC (PRC) has agreed to assign, free of royalty, the above-mentioned trademarks to CNACG for use in Hong Kong and Macau, respectively. On 25 August 2004, CNACG entered into two licence agreements with CNAC pursuant to which CNACG has agreed to grant licences to CNAC, free of royalty, for the rights to use those trademarks in Hong Kong and Macau, respectively, so long as CNAC is a direct or indirect subsidiary of CNAHC. These licence agreements supersede the licence agreement entered into between CNAC (PRC) and CNAC on 18 October 1997.

No royalty charge was levied in respect for the use of these trademarks during each of the two years ended 31 December 2005.

(b) Pursuant to certain of the Company's aircraft leasing arrangements and bank loans arrangements, the overseas lessors and lenders require guarantees to be given by some major PRC state-owned banks. In giving such guarantees, the PRC state-owned banks in turn require CNAHC and CNAF to provide counter-guarantees in favour of the banks. As at the balance sheet date, the amounts of such counter-guarantees provided by CNAHC and CNAF are as follows:

| | **Group** | |
|---|---|---|
| | **2005** | 2004 |
| | ***RMB'000*** | *RMB'000* |
| CNAHC : | | |
| Finance leases *(note 32)* | – | 921,000 |
| Bank loans *(note 33)* | – | 1,455,000 |
| | – | 2,376,000 |
| CNAF : | | |
| Finance leases *(note 32)* | – | 3,976,000 |
| Bank loans *(note 33)* | – | 761,000 |
| | – | 4,737,000 |
| | – | 7,113,000 |

(c) The Company entered into several agreements with CNAHC which govern the use of trademarks granted by the Company to CNAHC; the provision of financial services by CNAF; the provision of construction project management services by China National Aviation Construction and Development Company; the subcontracting of charter-flight services to CNAHC; the leasing of properties from and to CNAHC; the provision of air ticketing and cargo services; media and advertising services arrangement to China National Aviation Media and Advertising Co., Ltd.; the tourism services co-operation agreement with CNAHC; the comprehensive services agreement with CNAHC; and the provision of maintenance and other ground services by China Aircraft Services Limited.

(d) There were no pension payments relating to the Supplementary Pension Benefits of the Group for the year ended 31 December 2005. All pension payments relating to the Supplementary Pension Benefits of RMB39 million for the year ended 31 December 2004 were borne by CNAHC *(note 11)*.

# Notes to Financial Statements

Year ended 31 December 2005

## 46. RELATED PARTY TRANSACTIONS (Continued)

(e) On 19 August 2004, Fly Top Limited, a wholly-owned subsidiary of CNAC, entered into the following acquisition agreements:

(a) a sale and purchase agreement with CNACG in relation to the acquisition of approximately 16% of the issued share capital of LSGHK, a company incorporated in Hong Kong with limited liability (the "CNACG Agreement"); and

(b) a sale and purchase agreement with Hong Kong International Air Catering Limited ("HKIAC"), a company incorporated in Hong Kong with limited liability and in which Air China International Corporation has a 25% equity interest, in relation to the acquisition of approximately 4.2% of the issued share capital of LSGHK (the "HKIAC Agreement").

The total consideration of the above acquisitions is approximately RMB122 million. Immediately after the completion of the CNACG Agreement and the HKIAC Agreement, the Group's effective shareholding interests in LSGHK is approximately 14%.

The Group operates in an economic environment predominated by enterprises directly or indirectly owned or controlled by the PRC government through its numerous authorities, affiliates or other organisations (collectively "State-owned Enterprises"). During the year, the Group had transactions with State-owned Enterprises including, but not limited to, the provision of air passenger and air cargo services and purchases of services. The Directors consider that transactions with other State-owned Enterprises are activities in the ordinary course of the Group's business and that the dealings of the Group have not been significantly or unduly affected by the fact that the Group and the other State-owned Enterprises are ultimately controlled or owned by the PRC government. The Group has also established pricing policies for products and services, and such pricing policies do not depend on whether or not the customers are State-owned Enterprises. Having due regard to the substance of the relationships, the Directors are of the opinion that none of these transactions are material related party transactions that require separate disclosure.



## 47. NET PROFIT ATTRIBUTABLE TO EQUITY HOLDERS OF THE PARENT

The net profit attributable to equity holders of the parent for the year ended 31 December 2005 and for the period from 1 October 2004 to 31 December 2004 dealt with in the financial statements of the Company was approximately RMB2,113 million and RMB1,230 million *(note 38)*, respectively.

## 48. COMPARATIVE FIGURES

The following comparative figures have been reclassified to conform to the current year's presentation:

(a) Reclassification of profit and loss items:

| Nature of item | 2004 Classification | **2005 Classification** | **Group** *RMB'000* |
|---|---|---|---|
| Share of tax attributable to associates | Tax | **Share of profits less losses from associates** | **96,974** |
| Finance revenue (which includes interest income, net gains on fuel derivatives, net and dividend income from available-for-sale investments) | Finance costs | **Finance revenue** | **79,361** |

# Notes to Financial Statements

Year ended 31 December 2005

## 48. COMPARATIVE FIGURES (Continued)

(b) Reclassification of balance sheet items:

| Nature of item | 2004 Classification | **2005 Classification** | **Group** *RMB'000* | **Company** *RMB'000* |
|---|---|---|---|---|
| Non-pledged deposits with maturity of more than three months when acquired | Cash and cash equivalents | **Non-pledged deposits with maturity of more than three months when acquired** | 320,850 | 313,768 |
| Advance payments for aircraft and related equipment | Prepayments, deposits and other receivables | **Advance payments for aircraft and related equipment** | 2,193,458 | 1,958,515 |

The Directors are of the view that the above changes would result in a more appropriate presentation of the Group's financial statements and better reflect the Group's financial performance and financial position.

## 49. EVENTS AFTER THE BALANCE SHEET DATE



(a) On 17 January 2006, the Company and AIE, a wholly-owned subsidiary of the Company, entered into an aircraft purchase agreement with Boeing Company ("Boeing") pursuant to which the Company has agreed to purchase 10 Boeing 737-800 aircraft (the "Boeing Aircraft") from Boeing for an aggregate consideration of US$655.2 million (equivalent to approximately RMB5,288 million). The aggregate consideration for the acquisition of the Boeing Aircraft is payable in cash by installments and the Boeing Aircraft are scheduled to be delivered in stages from 2007 to 2008.

(b) On 24 January 2006, the Group, through a subsidiary and an associate of CNAC, entered into several agreements with Shun Tak Air Transport Limited and its subsidiaries (the "Macau Asia Express Agreements") to establish Macau Asia Express Limited ("Macau Asia Express") to engage in the business of operating low cost model air transport services based in Macau. Pursuant to the Macau Asia Express Agreements, the Group will hold an indirect effective interest of 30% in Macau Asia Express. The aggregate initial investment to Macau Asia Express is up to approximately HK$234 million (equivalent to approximately RMB243 million) and in which the share of investment cost attributable to the Group, in an aggregate amount of approximately HK$161 million (equivalent to approximately RMB167 million), will be funded by internal resources. The completion of the establishment of Macau Asia Express is subject to certain conditions to be fulfilled.

Macau Asia Express is a subsidiary of CNAC, as defined by the laws of Macau, but CNAC does not have unilateral control over the entity. Accordingly, it will be accounted for as a jointly controlled entity in the Group's financial statements accordance with IAS *31 Interests in Joint Ventures*.

## 50. APPROVAL OF THE FINANCIAL STATEMENTS

The financial statements were approved and authorised for issue by the Board of Directors on 18 April 2006.

# Glossary of Technical Terms

## Capacity Measurements

| | |
|---|---|
| "available seat kilometres" or "ASKs" | the number of seats available for sale multiplied by the kilometres flown |
| "available freight tonne kilometres" or "AFTKs" | the number of tonnes of capacity available for the carriage of cargo and mail multiplied by the kilometres flown |
| "available tonne kilometres" or "ATKs" | the number of tonnes of capacity available for the transportation of revenue load (passengers and cargo) multiplied by the kilometres flown |
| "tonne" | a metric ton, equivalent to 2,204.6 pounds |

## Traffic Measurements

| | |
|---|---|
| "revenue passenger kilometres" or "RPKs" | the number of revenue passengers carried multiplied by the kilometres flown |
| "passenger traffic" | measured in RPKs, unless otherwise specified |
| "revenue freight tonne kilometres" or "RFTKs" | the revenue cargo and mail load in tonnes multiplied by the kilometres flown |
| "cargo traffic" | measured in RFTKs, unless otherwise specified |
| "revenue tonne kilometres" or "RTKs" | the revenue load (passenger and cargo) in tonnes multiplied by the kilometres flown |



## Yield Measurements

| | |
|---|---|
| "passenger yield" | revenues from passenger operations divided by RPKs |
| "cargo yield" | revenues from cargo operations divided by RFTKs |

## Load Factors

| | |
|---|---|
| "cargo load factor" | RFTKs expressed as a percentage of AFTKs |
| "passenger load factor" | RPKs expressed as a percentage of ASKs |
| "overall load factor" | RTKs expressed as a percentage of ATKs |

## Utilisation

| | |
|---|---|
| "block hours" | each whole or partial hour elapsing from the moment the chocks are removed from the wheels of the aircraft for flights until the chocks are next again returned to the wheels of the aircraft |