

CHINA EASTERN AIRLINES CORP LTD

Form 20-F

June 28, 2004

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**SECURITIES AND EXCHANGE COMMISSION**  
Washington, DC 20549

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**FORM 20-F**

**REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR 12(g) OF THE SECURITIES EXCHANGE ACT OF 1934**

OR

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the fiscal year ended December 31, 2003**

OR

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 1-14550

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(Exact Name of Registrant as Specified in Its Charter)

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China Eastern Airlines Corporation Limited  
(Translation of Registrant's Name Into English)

The People's Republic of China  
(Jurisdiction of Incorporation or Organization)

2550 Hong Qiao Road  
Hong Qiao International Airport  
Shanghai 200335  
The People's Republic of China  
(8621) 6268-6268  
(Address and Telephone Number of Principal Executive Offices)

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Securities registered or to be registered pursuant to Section 12(b) of the Act:

| <u>Title of Each Class</u>   | <u>Name of Each Exchange on Which Registered</u>            |
|--|---|
| American Depositary Shares<br>Ordinary H Shares, par value RMB1.00 per share | The New York Stock Exchange<br>The New York Stock Exchange* |

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\* Not for trading, but only in connection with the registration of American Depositary Shares. The Ordinary H Shares are also listed and traded on The Stock Exchange of Hong Kong Limited.

Securities registered or to be registered pursuant to Section 12(g) of the Act:

None  
(Title of Class)

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act:

None  
(Title of Class)

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report.

As of December 31, 2003, 3,300,000,000 Ordinary Domestic Shares, par value RMB1.00 per share, were issued and outstanding, and 1,566,950,000 Ordinary H Shares par value RMB1.00 per share, were issued and outstanding. H Shares are Ordinary Shares of the Company listed on The Stock Exchange of Hong Kong Limited.

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark which financial statement item the registrant has elected to follow. Item 17  Item 18

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**SUPPLEMENTAL INFORMATION AND EXCHANGE RATES**

Unless otherwise specified, all references in this annual report to U.S. dollars , dollars or US\$ are to United States dollars; all references to HK dollars or HK\$ are to Hong Kong dollars; all references to Renminbi or RMB are to Renminbi, the legal tender currency of The People's Republic of China, or China or the PRC.

This annual report contains translations of certain amounts into U.S. dollars solely for your convenience. Except where otherwise specified, translations of amounts from Renminbi to U.S. dollars have been made at the noon buying rate, or the Noon Buying Rate, in New York City for cable transfers in foreign currencies as certified for customs purposes by the Federal Reserve Bank of New York on December 31, 2003 of US\$1.00 = RMB8.2767. You should not construe the translations as representations that the Renminbi amounts could have been, or could be, converted into U.S. dollars at that rate or at any other rate. On June 22, 2004, the Noon Buying Rate was US\$1.00 = RMB8.2766.

In this annual report, we , us , our , our company or China Eastern means China Eastern Airlines Corporation Limited, a company limited by shares incorporated under the laws of China on April 14, 1995, and, unless the context otherwise requires, its subsidiaries, or, in respect of references to any time prior to the incorporation of China Eastern Airlines Corporation Limited, the core airline business carried on by its predecessor, China Eastern Airlines, which was assumed by China Eastern Airlines Corporation Limited pursuant to the restructuring described in this annual report. CEA Holding means our parent, China Eastern Air Holding Company, which was established on October 11, 2002 as a result of the merger of our former controlling shareholder, Eastern Air Group Company, or EA Group, with China Northwest Airlines Company and Yunnan Airlines Company.

For purpose of this annual report, references to China or the PRC do not include the Hong Kong Special Administrative Region of China, or Hong Kong, the Macau Special Administrative Region of China, or Macau, or Taiwan. References to Chinese should be interpreted accordingly.

**CAUTIONARY STATEMENT WITH RESPECT TO FORWARD-LOOKING STATEMENTS**

This annual report contains certain forward-looking statements that are, by their nature, subject to significant risks and uncertainties. These forward-looking statements include, without limitation, statements relating to:

our fleet development plans, including, without limitation, related financing, schedule, intended use and planned disposition;

the planned expansion of our cargo operations;

the impact of changes in the policies of the Civil Aviation Administration of China, or the CAAC, regarding route rights;

the impact of the CAAC policies regarding the restructuring of the airline industry in China;

our expansion plans, including acquisition of other airlines;

our marketing plans, including the establishment of additional sales offices;

our plan to add new pilots; and



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the impact of unusual events on our business and operations.

The words anticipate , plan , believe , estimate , expect , intend and similar expressions, as they relate to our or its management, are intended to identify some of these forward-looking statements. These forward-looking statements reflect our current view with respect to future events. Actual events or results may differ materially from information contained in these forward-looking statements as a result of a number of factors, including, without limitation:

any changes in regulatory policies of the CAAC;

the effects of competition on the demand for and price of our services;

the availability of qualified flight personnel and airport facilities;

any significant depreciation of Renminbi or Hong Kong dollars against U.S. dollars, Japanese yen or Euro, the currencies in which the majority of our borrowings are denominated;

the availability and cost of the aviation fuel;

changes in political, economic, legal and social conditions in China;

the fluctuation of interest rates; and

our ability to obtain adequate financing, including any required external debt and acceptable bank guarantees.

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**GLOSSARY OF TECHNICAL TERMS**

*Capacity measurements*

|  |   |
|--|---|
| <b>ATK (available tonne kilometers)</b>          | the number of tonnes of capacity available for the carriage of revenue load (passengers and cargo) multiplied by the distance flown |
| <b>ASK (available seat kilometers)</b>           | the number of seats made available for sale multiplied by the distance flown  |
| <b>AFTK (available freight tonne-kilometers)</b> | the number of tonnes of capacity available for the carriage of cargo and mail multiplied by the distance flown                      |

*Traffic measurements*

|   |   |
|---|---|
| <b>revenue passenger-kilometers or RPK</b>        | the number of passengers carried multiplied by the distance flown     |
| <b>revenue freight tonne-kilometers or RFTK</b>   | cargo and mail load in tonnes multiplied by the distance flown        |
| <b>revenue passenger tonne-kilometers or RPTK</b> | passenger load in tonnes multiplied by the distance flown             |
| <b>revenue tonne-kilometers or RTK</b>            | load (passenger and cargo) in tonnes multiplied by the distance flown |

*Load factors*

|                               |   |
|-------------------------------|---|
| <b>overall load factor</b>    | tonne-kilometers expressed as a percentage of ATK   |
| <b>passenger load factor</b>  | passenger-kilometers expressed as a percentage of ASK   |
| <b>break-even load factor</b> | the load factor required to equate traffic revenue with our operating costs assuming that our total operating surplus is attributable to scheduled traffic operations |

*Yield and cost measurements*

|  |   |
|--|---|
| <b>passenger yield (revenue per passenger-kilometer)</b> | revenue from passenger operations divided by passenger-kilometers |
| <b>cargo yield (revenue per cargo tonne-kilometer)</b>   | revenue from cargo operations divided by cargo tonne-kilometers   |
| <b>average yield (revenue per total tonne-kilometer)</b> | revenue from airline operations divided by tonne-kilometers       |
| <b>unit cost</b>   | operating expenses divided by ATK                                 |



**tonne**

a metric ton, equivalent to 2,204.6 lbs

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**Table of Contents****PART I****Item 1. Identity of Directors, Senior Management and Advisers.**

Not applicable.

**Item 2. Offer Statistics and Expected Timetable.**

Not applicable.

**Item 3. Key Information.****A. Selected Financial Data**

The selected income statement data for the years ended December 31, 1999, 2000, 2001, 2002 and 2003 and the selected balance sheet data as of December 31, 1999, 2000, 2001, 2002 and 2003 have been derived from our audited consolidated financial statements, which have been prepared in accordance with the International Financial Reporting Standards, or IFRS, and audited by PricewaterhouseCoopers, Certified Public Accountants, Hong Kong. PricewaterhouseCoopers reports in respect of the income statements for the years ended December 31, 2001, 2002 and 2003 and the balance sheets as of December 31, 2002 and 2003 appear on page F-1 of this annual report. You should read Note 40 to our audited consolidated financial statements for a discussion of certain differences between IFRS and the generally accepted accounting principles in the United States, or U.S. GAAP, as they relate to our company, and a reconciliation to U.S. GAAP of profit attributable to shareholders for the years ended December 31, 2001, 2002 and 2003, and owners' equity as of December 31, 2002 and 2003.

|  | <b>Year Ended December 31,</b>                             |                           |                           |                           |             |             |
|--|--|---------------------------|---------------------------|---------------------------|-------------|-------------|
|  | <b>1999<sup>(1)</sup></b>                                  | <b>2000<sup>(1)</sup></b> | <b>2001<sup>(1)</sup></b> | <b>2002<sup>(1)</sup></b> | <b>2003</b> | <b>2003</b> |
|  | <b>RMB</b>   | <b>RMB</b>                | <b>RMB</b>                | <b>RMB</b>                | <b>RMB</b>  | <b>US\$</b> |
|  | <b>(millions, except per share or per ADS information)</b> |                           |                           |                           |             |             |
| <b>Income Statement Data:</b>                                    |  |                           |                           |                           |             |             |
| <b>IFRS:</b>   |  |                           |                           |                           |             |             |
| Revenues   | 10,163.27  | 11,220.06                 | 12,152.81                 | 13,078.99                 | 14,277.16   | 1,724.98    |
| Other operating income   | 294.15   | 223.11                    | 127.61                    | 226.37                    | 2.44        | 0.30        |
| Operating expenses   | (9,252.58)   | (10,444.21)               | (11,283.32)               | (12,241.90)               | (14,058.14) | (1,698.52)  |
| Operating profit   | 1,204.84   | 998.96                    | 997.10                    | 1,063.47                  | 221.46      | 26.76       |
| Interest income (expense), net                                   | (965.83)   | (814.49)                  | (814.38)                  | (731.39)                  | (712.46)    | (86.08)     |
| Profit (loss) before taxation                                    | 128.22   | 304.40                    | 313.58                    | 262.89                    | (589.83)    | (71.26)     |
| Profit (loss) attributable to shareholders                       | 84.29  | 175.53                    | 541.71                    | 86.37                     | (949.82)    | (114.76)    |
| Basic and fully diluted earnings (loss) per share <sup>(2)</sup> | 0.02   | 0.04                      | 0.11                      | 0.02                      | (0.20)      | (0.02)      |
| Basic and fully diluted earnings (loss) per ADS                  | 1.73   | 3.61                      | 11.13                     | 1.77                      | (19.52)     | (2.36)      |
| <b>U.S. GAAP:</b>  |  |                           |                           |                           |             |             |

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|  |        |        |        |        |          |          |
|--|--------|--------|--------|--------|----------|----------|
| Profit (loss) attributable to shareholders                       | 319.80 | 734.36 | 474.47 | 247.74 | (898.25) | (108.53) |
| Basic and fully diluted earnings (loss) per share <sup>(2)</sup> | 0.07   | 0.15   | 0.10   | 0.05   | (0.19)   | (0.02)   |
| Basic and fully diluted earnings (loss) per ADS                  | 6.57   | 15.09  | 9.75   | 5.09   | (18.46)  | (2.23)   |

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- (1) In 2002, certain income and expenses have been reclassified pursuant to IFRS. As a result, the numbers for the year ended December 31, 1999, 2000 and 2001 have been adjusted to reflect such reclassification. This reclassification has no effect on the profit (loss) attributable to shareholders.
- (2) The calculation of earnings (loss) per share is based on the consolidated profit (loss) attributable to shareholders and 4,866,950,000 shares in issue.

|  | <u>1999</u> | <u>2000</u> | <u>2001</u> | <u>2002</u> | <u>2003</u> | <u>2003</u> |
|--|-------------|-------------|-------------|-------------|-------------|-------------|
|  | <b>RMB</b>  | <b>RMB</b>  | <b>RMB</b>  | <b>RMB</b>  | <b>RMB</b>  | <b>US\$</b> |
|  | (millions)  |             |             |             |             |             |
| Balance Sheet Data:                                  |             |             |             |             |             |             |
| <b>IFRS:</b>   |             |             |             |             |             |             |
| Cash and cash equivalents                            | 1,315.20    | 1,422.89    | 1,330.98    | 1,944.52    | 1,582.78    | 191.23      |
| Working capital (deficiency)                         | (656.82)    | (858.32)    | (3,162.91)  | (7,436.75)  | (9,941.35)  | (1,201.13)  |
| Non-current assets                                   | 24,320.39   | 24,725.46   | 25,201.24   | 28,150.78   | 33,175.44   | 4,008.29    |
| Total assets   | 28,261.00   | 28,652.00   | 28,610.95   | 32,761.58   | 38,007.11   | 4,592.06    |
| Long-term loans, including current portion           | 4,706.17    | 4,804.19    | 5,300.57    | 6,494.63    | 11,222.92   | 1,355.97    |
| Capital lease obligations, including current portion | 11,557.27   | 11,308.18   | 9,871.35    | 8,183.97    | 7,100.89    | 857.94      |
| Owner s equity                                       | 7,013.50    | 6,870.53    | 7,320.10    | 7,379.10    | 6,382.15    | 771.10      |
| <b>U.S. GAAP:</b>                                    |             |             |             |             |             |             |
| Total assets   | 27,194.50   | 28,077.50   | 28,297.00   | 32,512.00   | 37,789.47   | 4,565.77    |
| Owner s equity                                       | 5,923.90    | 6,658.30    | 7,040.83    | 7,157.61    | 6,209.71    | 750.27      |

**Exchange Rate Information**

The noon buying rate in New York City for cable transfers as certified for customs purposes by the Federal Reserve Bank of New York was RMB8.2766 = US\$1.00, on June 22, 2004. The following tables set forth certain information concerning exchange rates between Renminbi and U.S. dollars for the periods indicated:

| <u>Average<sup>(1)</sup> Noon Buying Rate<sup>(2)</sup> (RMB per US\$)</u> | <u>Noon Buying Rate (RMB per US\$)</u> |               |             |            |
|--|--|---------------|-------------|------------|
| <u>Period</u>  |  | <u>Period</u> | <u>High</u> | <u>Low</u> |
| 2003   | 8.2772                                 | December 2003 | 8.2772      | 8.2765     |
| 2002   | 8.2772                                 | January 2004  | 8.2772      | 8.2767     |
| 2001   | 8.2772                                 | February 2004 | 8.2773      | 8.2769     |
| 2000   | 8.2784                                 | March 2004    | 8.2774      | 8.2767     |
| 1999   | 8.2785                                 | April 2004    | 8.2772      | 8.2768     |
|  |  | May 2004      | 8.2773      | 8.2768     |

- (1) Determined by averaging the rates on the last business day of each month during the relevant period.
- (2) Noon Buying Rate in New York City for cable transfers payable in foreign currencies as certified for customs purpose by the Federal Reserve Bank of New York.

**Selected Operating Data**

The following table sets forth certain operating data of our company for the five years ended December 31, 2003, which have been derived from financial information prepared in accordance with IFRS and other data provided by us and are not audited. All references in this annual report to our cargo operations, cargo statistics or cargo revenues include figures for cargo and mail.

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|  | <b>Year Ended December 31,</b> |             |             |             |             |
|--|--------------------------------|-------------|-------------|-------------|-------------|
|  | <b>1999</b>                    | <b>2000</b> | <b>2001</b> | <b>2002</b> | <b>2003</b> |
| <b>Selected Airline Operating Data:</b>                      |                                |             |             |             |             |
| <b>Capacity:</b>   |                                |             |             |             |             |
| ATK (millions)   | 3,352.5                        | 3,646.3     | 4,188.2     | 4,366.6     | 4,774.5     |
| ASK (millions)   | 22,479.4                       | 22,596.2    | 25,813.5    | 27,962.5    | 29,780.0    |
| AFTK (millions)  | 1,329.4                        | 1,612.6     | 1,865.0     | 1,850.0     | 2,094.3     |
| <b>Traffic:</b>  |                                |             |             |             |             |
| Revenue passenger-kilometers (millions)                      | 13,257.4                       | 14,101.6    | 15,911.4    | 18,206.4    | 18,002.7    |
| Revenue tonne-kilometers (millions)                          | 1,873.9                        | 2,165.3     | 2,373.2     | 2,652.2     | 2,907.7     |
| Revenue passenger tonne-kilometers (millions)                | 1,184.6                        | 1,261.0     | 1,423.4     | 1,629.2     | 1,611.1     |
| Revenue freight tonne-kilometers (millions)                  | 689.3                          | 904.3       | 949.8       | 1,023.0     | 1,296.6     |
| Kilometers flown (millions)                                  | 116.4                          | 121.2       | 147.2       | 158.8       | 176.5       |
| Hours flown (thousands)                                      | 174.3                          | 180.8       | 220.4       | 234.6       | 259.4       |
| Number of passengers carried (thousands)                     | 8,754.3                        | 9,113.3     | 10,371.4    | 11,533.1    | 12,040.2    |
| Weight of cargo carried (millions of kilograms)              | 248.5                          | 286.4       | 302.0       | 344.7       | 459.8       |
| Average distance flown (kilometers per passenger)            | 1,516.0                        | 1,547.8     | 1,534.2     | 1,578.6     | 1,495.2     |
| <b>Load Factor:</b>  |                                |             |             |             |             |
| Overall load factor (%)                                      | 55.9                           | 59.4        | 56.7        | 60.7        | 60.9        |
| Passenger load factor (%)                                    | 59.0                           | 62.4        | 61.6        | 65.1        | 60.5        |
| Break-even load factor (based on ATK) (%)                    | 52.4                           | 57.7        | 54.7        | 59.9        | 63.6        |
| <b>Yield and Cost Statistics (RMB):</b>                      |                                |             |             |             |             |
| Passenger yield (passenger revenue/passenger-kilometers)     | 0.61                           | 0.61        | 0.60        | 0.55        | 0.57        |
| Cargo yield (cargo revenue/cargo tonne-kilometers)           | 2.51                           | 2.35        | 2.20        | 2.39        | 2.46        |
| Average yield (passenger and cargo revenue/tonne-kilometers) | 5.21                           | 4.97        | 4.92        | 4.71        | 4.62        |
| Unit cost (operating expenses/ATK)                           | 2.73                           | 2.87        | 2.69        | 2.87        | 2.94        |

**B. Capitalization and Indebtedness**

Not applicable.

**C. Reasons for the Offer and Use of Proceeds**

Not applicable.

**D. Risk Factors**

An investment in our ADSs or H shares involves a number of risks. An investment in our company also involves special concerns and significant risks not usually involved with an investment in the equity securities of a United States company. You should carefully consider the following information about these risks, together with the other information in this annual report.

*Government regulation*

The Chinese civil aviation industry is subject to a high degree of regulation by the CAAC. Regulatory policies issued or implemented by the CAAC encompass virtually every aspect of airline operations, including, among others:

route allocation;

domestic airfare;

the administration of air traffic control systems and certain airports; and

aircraft registration and aircraft airworthiness certification.

As a result, we may face significant constraints on our flexibility and ability to expand our business operations or to maximize our profitability.

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### *Government ownership and control of our company*

Most of the airline companies in China are currently 100% or majority owned either by the central government of China or by provincial or municipal governments in China. CEA Holding currently holds approximately 61.64% of our company's equity interest on behalf of the Chinese government. As a result, CEA Holding will be able to elect our entire board of directors and otherwise be able to control us. CEA Holding will also have sufficient voting control to effect transactions without the concurrence of our minority shareholders. The interests of the Chinese government as the ultimate controlling person of our company and other Chinese airlines could conflict with the interests of our minority shareholders. Although the CAAC currently has a policy of equal treatment for all Chinese airlines, we cannot assure you that the CAAC will not favor other Chinese airlines.

### *Competition*

We face intense competition in each of the domestic, Hong Kong regional and international markets we serve. As a result, we may have to lower our airfare in order to maintain passenger traffic and compete with certain smaller domestic airline companies that operate with costs lower than our company or pursue a strategy of offering lower fares. In addition, many of our competitors have significantly longer operating history, greater name recognition, more resources and larger sales networks than our company or participate in reservation systems that are more convenient than ours. The public's perception of the safety records of Chinese airlines also adversely affects our ability to compete against our international competitors. Increased competition may have a material adverse effect on our financial condition and results of operations.

### *Insurance coverage and cost*

As a result of the September 11, 2001 events, aviation insurers have significantly reduced the maximum amount of insurance coverage available to commercial air carriers for liability to persons other than employees or passengers for claims resulting from acts of terrorism, war or similar events, or war-risk coverage. At the same time, they significantly increased the premiums for such coverage as well as for aviation insurance in general. Our company has extended our insurance coverage purchased prior to the September 11 events to November 31, 2004. However, if the insurance carriers reduce further the amount of insurance coverage available or increase the premium for such coverage when we renew our insurance coverage, our financial condition and results of operations will be adversely affected.

### *Direct air link between China's mainland and Taiwan*

Currently, our operations on the Hong Kong regional routes benefit from traffic between Hong Kong and mainland China ultimately originating in Taiwan. During the Lunar Chinese New Year peak travel season in 2003, from late-January to mid-February, the Chinese government allowed special chartered flights between Shanghai and Taiwan for the first time. There was no such direct chartered flights in 2004 so far. Although regular direct flights between Taiwan and mainland China are still not permitted, our Hong Kong regional routes may be adversely affected if such direct flights are permitted in the future. We cannot assure you that we will obtain sufficient Taiwan-mainland China routes, or that the yields on these routes will be adequate, to offset any adverse effect on our revenues derived from our Hong Kong regional routes.

### *Chinese aviation infrastructure limitations and safety*

The rapid increase in air traffic volume in China in recent years has put pressure on many components of the Chinese airline industry, including air traffic control systems, the availability of





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qualified flight personnel and airport facilities. Our ability to provide safe air transportation depends on the availability of qualified and experienced pilots in China and the improvement of maintenance services, national air traffic control and navigational systems and ground control operations at Chinese airports. If any of these is not available or is inadequate, our ability to provide safe air transportation will be compromised and our financial condition and results of operations will be materially adversely affected.

### *Fuel supply and costs*

The availability and cost of the aviation fuel has a significant impact on our financial condition and results of operations. In the past, jet fuel shortages have occurred in China and, on limited occasions, required us to delay or cancel flights. Although jet fuel shortages have not occurred since the end of 1993, we cannot assure you that jet fuel shortages will not occur in the future. As of May 31, 2004, the official domestic fuel price increased 16.6% compared to the price as of May 31, 2003. The international and domestic fuel prices may continue to increase in the future, in part due to the domestic turmoil in Iraq and other oil producing regions. The fuel costs accounted for approximately 21.7% of our operating expenses in 2003. In 2003, our fuel expenses increased 18.8% as a result of increased weighted average domestic and international fuel prices and the expansion of our fleet. In particular, the weighted average domestic and international fuel prices paid by our company in 2003 increased by approximately 10.6% and 3.6%, respectively. Due to the highly competitive nature of the airline industry, we may be unable to pass on to our customers any increased fuel costs we may encounter in the future. Any jet fuel shortages or any increase in domestic or international jet fuel price may materially adversely affect our financial condition and results of operations.

### *Operating leverage*

The airline industry is characterized by a high degree of operating leverage. Due to high fixed costs, including payments made in connection with aircraft leases, the expenses relating to the operation of any given flight do not vary proportionately with the number of passengers carried, while revenues generated from a particular flight are directly related to the number of passengers carried and the fare structure of the flight. Accordingly, a decrease in revenues may result in a proportionately higher decrease in profits.

### *Future financing requirements*

We require significant amounts of external financing to meet our capital commitments for additions of and upgrades on the aircraft and flight equipment and other business expansion needs. In the past, we have obtained, sometimes with the assistance of the CAAC, guarantees from Bank of China and other Chinese banks in respect of payments under our foreign loan and capital lease obligations. However, we cannot assure you that we will be able to continue to obtain bank guarantees in the future. The unavailability of Bank of China or other acceptable bank guarantees or the increased cost of such guarantees may adversely affect our ability to borrow internationally or enter into international aircraft lease financings on acceptable terms. The ability of our company to obtain financing may also be affected by our financial position and leverage as well as by prevailing economic conditions and the cost of financing generally. If we were unable to obtain financing for a significant portion of our capital requirements, our ability to acquire new aircraft or to expand our operations may be impaired. We have and in the future will likely continue to have substantial debts. As a result, the interest cost associated with these debts might impair our future profitability and cause our earnings to be subject to a higher degree of volatility.

### *Related party transactions; conflict of interests*

We have engaged from time to time and will continue to engage in a variety of transactions with CEA Holding and various members of CEA Holding, which provide a number of services to us, including



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in-flight catering and import of aircraft, flight equipment and flight equipment spare parts. Our transactions with CEA Holding and members of CEA Holding are conducted pursuant to a number of service and other contracts between CEA Holding and us, the terms of which were negotiated on an arm's length basis. Since CEA Holding is our controlling shareholder and the interests of CEA Holding may conflict with our company's own interests, CEA Holding or any member of CEA Holding may take actions that favor the interests of other members of CEA Holding over our company's interests.

### *Limitation on foreign ownership*

The current CAAC policies limit foreign ownership in Chinese airlines. Under these limits, non-Chinese residents and Hong Kong, Macau or Taiwan residents cannot hold majority equity interest in a Chinese airline company. At present, approximately 32.2% of our total outstanding shares are held by non-Chinese residents and Hong Kong, Macau or Taiwan residents. As a result, our access to international equity capital markets may be limited. This restriction may also limit the opportunities available to our company to obtain funding or other benefits through the creation of equity-based strategic alliances with foreign carriers. We cannot assure you that the CAAC will increase these limits in the near future or at all.

### *Adverse impact of unusual events*

On March 19, 2003, the United States commenced its military campaign against Iraq. The number of passengers for some of our company's international routes, in particular, the U.S. route of our company, decreased after the commencement of the war in Iraq. The demand on our international routes may continue to decrease due in part to fears of terrorism that ensued the Iraqi war, which may materially adversely affect our financial condition and results of operations.

From November 2002 to June 2003, China and certain other countries and regions experienced an outbreak of a new and highly contagious form of atypical pneumonia now known as severe acute respiratory syndrome, or SARS. On July 5, 2003, the World Health Organization declared that the SARS outbreak had been contained in China. However, new cases of SARS were reported in China since April 22, 2004. Any future outbreak of SARS or similar contagious epidemic will, among other things, significantly reduce demand for our services and will have a material adverse effect on our financial condition and results of operations.

### *Changes in the economic policies of the Chinese government*

Since the late 1970s, the Chinese government has been reforming the Chinese economic system. These reforms have resulted in significant economic growth and social progress. Although we believe that economic reform and macroeconomic policies and measures adopted by the Chinese government will continue to have a positive effect on the economic development in China and that we will continue to benefit from these policies and measures, these policies and measures may from time to time be modified or revised. Adverse changes in economic and social conditions in China, in the policies of the Chinese government or in the laws and regulations in China, if any, may have a material adverse effect on the overall economic growth of China and investment in the airline industry in China. These developments, in turn, may materially adversely affect our business operations, such as an adverse effect on the demand for our services, and may also materially adversely affect our financial condition and results of operations.

### *Convertibility of Renminbi*

A significant portion of our revenue and operating expenses are denominated in Renminbi, while a portion of our revenue, capital expenditures and debts are denominated in U.S. dollars and other foreign currencies. Renminbi is

currently freely convertible under the current account, which includes dividends,

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trade and service-related foreign currency transactions, but not under the capital account, which includes foreign direct investment, unless the prior approval of the State Administration of Foreign Exchange, or SAFE, is obtained. As a foreign investment enterprise approved by the PRC Ministry of Commerce, or MOC, we can purchase foreign currency without the approval of SAFE for settlement of current account transactions, including payment of dividends, by providing commercial documents evidencing these transactions. We can also retain foreign exchange in our current accounts, subject to a maximum amount approved by SAFE, to satisfy foreign currency liabilities or to pay dividends. However, the relevant Chinese government authorities may limit or eliminate our ability to purchase and retain foreign currencies in the future. Foreign currency transactions under the capital account are still subject to limitations and require approvals from SAFE. This may affect our ability to obtain foreign exchange through debt or equity financing, including by means of loans or capital contributions. We cannot assure you that we will be able to obtain sufficient foreign exchange to pay dividends or satisfy our foreign exchange liabilities.

### *Fluctuations in exchange rates*

The value of Renminbi fluctuates and is subject to significant changes in China's political and economic conditions. While the official exchange rate for the conversion of Renminbi to U.S. dollars has generally been stable in recent years, any devaluation of Renminbi may adversely affect the value of dividends, if any, payable on our H shares in foreign currency terms. We use currency forward contracts to reduce risks of changes in currency exchange rates in respect of ticket sales and expenses denominated in foreign currencies. These currency forward contracts will expire between 2004 and 2010. Since we may not be able to fully hedge against Renminbi devaluations, future movements in the exchange rate of Renminbi and other currencies may have an adverse effect on our financial condition and results of operations.

### *Uncertainties embodied in the Chinese legal system*

The Chinese legal system is a civil law system based on written statutes. Unlike common law systems, it is a system in which decided legal cases have little precedential value. In 1979, the Chinese government began to promulgate a comprehensive system of laws and regulations governing economic matters in general. Legislation over the past 20 years has significantly enhanced the protection afforded to foreign investment in China. However, the interpretation and enforcement of some of these laws, regulations and other legal requirements involve uncertainties that may limit the legal protection available to you.

## **Item 4. Information on the Company.**

### **History and Development of the Company**

Our company was established on April 14, 1995 under the laws of China as a company limited by shares in connection with the restructuring of our predecessor and our initial public offering. Our registered office is located at 66 Airport Street, Pudong International Airport, Shanghai, China, 201202. Our principal executive office is located at 2550 Hong Qiao Road, Hong Qiao International Airport, Shanghai, China, 200335. The telephone number of our principal executive office is (86-21) 6268-6268. We currently do not have an agent for service of process in the United States. Our predecessor was one of the six original airlines established in 1988 as part of the decentralization of the airline industry in China undertaken in connection with China's overall economic reform efforts. Prior to 1988, the CAAC was responsible for all aspects of civil aviation in China, including the regulation and operation of China's airlines and airports. In connection with our initial public offering, our predecessor was restructured into two separate legal entities, our company and EA Group. According to the restructuring arrangement, by operation of law, our company succeeded to substantially all of the assets and liabilities relating to the airline business of our predecessor. EA Group succeeded to our predecessor's assets and liabilities that do not directly relate to the airline



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operations and do not compete with our businesses. Assets transferred to EA Group included our predecessor's equity interests in companies engaged in import and export, real estate, advertising, in-flight catering, tourism and certain other businesses. In connection with the restructuring, we entered into various agreements with EA Group and its subsidiaries for the provision of certain services to our company. CEA Holding assumed the rights and liabilities of EA Group under these agreements after it is formed by merging EA Group, Yunnan Airlines Company and China Northwest Airlines Company in October 2002. See Item 7. Major Shareholders and Related Party Transactions for more details. In 2003, our company's total revenue accounted for approximately 70.5% of CEA Holding's total revenue. The following chart sets forth the organizational structure of our company and our significant subsidiaries, all of which were incorporated in China.

In February 1997, we completed our initial public offering of 1,566,950,000 ordinary H shares, par value RMB1.00 per share, and listed our ordinary H shares on The Stock Exchange of Hong Kong Limited, or the Hong Kong Stock Exchange, and American Depositary Shares, or ADSs, representing our H shares, on the New York Stock Exchange. Prior to our initial public offering, all of the issued and outstanding shares of our capital stock, consisting of 3,000,000,000 ordinary domestic shares, par value RMB1.00 per share, were owned by EA Group, which exercises, on behalf of the Chinese government and under the supervision and direction of the CAAC, the shareholder rights in our company. In October 1997, we completed a public offering of 300,000,000 new ordinary domestic shares in the form of A shares to public shareholders in China and listed our A shares on the Shanghai Stock Exchange. Following the A share offering, EA Group continued to own 3,000,000,000 ordinary domestic shares, which represent 90.91% of our total ordinary domestic shares and 61.64% of our issued and outstanding share capital. H shares are our ordinary shares listed on the Hong Kong Stock Exchange and A shares are our ordinary shares listed on the Shanghai Stock Exchange. Our H shares and A shares are identical in respect of all rights and preferences, except that the A shares may only be held by Chinese domestic investors and certain qualified foreign institutional investors. In addition, dividends on the A shares are payable in Renminbi.

Since our initial public offering, we have expanded our operations through acquisitions and joint ventures. In July 1998, our company and China Ocean Shipping (Group) Company jointly established China Cargo Airlines Limited, which specializes in the air freight business. Our total investment in this joint venture was approximately RMB350 million, representing 70% of the equity interest of China Cargo Airlines Limited. In addition, we purchased from EA Group the assets and liabilities relating to airline operations of China General Aviation Company, for approximately RMB88 million in November 1999. China General Aviation Company was based in Shanxi Province in China and served primarily the northern region of China. Moreover, we completed our acquisition of Air Great Wall in June 2001 and established



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our Ningbo Branch following the acquisition. Air Great Wall was based in Ningbo, Zhejiang Province in China and served primarily the southeastern region of China.

In May 2002, our company, jointly with Shanghai Civil Aviation Eastern China Kaiya System Integration Co., Ltd., established Shanghai Eastern Airlines Investment Co., Ltd., or SEAI. We hold a 99% equity interest in SEAI. The joint venture serves as one of the investment vehicles of our company for our investments in other industrial projects and provides consulting services. In August 2002, our company, jointly with Wuhan Municipal State-owned Assets Management Committee Office and two other independent third parties, established China Eastern Airlines Wuhan Limited, in which our company holds a 40% equity interest. China Eastern Airlines Wuhan Limited serves primarily the market in Hubei Province. We also entered into an agreement with Rockwell Collins International Inc. of the United States to establish a joint venture avionics maintenance service company in China in September 2002. Moreover, in November 2002, our company, jointly with China Aircraft Services Limited, established Shanghai Eastern Aircraft Maintenance Limited, in which our company holds a 60% equity interest. In order to expand our company's operations in Jiangsu Province of China, we increased our investment in China Eastern Airlines Jiangsu Co., Ltd., or Eastern Jiangsu, in December 2002, together with other shareholders of Eastern Jiangsu. Our equity interest in Eastern Jiangsu remains at 55% after the investment.

In April 2003, we entered into a share transfer agreement with CEA Holding, pursuant to which we have acquired from CEA Holding a 45% equity interest in Eastern Aviation Import and Export Company, or EAIEC, for a consideration of approximately RMB44 million. EAIEC was a wholly-owned subsidiary of CEA Holding prior to the transaction. Under the share transfer agreement, our company and CEA Holding each undertakes to the other party that it will not establish any other entity engaging in any business similar in nature or scope to the business conducted by EAIEC. We believe that the acquisition of 45% equity interest in EAIEC could reduce our company's cost of importing aviation raw materials and enhance our company's profitability.

In December 2003, we also entered into a joint venture agreement with CEA Holding to establish China Eastern Air Catering Investment Company Ltd., or CEA Catering Investment. The registered capital of CEA Catering Investment is RMB350 million. Pursuant to the joint venture agreement, CEA Holding and our company made capital contributions of approximately RMB192.5 million and RMB157.5 million, respectively. As a result, CEA Holding and our company hold a 55% and a 45% equity interest in CEA Catering Investment, respectively. CEA Catering Investment is primarily engaged in the business of providing air and ground catering services, food and beverage supplies and other related services. Our board believes that our investment in CEA Catering Investment is beneficial to our company and its shareholders, and expects it to reduce the cost incurred by our company in providing catering services and to enhance our profitability and competitiveness in the domestic aviation industry.

In addition, also in December 2003, we entered into an equity transfer and capital increase agreement with CEA Holding and Shanghai Eastern Development Corporation Limited, or SEDC, pursuant to which our company acquired 10% of SEDC's then equity interest and 35% of CEA Holding's then equity interest in Shanghai Dong Mei Aviation Travel Corporation Limited, a company that is primarily engaged in the business of selling air tickets, hotel reservation, travel agency and other related services. After the transaction, our company holds a 45% equity interest in Shanghai Dong Mei. Our aggregate investment in Shanghai Dong Mei was approximately RMB14.9 million.

On February 18, 2004, we entered into a joint venture agreement with CEA Holding to establish China Eastern Real Estate Investment Co. Ltd., or CEA Real Estate, a limited liability company established under the laws of the PRC. The registered capital of CEA Real Estate is RMB100 million. Pursuant to the joint venture agreement, CEA Holding and our company shall make capital contributions of approximately RMB95 million and RMB5 million, respectively. As a result, CEA Holding and our company hold a 95%



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and a 5% equity interest in CEA Real Estate, respectively. CEA Real Estate is primarily engaged in the real estate business, including the development and sales of commercial premises and property leasing in Shanghai, China. Our board believes that the investment in CEA Real Estate is in the interests of our company and its shareholders.

Pursuant to the CAAC's airline industry restructuring plan, EA Group merged with Yunnan Airlines Company and China Northwest Airlines Company and formed CEA Holding in October 2002. Yunnan Airlines Company and China Northwest Airlines Company were restructured as wholly-owned subsidiaries of CEA Holding after the merger. China Northwest Airlines Company is based in Xi'an, Shanxi Province in China with approximately 30 jet aircraft and serves primarily the western region of China. Yunnan Airlines Company is based in Kunming, Yunnan Province in China with approximately 26 jet aircraft and serves primarily the southwestern region of China. The airline operations currently conducted by Yunnan Airlines Company and China Northwest Airlines Company compete with our company, in particular, on the Shanghai-Wenzhou route, Shanghai-Harbin route, Shanghai-Qingdao route, Shanghai-Changsha route, Changchun-Kunming route, Changsha-Ningbo route, Changsha-Kunming route and Changsha-Nanjing route. We are discussing with CEA Holding with respect to the potential acquisition from CEA Holding of assets relating to airline operations currently conducted by Yunnan Airlines Company and China Northwest Airlines Company. However, we cannot assure you when the acquisition of relevant assets by our company can be completed or at all due to the complex procedures and uncertainties relating to our operating environment. CEA Holding has used its best efforts to reduce the competition between us and Yunnan Airlines Company or China Northwest Airlines Company, and has used its best efforts to cause Yunnan Airlines Company and China Northwest Airlines Company not to launch any new routes that compete or may compete with us.

As part of our continuing effort to upgrade our fleet, we have disposed of old aircraft and added new aircraft to our fleet. Our aircraft dispositions have reduced the average age of our fleet. All of our aircraft are registered with the CAAC. The table below sets forth our significant aircraft dispositions and additions since December 31, 1999:

|  | <u>2000</u>   | <u>2001</u>  | <u>2002</u>  | <u>2003</u>   | <u>2004<sup>(1)</sup></u>  |
|--|---|--|--|---|--|
| Additions<br>(Capital Leases<br>and Purchases) | 4 Airbus 320<br>aircraft  | 3 Airbus 320<br>aircraft<br>3 Boeing 737-200<br>aircraft | 4 Boeing<br>737-700 aircraft                             | 10 Airbus 320<br>aircraft<br>3 Airbus<br>340-600 aircraft | 2 Airbus 340-600<br>aircraft<br>2 Airbus 321 aircraft<br>5 Airbus 320 aircraft |
| Additions<br>(Operating<br>leases)             | 4 Airbus 319<br>aircraft<br>2 MD-82<br>aircraft<br>1 Boeing<br>747-200F<br>aircraft | 4 Airbus 319<br>aircraft                                 | 2 Airbus 319<br>aircraft<br>2 Boeing<br>737-700 aircraft | 5 Boeing<br>737-700 aircraft                              |  |
| Dispositions                                   | 4 MD-82<br>aircraft   | 0  | 2 Airbus 310<br>aircraft                                 | 3 Boeing<br>737-200 aircraft                              |  |

(1) Currently contemplated by our company.

**Business Overview**

Our company is one of the three largest air carriers in China in terms of tonne-kilometers and number of passengers carried in 2003, and is the primary air carrier serving Shanghai, China's eastern gateway. We accounted for approximately 17.0% of the total commercial air traffic (as measured in tonne-kilometers) handled by Chinese airlines in 2003. We operate primarily from Shanghai's Hong Qiao International Airport and Pudong International Airport. In

2003, we accounted for approximately 26.8% of the total passenger traffic volume and 18.0% of the total freight volume on routes to and from Shanghai. We

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have been consistently ranked as one of the best Chinese airlines in terms of service quality in each of the past five years according to a poll conducted by the China Civil Aviation Association.

Compared to 2002, our traffic volume increased by approximately 9.6% in 2003. Our passenger traffic volume decreased from 18,206.4 million passenger-kilometers in 2002 to 18,002.7 million passenger-kilometers in 2003, or 1.1%. Our cargo and mail traffic volume increased by 26.7% from 1,023.0 million tonne-kilometers in 2002 to 1,296.6 million tonne-kilometers. In 2003, our average on-time performance rate was approximately 78.4%, which was slightly lower than the industry average rate of 79.8% in China.

**Airline Operations and Route Network**

The following table sets forth our traffic revenues by activity for each of the five years ended December 31, 2003:

|                        | <u>1999</u>          | <u>2000</u>          | <u>2001</u>          | <u>2002</u>          | <u>2003</u>          | <u>2003</u>           |
|------------------------|----------------------|----------------------|----------------------|----------------------|----------------------|-----------------------|
|                        | (millions of<br>RMB) | (millions of<br>RMB) | (millions of<br>RMB) | (millions of<br>RMB) | (millions of<br>RMB) | (millions of<br>US\$) |
| Traffic Revenues       |                      |                      |                      |                      |                      |                       |
| Passengers             | 8,031                | 8,644                | 9,586                | 10,038               | 10,261               | 1,240                 |
| Cargo and mail         | 1,730                | 2,124                | 2,092                | 2,445                | 3,187                | 385                   |
|                        | <u>          </u>    | <u>          </u>    | <u>          </u>    | <u>          </u>    | <u>          </u>    | <u>          </u>     |
| Total Traffic Revenues | <u>9,761</u>         | <u>10,768</u>        | <u>11,679</u>        | <u>12,483</u>        | <u>13,448</u>        | <u>1,625</u>          |

*Passenger Operations*

The following table sets forth certain passenger operating statistics of our company by geographic region for each of the five years ended December 31, 2003:

|   | <u>1999</u> | <u>2000</u> | <u>2001</u> | <u>2002</u> | <u>2003</u> |
|---|-------------|-------------|-------------|-------------|-------------|
| Passenger Traffic (millions of passenger kilometers)              | 13,257      | 14,102      | 15,911      | 18,206      | 18,003      |
| Domestic  | 6,229       | 6,326       | 7,512       | 8,516       | 10,302      |
| Hong Kong   | 1,758       | 1,896       | 2,028       | 2,234       | 1,934       |
| International   | 5,270       | 5,879       | 6,371       | 7,457       | 5,767       |
| ASK (millions)  | 22,479      | 22,596      | 25,814      | 27,963      | 29,780      |
| Domestic  | 11,259      | 10,874      | 12,928      | 13,494      | 15,909      |
| Hong Kong   | 2,921       | 3,115       | 3,609       | 3,650       | 3,692       |
| International   | 8,300       | 8,608       | 9,277       | 10,819      | 10,178      |
| Passenger Yield (passenger revenues/passenger kilometers, in RMB) | 0.62        | 0.61        | 0.60        | 0.55        | 0.57        |
| Domestic  | 0.65        | 0.63        | 0.63        | 0.55        | 0.54        |

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|                           |       |       |       |       |       |
|---------------------------|-------|-------|-------|-------|-------|
| Hong Kong                 | 0.98  | 0.99  | 0.95  | 0.86  | 0.84  |
| International             | 0.44  | 0.48  | 0.48  | 0.46  | 0.53  |
| Passenger Load Factor (%) | 58.98 | 62.43 | 61.64 | 65.11 | 60.45 |
| Domestic                  | 55.33 | 58.20 | 58.10 | 63.11 | 64.75 |
| Hong Kong                 | 60.19 | 60.85 | 56.20 | 61.21 | 52.37 |
| International             | 63.50 | 68.33 | 68.68 | 68.93 | 56.66 |

The primary focus of our business is the provision of domestic, Hong Kong regional and international passenger airline services. In 2003, our passenger operations generated revenues of

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approximately RMB10,261.0 million (approximately US\$1,239.7 million), or approximately 76.3% of our operating revenues. We operated over 3,090 scheduled flights per week (excluding charter flights), serving a route network that covers 81 cities within China and abroad. In 2003, we operated approximately 210 routes.

In 2003, we operated approximately 1,894 domestic flights per week on 152 routes. Our domestic routes generated approximately 54.4% of our passenger revenues. Our most heavily traveled domestic routes generally link Shanghai to the large commercial and business centers of China, such as Beijing, Guangzhou and Shenzhen.

In 2003, we also operated approximately 400 flights per week on 14 routes to and from Hong Kong, originating from Shanghai and 13 other major cities in eastern and northern China. Our Hong Kong regional routes accounted for approximately 15.9% of our passenger revenues in 2003.

In 2003, we operated approximately 296 international flights per week on 44 routes, serving 30 cities in 11 countries, primarily linking Shanghai to major cities in east and southeast Asian countries (Japan, Korea, India, Singapore and Thailand) and certain strategic locations in Europe, the United States and Australia. In 2003, we successively launched new passenger routes of Shanghai-Phuket and Shanghai-Melbourne. In addition, based on our detailed market studies, we terminated the relatively low-yielding passenger route of Shanghai-Munich-Madrid and increased the flight frequency on the Shanghai-Paris passenger route in order to retain European passengers. The launch of the international transit route from Sydney to Paris via Shanghai improved our capacity in providing transit services. We also enhanced our services and competitiveness on the China-U.S. routes by replacing the old MD-11 aircraft serving those routes with Airbus A340-600 aircraft acquired in 2003. Revenues derived from our operations on international routes accounted for approximately 29.6% of our passenger revenues. Revenues derived from our operations on our 11 Japan routes accounted for approximately 9.5% of our passenger revenues and approximately 32.1% of our international passenger revenues in 2003. Our Korea and Japan international routes and Hong Kong regional routes generally have been our highest yielding routes.

Most of our international and Hong Kong regional flights and a substantial portion of our domestic flights either originate or terminate in Shanghai, the central hub of our route network. Our operations in Shanghai are conducted primarily at Hong Qiao International Airport and Pudong International Airport. All of our international flights originate or terminate at Pudong International Airport. Pudong International Airport is a newly constructed airport and is relatively further away from the central business district of Shanghai.

In addition to our core Shanghai-based operations, we currently also have nine provincial hubs in eastern and northern China, each of which primarily serves, and is located in a principal commercial center of, one of the following provinces: Anhui, Jiangsu, Jiangxi, Shandong, Shanxi, Hebei, Zhejiang and Hubei. Jiangsu, Zhejiang and Shandong are among the most economically developed provinces in China. We believe that we will benefit from the level of development and growth opportunities in eastern and northern China as a whole by providing direct services between various cities in those regions and between those regions and other major cities in China. The provincial hubs also enable us to provide convenient connections for passengers on certain flights to and from Shanghai. Aircraft used for regional operations are mainly maintained by us on site at the hubs, and our sales offices are also based at each provincial hub.

*Cargo and Mail Operations*

The following table sets forth certain cargo and mail operating statistics of our company by geographic region for each of the five years ended December 31, 2003:

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|  | <b>Year Ended December 31,</b> |             |             |             |             |
|--|--------------------------------|-------------|-------------|-------------|-------------|
|  | <b>1999</b>                    | <b>2000</b> | <b>2001</b> | <b>2002</b> | <b>2003</b> |
| Cargo and Mail Tonne-Kilometers (millions)   | 689                            | 904         | 950         | 1,023       | 1,297       |
| Domestic   | 150                            | 159         | 176         | 206         | 258         |
| Hong Kong  | 44                             | 53          | 48          | 53          | 81          |
| International  | 496                            | 693         | 726         | 764         | 958         |
| Weight of Cargo and Mail Carried (millions of kilograms)                               | 248                            | 286         | 302         | 345         | 460         |
| Domestic   | 126                            | 133         | 146         | 170         | 205         |
| Hong Kong  | 31                             | 37          | 33          | 39          | 57          |
| International  | 92                             | 116         | 116         | 136         | 198         |
| Cargo and Mail Yield (cargo and mail revenues/cargo and mail tonne-kilometers, in RMB) | 2.51                           | 2.35        | 2.20        | 2.39        | 2.46        |

Our cargo and mail business generated revenues of approximately RMB3,187.0 million (approximately US\$385.1 million) in 2003, representing approximately 23.7% of our operating revenues for the year.

We must obtain from the CAAC the right to carry passengers or cargo on any domestic or international route. Our cargo and mail business generally utilizes the same route network used by our passenger airline business. China Cargo Airlines Limited also maintains seven cargo routes. We carry cargo and mail on our freight aircraft as well as in available cargo space on our passenger aircraft. Our most significant cargo and mail routes are international routes. Revenues derived from our operations on international cargo and mail routes accounted for approximately 79.0% of our total cargo and mail revenues in 2003. Revenues derived from our operations on routes to Japan accounted for approximately 23.4% of our international cargo and mail revenues in 2003. In 2003, we successively launched new cargo routes of Shanghai-Beijing-Luxembourg and Shanghai-Anchorage-Los Angeles-Seattle-Dallas-Chicago.

The development of cargo operations is an important part of our company's growth strategy. After the establishment of China Cargo Airlines Limited, we have converted six MD-11 passenger aircraft into freight aircraft that are designated for cargo and mail operations, three of which were converted in the second half of 2003. We also wet-leased a Boeing B747-200 freighter aircraft on short-term for our cargo operations in 2003.

**Regulation**

The PRC Civil Aviation Law provides the framework for regulation of many important aspects of civil aviation activities in China, including:

- the administration of airports and air traffic control systems;
- aircraft registration and aircraft airworthiness certification;
- operational safety standards; and
- the liabilities of carriers.

The Chinese airline industry is also subject to a high degree of regulation by the CAAC. Regulations issued or implemented by the CAAC encompass virtually every aspect of airline operations, including route allocation, domestic airfare, licensing of pilots, operational safety standards, aircraft acquisition, aircraft airworthiness certification, fuel prices, standards for aircraft maintenance and air traffic control and standards for airport operations. Although China's airlines operate under the supervision and regulation of the CAAC, they are accorded a significant



degree of operational autonomy. These areas of operational autonomy include:

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whether to apply for any route;

the allocation of aircraft among routes;

the airfare pricing for the international and Hong Kong passenger routes;

the airfare pricing within the limit provided by the CAAC for the domestic passenger routes;

the training and supervision of personnel; and

many other areas of day-to-day operations.

Although we have generally been allocated adequate routes in the past to accommodate our expansion plans and other changes in our operations, those routes are subject to allocation and re-allocation in response to changes in governmental policies or otherwise at the discretion of the CAAC. Consequently, we cannot assure you that our route structure will be adequate to satisfy our expansion plans.

The CAAC has established regulatory policies intended to promote controlled growth of the Chinese airline industry. We believe those policies would be beneficial to the development of and prospects for the Chinese airline industry as a whole. Nevertheless, those regulatory policies could limit our flexibility to respond to changes in market conditions, competition or our cost structure. Moreover, while our company generally benefits from regulatory policies that are beneficial to the airline industry in China as a whole, the implementation of specific regulatory policies may from time to time adversely affect our business operations.

Because our company provides services on international routes, we are also subject to a variety of bilateral civil air transport agreements between China and other countries. In addition, China is a contracting state as well as a permanent member of the International Civil Aviation Organization, an agency of the United Nations established in 1947 to assist in the planning and development of the international air transportation. International Civil Aviation Organization establishes technical standards for the international airline industry. China is also a party to a number of other international aviation conventions. The business operations of our company are subject to those international aviation conventions as well.

*Domestic Route Rights.* Chinese airlines must obtain from the CAAC the right to carry passengers or cargo on any domestic route. The CAAC's policy on domestic route rights is to assign routes to the airline or airlines suitable for a particular route. The CAAC will take into account whether an applicant for a route is based at the point of origin or termination of a particular route. This policy benefits airlines, such as our company, that have a hub located at each of the active air traffic centers in China. The CAAC also considers other factors that will make a particular airline suitable for an additional route, including the applicant's safety record, previous on-time performance and level of service and availability of aircraft and pilots. The CAAC will consider the market conditions applicable to any given route before such route is allocated to one or more airlines. Generally, the CAAC will permit additional airlines to service a route that is already being serviced only when there is strong demand for a particular route relative to the available supply. The CAAC's current general policy is to require the passenger load factor of one or two airlines on a particular route to reach a certain level, currently 65%, before another carrier is permitted to commence operations on such route.

*Hong Kong Route Rights.* Hong Kong routes and the corresponding landing rights were formerly derived from the Sino-British air services agreement. In February 2000, the Chinese central government, acting through the CAAC, and Hong Kong signed the Air Transportation Arrangement between mainland China and Hong Kong. The Air Transportation Arrangement provides for equal opportunity for airlines based in Hong Kong and mainland China. Competition from airlines based in Hong Kong increased after the execution of the Air Transportation Arrangement.

The CAAC allocates route and landing rights among the seven Chinese airlines currently permitted to fly to Hong Kong. The CAAC normally will not allocate

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an international route or a Hong Kong route to more than one domestic airline unless certain criteria, including minimum load factors on existing flights, are met. Although no other Chinese airline currently operates on any of our Hong Kong routes, we cannot assure you that this will remain the case.

*International Route Rights.* International route rights, along with the corresponding landing rights, are derived from air services agreements negotiated between the Chinese central government, acting through the CAAC, and the government of the relevant foreign country. Each government grants to the other the right to designate one or more domestic airlines to operate scheduled services between certain points within each country. Upon entering into an air services agreement, the CAAC seeks applications from the seven Chinese airlines currently approved to fly international routes. The CAAC awards the relevant route to an airline based on various criteria, including:

availability of appropriate aircraft and flight personnel;

safety record;

on-time performance; and

hub location.

Although hub location is an important criteria, an airline may be awarded a route which does not originate from an airport where it has a hub. The route rights awarded do not have a fixed expiry date and can be terminated at the discretion of the CAAC.

*Airfare Pricing Policy.* The PRC Civil Aviation Law provides that airfare for domestic routes are determined jointly by the CAAC and the agency of the State Council responsible for price control, primarily based upon average airline operating costs and market conditions. From February 1999 to March 2001, all domestic airlines were required to adhere to unified domestic airfare published by the CAAC from time to time and discounted sales were prohibited. In 2001, the CAAC gradually relaxed its control over domestic airfare pricing and, effective March 1, 2001, domestic airlines were permitted to offer discounts on several major domestic routes.

On March 17, 2004, China's State Council approved the Pricing Reform Plan for the Domestic Civil Aviation Industry, or the Pricing Reform Plan, effective April 20, 2004. Pursuant to the Pricing Reform Plan, the governmental authorities responsible for price control will no longer directly set the airfare for domestic routes, but will indirectly control the airfare for domestic routes by setting basic airfare levels and permitted ranges within which the actual airfare of Chinese airlines can deviate from such basic airfare levels. Chinese airlines will be able to set their own airfare for their domestic routes within the permitted ranges and adopt more flexible sales policies to promote their services.

The CAAC and the State Development and Reform Commission will jointly publish the pricing guidelines from time to time, which set forth the basic airfare levels and permitted ranges. Pursuant to the current pricing guidelines, the basic airfare for domestic routes will be the published airfare implemented by Chinese airlines immediately prior to the approval of the Pricing Reform Plan (the average basic airfare for domestic routes is RMB0.75 per passenger-kilometer). Except for certain domestic routes, the actual airfare set by each Chinese airline for its domestic routes cannot be 25% higher and 45% lower than the basic airfare. Domestic routes that are not subject to the deviation range restrictions include short-haul routes between cities in the same province or autonomous region, or between a municipality and adjacent provinces, autonomous regions or another municipality. Certain tourist routes and routes served by only one Chinese airline are not subject to the bottom range restriction. The CAAC and the State Development and Reform Commission will announce the routes that are not subject to the deviation range restrictions through the airfare information system known as Airtis.net. Chinese airlines may apply to the CAAC and the State Development and Reform Commission for exemption from the bottom range restriction for a



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particular route. Chinese airlines are also required to file the actual airfare they set for their domestic routes within the ranges through Airtis.net 30 days prior to its implementation.

The CAAC and the State Development and Reform Commission will regularly review the average operating costs of Chinese airlines, and may adjust the basic airfare for particular domestic routes which, in their view, are not at a reasonable level. We expect that, as reforms continue to accelerate in 2004, we will have more flexibility in operating our aviation business in the future. The promotion by Chinese regulators of a regulated and orderly market and a fair and positive competition mechanism will also provide a favorable environment for the growth of our business.

Under the PRC Civil Aviation Law, maximum airfare on Hong Kong and international routes is set in accordance with the terms of the air services agreements pursuant to which these routes are operated. In the absence of an air services agreement, the airfare is set by the airlines themselves or the CAAC with reference to comparable market prices, taking into account the international airfare standards established through the coordination of the International Air Transport Association, which organizes periodic air traffic conferences for the purpose of coordinating international airfare. Discount is permitted on Hong Kong and international routes. For the airline industry in China as a whole, airfare per kilometer is substantially higher for Hong Kong and international routes than for domestic routes.

*Acquisition of Aircraft and Spare Parts.* Most Chinese airlines are required to purchase their aircraft, aircraft spare parts and other aviation equipment through the China Aviation Supplies Corporation, or the CASC, an entity controlled by the CAAC. However, our company is permitted to import aircraft, aircraft spare parts and other equipment for our own use from manufacturers through EAIEC, which is 55% owned by CEA Holding and 45% owned by our company. This gives us freedom in rationalizing our maintenance practices by allowing us to maintain a relatively lower overall inventory level of aircraft parts and equipment. We are still required to obtain an approval from the State Development and Reform Commission for any import of aircraft. We generally pay a commission to China Eastern Aviation Import and Export Company in connection with these imports.

*Domestic Fuel Supply and Pricing.* The Civil Aviation Oil Supply Company, or CAOSC, which is controlled by the CAAC, is currently the dominant civil aviation fuel supply company in China. We currently purchase a significant portion of our domestic fuel supply from CAOSC. The Chinese government determines the fuel price at which the CAOSC acquires fuel from domestic suppliers and the CAAC determines the retail price at which the CAOSC resells fuel to airline customers.

*Safety.* The CAAC has made the improvement of air traffic safety in China a high priority. The CAAC is responsible for the establishment of operational safety, maintenance and training standards for all Chinese airlines, which have been formulated based on international standards. Each Chinese airline is required to provide flight safety reports to the CAAC, including reports of flight incidents or accidents involving its aircraft occurred during the relevant reporting period and other safety related problems. The CAAC conducts safety inspections on each airline periodically.

The CAAC oversees the training of most Chinese airline pilots through its operation of the pilot training college. The CAAC implements a unified pilot certification process applicable to all Chinese airline pilots and is responsible for the issuance, renewal, suspension and cancellation of pilot licenses. Each pilot is required to pass the CAAC-administered examinations before obtaining a pilot license and is subject to an annual examination in order to have such certification renewed.

All aircraft operated by Chinese airlines, other than a limited number of leased aircraft registered in foreign countries, are required to be registered with the CAAC. All of our aircraft are registered with the CAAC. All aircraft operated by Chinese airlines must have a valid certificate of airworthiness issued and



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annually renewed by the CAAC. In addition, maintenance permits are issued to a Chinese airline only after the maintenance capabilities of that Chinese airline have been examined and assessed by the CAAC. These maintenance permits are renewed annually. All aircraft operated by Chinese airlines may be maintained and repaired only by the CAAC certified maintenance facilities, whether located within or outside China. Aircraft maintenance personnel must be certified by the CAAC before assuming aircraft maintenance posts.

*Security.* The CAAC establishes and oversees the implementation of security standards and regulations based on the PRC laws and standards established by international civil aviation organizations. Each airline is required to submit to the CAAC an aviation security handbook describing specific security procedures established by the airline for the day-to-day operations of the civil aviation and security training for staff of such airline. Such security procedures must be formulated based on the relevant CAAC regulations. Chinese airlines that operate international routes must also adopt security measures in accordance with the requirements of the relevant international agreements. We believe that our company is in compliance with all applicable security regulations.



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*Noise and Environmental Regulation.* All airlines and airports in China are required to comply with noise and environmental regulations of the State Environmental Protection Agency that are modeled after international standards. The CAAC regulations allow Chinese airports to refuse take-off and landing rights to any aircraft that does not comply with state noise regulations. We believe that our company is in compliance with all applicable noise and environmental regulations.

*Chinese Airport Policy.* Prior to September 2003, all civilian airports in China were operated directly by the CAAC or by provincial or municipal governments. In September 2003, as part of the restructuring of the aviation industry in China, the CAAC handed over 93 civilian airports to local provincial or municipal governments. The CAAC retained the authority to determine the take-off and landing charges, as well as charges on airlines for the use of airports and airport services. Prior to 2004, Chinese airlines were generally required to collect from their passengers on behalf of the CAAC a levy for contribution to the civil aviation infrastructure fund, which was used for improving China's civilian airport facilities. Our revenue for the previous years is shown net of this levy. In 2003, the levy was 5% of domestic airfare for domestic routes and 2% of international airfare for international routes. The levy was waived by the CAAC from May 1, 2003 to December 31, 2003. We were officially notified by the CAAC that effective from January 1, 2004, the CAAC no longer charges such levy. However, we cannot assure that the CAAC will not charge other similar levies in the future.

*Limitation on Foreign Ownership.* The CAAC's present policies limit foreign ownership in Chinese airlines. Under these limits, non-Chinese residents and Hong Kong, Macau or Taiwan residents cannot hold a majority of our total outstanding shares. Currently, approximately 32.2% of our total outstanding shares are held by non-Chinese residents and Hong Kong, Macau or Taiwan residents.

## **Competition**

*Domestic.* Domestic competition from other Chinese airlines has been increasing recently as our competitors have increased capacity and expanded operations by adding new routes or additional flights to existing routes and acquiring other airlines. We expect that competition in the future from other Chinese airlines on our routes will further increase as the CAAC promotes controlled competition in order to advance the growth of the domestic airline industry as a whole. Our company competes against our domestic competitors primarily on the basis of safety, quality of service and frequency of scheduled flights. With the combination of our dominant position in Shanghai, our route network and our continued commitment to safety and service quality, we believe that our company is well-positioned to compete against our domestic competitors in the growing airline industry in China.

There are currently approximately 20 Chinese passenger airlines operating in China, and our company competes with many of them on various domestic routes. All of these airlines operate under the regulatory supervision of the CAAC. Our company, Air China, which is based in Beijing, and China Southern Airlines, which is based in Guangzhou, are the three leading air carriers in China, both in terms of revenue tonne-kilometers and size of operations. Each of these three airlines operates at least 100 routes and has a fleet of at least 60 jet aircraft. As of December 31, 2003, our company, Air China and China Southern Airlines accounted for approximately 69.4% of the total commercial air traffic (as measured in tonne-kilometers) handled by Chinese airlines.

Each of the domestic airlines competes against other airlines operating the same routes or flying indirect routes to the same destinations. Our principal competitors in the domestic market are China Southern Airlines and Air China, which provide transportation services on some of our routes as well, principally routes originating from the major air transportation hubs in China, such as Shanghai, Guangzhou and Beijing. Some of these routes are among our most heavily traveled routes. Since most of the major domestic airlines operate routes from their respective hubs to Shanghai, our company also



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competes against virtually all of the major domestic airlines on these routes. The number of airlines operating flights to and from Shanghai has increased significantly in recent years. We also face domestic competition from Shanghai Airlines, an airline based in Shanghai which is smaller than our company. Competition between Shanghai Airlines and us has increased as Shanghai Airlines expands its long-haul capacity and operates routes to more cities served by our company.

*Hong Kong.* Our high yielding Hong Kong routes are highly competitive. The primary competitor on our Hong Kong routes is Dragon Air, which is controlled by China National Aviation Corporation, or CNAC, CITIC Pacific Limited and Cathay Pacific Airways Limited. We currently operate approximately 400 flights per week on routes between 14 Chinese cities and Hong Kong. Dragon Air competes with us on several of these routes. Moreover, in April 2003, Cathay Pacific Airways obtained the licenses to fly to Beijing, Shanghai and Xiamen in China. Cathay Pacific Airways commenced its services between Hong Kong and Beijing on December 2, 2003. Cathay Pacific Airways has not announced when it will commence operations on the Hong Kong-Shanghai route and the Hong Kong-Xiamen route. After Cathay Pacific Airways commences its operations on the Hong Kong-Shanghai route, we will face more intensified competition on our Hong Kong-Shanghai route. In addition to the frequency and convenience of our flights and the number of routes offered, our company's competitive strategy for the Hong Kong routes also stresses safety and service quality. The new Air Transportation Arrangement signed between the Chinese central government and the administrative government of Hong Kong in February 2000 provides for equal opportunity for airlines based in Hong Kong and mainland China. As a result, Dragon Air has increased the frequency of its flights on several of our Hong Kong routes and intensified the competition. At present, our Hong Kong routes benefit from traffic between Hong Kong and mainland China ultimately originating in Taiwan. During the Lunar Chinese New Year peak travel season in 2003, from late-January to mid-February, the Chinese government allowed special chartered flights between Shanghai and Taiwan for the first time. There was no such direct chartered flights in 2004 so far. Although regular direct flights between Taiwan and mainland China are still not permitted, our results of operation on Hong Kong routes could be adversely affected if direct flights between Taiwan and mainland China are permitted in the future. We cannot assure you that our company can obtain sufficient Taiwan-mainland China routes or that the yields on these routes would be adequate to offset any adverse effect on our revenues derived from operation on our Hong Kong routes. Our company also faces competition from Dragon Air in our Hong Kong cargo operations.

In 1995, CNAC acquired an interest in Air Macau. Air Macau started to operate routes in 1996 between Macau and mainland China, including routes to cities in mainland China such as Beijing, Shanghai, Xiamen and Wuhan. Air Macau also operates routes between Macau and Taiwan, including flights which allow passengers to travel between mainland China and Taiwan through Macau without changing planes in Macau. Air Macau's routes provide an alternative to our Hong Kong routes for passengers traveling between Taiwan and mainland China. The airfare on some of Air Macau's routes is significantly lower than airfare on our company's comparable routes.

*International.* We compete with Air China, China Southern Airlines, United Airlines and many other well-established foreign carriers on our international routes. Most of our international competitors are very well known international carriers and are substantially larger and have substantially greater financial resources than us. Many of our international competitors also have significantly longer operating history and greater name recognition than our company. Some international passengers, who may perceive these airlines to be safer than Chinese airlines in general, may prefer to travel on these airlines. In addition, many of our international competitors have more extensive sales networks and participate in reservation systems that are more convenient than those of ours, or engage in promotional activities, such as frequent flyer programs, that may be more popular than those of ours and effectively enhance their ability to attract international passengers. We also face significant competition in our international cargo operations. For



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instance, we compete with All Nippon Airways and Japan Airlines System in cargo operations on our Japan routes.

Air China operates the largest number of international routes among all Chinese airlines. Beijing, the hub of Air China's operations, is the destination for most international flights to China. We compete with Air China, All Nippon Airways, Japan Airlines System and Northwest Airlines, Inc. on our passenger routes to Japan. Our primary competition on our flights to southeast Asia comes from Thai Airways International, Singapore Airlines and China Southern Airlines. On our passenger flights to the United States, our principal competitors include Northwest Airlines, Inc., United Airlines, Air China and China Southern Airlines. On our European routes, our competitors include Air China, KLM-Royal Dutch Airlines, Air France and Lufthansa German Airlines. We compete with Air China and Qantas Airways Ltd. on our Australian routes. In September 1997, Shanghai Airlines was awarded limited international route rights by the CAAC. Our company competes in the international market on the basis of price, service quality, frequency of scheduled flights and convenient sales arrangements. To improve our competitive position in international markets, we have established additional overseas dedicated sales offices, launched our own frequent flyer program, participated the Asia Miles frequent flyer program which is popular in Asia, and entered into code-sharing arrangements with a number of foreign airlines. We have also improved our online reservation and payment system.

## **Maintenance and Safety**

The rapid increase in air traffic volume in China in recent years has put pressure on many components of the Chinese airline industry, including air traffic control systems, the availability of qualified flight personnel and airport facilities. In recent years, the CAAC has placed increasing emphasis on the safety of Chinese airline operations and has implemented a number of measures aimed at improving the safety record of the airlines. Our company's ability to provide safe air transportation in the future depends on the availability of qualified and experienced pilots in China and the improvement of maintenance services, national air traffic control and navigational systems and ground control operations at Chinese airports. Our company has a good safety record and regards the safety of our flights as the most important component of our operations. Our company's aircraft have not been involved in any accidents involving fatalities since 1995.

*Maintenance Capability.* We currently perform regular repair and maintenance checks for all of our aircraft. We are able to perform 2D checks on our MD-82 aircraft, 4C checks on our Airbus A320 and Airbus A340-300 aircraft, and 12C checks on our A300-600 aircraft. We also perform certain maintenance services for other Chinese airlines. Our primary aircraft maintenance base is at Hong Qiao International Airport. We have additional maintenance bases at Pudong International Airport and each of our provincial hubs. Our maintenance staff in Shanghai supervises the operation of our regional maintenance facilities. Our company currently employs approximately 2,696 workers as maintenance and engineering personnel. Some of our aircraft maintenance personnel participated in the manufacturer training and support programs sponsored by Airbus Industrie G.I.E., or Airbus, and Boeing Corporation, or Boeing. In order to enhance our maintenance capabilities and to reduce our maintenance costs, we have, over the past few years, acquired additional maintenance equipment, tools and fixtures and other assets, such as airborne testing and aircraft data recovery and analysis equipment. Our company's avionics electronic equipment is primarily maintained and repaired at our electronic maintenance equipment center located in Shanghai, which was set up in cooperation with Honeywell, Inc. and is one of the largest and most advanced avionic electronic facilities in China. In September 2002, our company and Rockwell Collins International Inc. of the United States entered into a joint venture agreement to establish Collins Aviation Maintenance Service Shanghai Limited, a joint venture that is primarily engaged in the provision of repair and maintenance services for avionics and aircraft entertaining facilities in China. Our company and Rockwell Collins International Inc. hold 35% and 65% equity interest in the joint venture, respectively. Moreover, in November 2002, our



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company, jointly with China Aircraft Services Limited, established Shanghai Eastern Aircraft Maintenance Limited, in which our company holds a 60% equity interest. We expect the joint venture company to provide supplemental avionics and other maintenance services to our company.

In July 1996, we established a joint venture with Allied Signal Inc. in Shanghai for the purpose of performing maintenance and repairs on aircraft wheel assemblies and brakes. In 1997, our company entered into an agreement with Singapore Aviation Services Company, or SASCO, for the provision of additional maintenance services by SASCO to our company. In October 1997, we completed the construction of a maintenance hangar at Hong Qiao International Airport which has the capacity to house two widebody aircraft.

The enhancement of our maintenance capabilities allows our company to perform various maintenance operations in-house and continue to maintain lower spare parts inventory levels.

*Safety.* The provision of safe and reliable air services for all of our customers is one of our primary operational objectives. Our company implements uniform safety standards and safety-related training programs in all operations. Our flight safety management division monitors and supervises our company's flight safety. We have had a flight safety committee since the commencement of our business, comprised of members of our senior management, to formulate policies and implement routine safety checks at our Shanghai headquarters and all provincial hubs. The flight safety committee meets monthly to review our overall operation safety record during the most recent quarter and to adopt measures to improve flight safety based upon these reviews. We have also implemented an employee incentive program, using a system of monetary rewards and discipline, to encourage compliance with the CAAC safety standards and our safety procedures. We periodically evaluate the skills, experience and safety records of our pilots in order to maintain strict control over the quality of our pilot crews.

The management of each of our provincial hub operations is responsible for the flight safety operations at that hub under the supervision of our flight safety management division. We prepare monthly safety bulletins detailing recent developments in safety practices and procedures and distribute them to each of our flight crew, the maintenance department and the flight safety management department. The CAAC also requires our company to prepare and submit semi-annual and annual flight safety reports.

All of our jet passenger aircraft pilots participated in the manufacturer training and support programs sponsored by Airbus and Boeing and are required to undergo recurrent flight simulator training and to participate in a flight theory course periodically. Our company maintains an MD-82 flight simulator at our training facility located at the Pudong district in Shanghai, which is used for both initial and recurrent training of all of our MD-82 aircraft pilots. We also use an A300-600R flight simulator and an A320 flight simulator located at the Pudong district for training of our A300-600R pilots and A320 pilots, respectively. At present, we send all other jet passenger aircraft pilots to the training center of the CAAC or abroad for flight simulator training.

## **Fuel Supplies**

Fuel costs represented approximately 21.7% of our operating expenses in 2003. We currently purchase a significant portion of the aviation fuel for our domestic routes from regional branches of the CAOSC. Fuel costs in China are affected by costs at domestic refineries and limitations in the transportation infrastructure, as well as by insufficient storage facilities for aviation fuel in certain regions of China. We purchase a portion of the aviation fuel for our international routes from foreign fuel suppliers located at the destinations of these routes, generally at international market prices.

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In 2003, our fuel expenses increased 18.8% as a result of increased weighted average domestic and international fuel prices and the expansion of our fleet. In particular, in 2003, the weighted average domestic and international fuel prices paid by our company increased by approximately 10.6% and 3.6%, respectively.

### **Ground Facilities and Services**

The center of our operations is Shanghai, one of China's principal air transportation hubs. Our Shanghai operations are based at Hong Qiao International Airport and Pudong International Airport. We currently also operate from various other airports in China, including Yaoqiang Airport in Jinan, Lukou Airport in Nanjing, Liuting Airport in Qingdao, Luogang Airport in Hefei, Xiangtang Airport in Nanchang, Wushu Airport in Taiyuan, Zhengding Airport in Shijiazhuang, Lishe Airport in Ningbo and Tianhe Airport in Wuhan. We own hangars, aircraft parking and other airport service facilities at Hong Qiao International Airport and Pudong International Airport and lease from CEA Holding certain buildings at Hong Qiao International Airport where our principal executive offices are located.

We have our own ground services and other operational services, such as aircraft cleaning and refueling and the handling of passengers and cargo for our operations at Hong Qiao International Airport and Pudong International Airport. We also provide ground services for many other airlines that operate to and from Hong Qiao International Airport and Pudong International Airport. At other airports served by our company, we generally contract for ground services with these airports or the principal airlines based at these airports for fees and other charges which are typically based on passenger or cargo volume or aircraft tonnage.

In-flight meals and other catering services for our Shanghai-originated flights are provided primarily by Shanghai Eastern Air Catering Limited Liability Company, a joint venture company affiliated with CEA Holding. We generally contract with local catering companies for flights originating from other airports. We have improved the quality of our in-flight meal service in recent years.

We incur certain airport usage fees and other charges for services performed by the airports where our company operates, such as air traffic control charges, take-off and landing fees, aircraft parking fees and fees payable in connection with the use of passenger waiting rooms and check-in counter space. At domestic airports, such fees are generally charged at rates prescribed by the CAAC, which are lower than rates generally in effect at airports outside China.

### **Marketing and Sales**

*Passenger Operations.* Our marketing strategy with respect to passenger operations is primarily aimed at increasing our market share for all categories of air travelers. With respect to our Hong Kong and international routes, we are permitted to market our services on the basis of price. We also have limited flexibility in setting our airfare for domestic routes after the implementation of the Pricing Reform Plan in April 2004, and therefore are able to adjust our airfare in response to the market demand on our domestic routes. As part of our overall marketing strategy, we emphasize our commitment to safety and service quality. We believe that emphasis on safety is a critical component of our ability to compete successfully. In order to improve our customer services, we participated in joint cabin crew training and exchange programs with foreign airlines, including Asiana Airlines and Japan Airlines System.

We have also adopted customized strategies to market our services to particular travelers. We seek to establish long-term customer relationships with business entities that have significant air travel requirements. In order to attract and retain business travelers, we focus on frequency of flights between major business centers, convenient transit services and extensive sales network. We launched our Golden





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Swallow frequent flyer program in 1998 and joined the Asia Miles frequent flyer program in April 2001 to attract and retain travelers. In August 2003, we changed the name of our frequent flyer program to Eastern Miles and introduced a series of new services, including, among others, instant registration of membership and mileage, online registration of mileage, and accumulation of mileage on expenses at certain hotels and restaurants that are our strategic partners. We achieved our goal of one million members for our frequent flyer program before the end of 2003. In 2000, we launched the China Eastern Airlines-Great Wall co-branded credit card jointly with the Bank of China, which provides to our customers benefits such as airfare discounts, hotel room reservation packages and increased baggage allowances. In addition, we continued to promote our China Eastern Express services on our Shanghai-Hong Kong and Shanghai-Beijing routes and our China Shuttle transit services. Our China Eastern Express services provide more scheduled flights on the heavily traveled routes of Shanghai-Beijing and Shanghai-Hong Kong, compared with our other routes. Our China Shuttle services provide expedite transit services at Hong Qiao International Airport and Pudong International Airport for transit travelers on domestic routes and certain international routes, which significantly enhanced our customer service. We also maintain an extensive domestic network of sales agents and representatives in order to promote ticket sales and assist customers. In 2002, we upgraded our online ticket booking and payment system to facilitate customer purchases of tickets via the Internet.

We have entered into code-sharing arrangements with American Airlines, Japan Airlines System, Korean Airlines, Asiana Airlines, Qantas Airways and Air France. We are also contemplating more code-sharing arrangements with other airlines and plan to continue to strengthen our existing cooperation with other international airlines.

Our advertising, marketing and other promotional activities include the use of radio, television and print advertisements. We plan to continue to use advertising and promotional campaigns to increase sales on new routes and competitive routes.

The majority of our airline tickets are sold by domestic and international sales agents. Our tickets are sold throughout China through approximately 200 sales agents and travel agents who have contractual relationships with us. Currently, our direct domestic ticket sales are handled primarily through employees based at our ticket counters located at Hong Qiao International Airport, Pudong International Airport, in downtown Shanghai and at our provincial hubs in Anhui, Jiangsu, Zhejiang, Jiangxi, Shandong, Shanxi, Hebei and Hubei provinces, as well as at the airports in Beijing, Chengdu, Fuzhou, Guangzhou, Hangzhou, Kunming, Ningbo, Shenzhen, Xiamen and Yantai. Direct sales are also promoted by the availability of telephone reservation and confirmation services. In addition to our domestic sales agents, we maintain overseas representative offices in Brussels, Chicago, Los Angeles, Seattle, Madrid, Munich, Paris, Sydney, Tokyo, Osaka, Nagasaki, Fukuoka, Nagoya, Okayama, Singapore, Bangkok, Seoul, Dehli and Hong Kong, which facilitate the sale of international and Hong Kong air tickets and provide reservation confirmation and other services. In order to promote international ticket sales, we intend to increase our international sales force by expanding our overseas network of commissioned independent sales agents.

We computerize in all of our direct passenger ticket sales. All Chinese airlines, including us, are required to use the passenger reservation service system provided by the CAAC's computer information management center, which is linked with the computer systems of approximately 20 domestic airlines. We have entered into membership agreements with several international reservation systems, including ABACUS, the largest computer reservation system in southeast Asia, TOPAS of Korea, SABRE, GALILEO and WORLDSPAN of the United States, AMADEUS of Europe, and INFINI and AXESS of Japan, which have made it easier for customers and sales agents to make reservations and purchase tickets for our international flights.

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*Cargo Operations.* We maintain a network of cargo sales agents domestically and internationally. We established domestic cargo sales offices in Dalian, Beijing, Shanghai, Xiamen and other major transportation hubs in China, and international cargo sales offices in Hong Kong, Los Angeles, Paris and our other overseas flight destinations. We are also improving our cargo sales on passenger flights through full utilization of our existing passenger sales network.

### **Ancillary Airline Activities**

In addition to our airline operations, we also generate commission revenues from tickets sold on behalf of other airlines. Commission rates for these sales are determined by the CAAC and are based on the price of the tickets sold.

Moreover, we derive revenues from the provision of airport ground services for airlines operating to or from Hong Qiao International Airport and Pudong International Airport, including aircraft cleaning, refueling, loading, unloading, storage and ground transportation of cargo and passenger luggage. At present we are the principal provider of these services at Hong Qiao International Airport and Pudong International Airport. We provide these services to foreign carriers generally pursuant to one-year renewable contracts. In 2003, we generated revenues of approximately RMB671.4 million (approximately US\$81.1 million) from our airport ground services and ticket handling services.

### **Patents and Trademarks**

We own or have obtained licenses to use various domestic and foreign patents, patent applications and trademarks related to our business. While patents, patent applications and trademarks are important to our competitive position, no single one is material to us as a whole.

We own various trademarks related to our business. The most important trademark is the service trademark of China Eastern Airlines Corporation Limited. All of our trademarks are registered in China.

### **Insurance**

The CAAC purchases fleet insurance from PICC Property and Casualty Company Limited, or PICC, on behalf of all Chinese airlines. PICC reinsures a substantial portion of its aircraft insurance business through Lloyd's of London. The fleet insurance is subject to certain amount of deductibles. The premium payable in connection with these insurance is allocated among all Chinese airlines based on the aircraft owned by these airlines. Under the relevant PRC laws, the maximum civil liability of Chinese airlines for injuries to passengers traveling on domestic flights is RMB70,000 (approximately US\$8,457) per passenger, for which our company also purchases insurance. Unless there is a separate agreement applicable for flights to or from a specific country, the Convention for the Unification of Certain Rules Relating to International Transportation by Air of 1929, or the Warsaw Convention, as amended by the protocol of 1955, provides that the maximum civil liability of airlines for international flights is US\$20,000 per passenger. Our company is insured for the maximum international civil liability under any agreement applicable to us and under the Warsaw Convention. We also maintain hull all risk, hull war risk and aircraft legal liability insurance, including third party liability insurance, of the types and in amounts customary for Chinese airlines. See also Item 3. Key Information Risk Factors Insurance coverage and cost for more information on our company's insurance coverage.

**Table of Contents****Description of Property****Fleet**

We are required to obtain approvals from the State Development and Reform Commission for importing aircraft. In 2003, we purchased three Airbus A340-600 aircraft and ten Airbus A320 aircraft and acquired five Boeing B737-700 aircraft under operating leases. In addition, we wet-leased two Airbus A300-600 aircraft and two CRJ-200 aircraft from China Eastern Air Northwest Company and China Eastern Air Yunnan Company, respectively, for the period from October 1, 2003 to March 31, 2004. Also in 2003, we terminated the service of three aged Boeing B737-200 aircraft. As of May 31, 2004, we had a fleet of 102 aircraft, including 89 jet passenger aircraft that have more than 100 seats, two passenger aircraft for feeder routers and six jet freighters. The remainder of our fleet consists of smaller aircraft with limited range, used primarily for aerial photography, pesticide spraying, afforestation and other general aviation services. The following table sets forth the details of our fleet as of May 31, 2004:

|                                     | <b>Total<br/>Number<br/>of Aircraft</b> | <b>Number<br/>of<br/>Aircraft<br/>Owned</b> | <b>Number of<br/>Aircraft<br/>under<br/>Operating<br/>Lease</b> | <b>Number of<br/>Aircraft<br/>under<br/>Capital<br/>Lease</b> | <b>Average<br/>Number<br/>of<br/>Seats</b> | <b>Average<br/>age<br/>(in<br/>years)<sup>(1)</sup></b> |
|-------------------------------------|---|---|---|---|--|---|
| Jet Passenger Aircraft:             |   |   |   |   |  |   |
| Wide-body:                          |   |   |   |   |  |   |
| A340-600                            | 3                                       | 3   |   |   | 322  | 0.7   |
| A340-300                            | 5                                       |   |   | 5   | 289  | 7.6   |
| A300-600R                           | 12                                      | 3   | 5   | 4   | 274  | 10.7  |
| Boeing 737-700                      | 11                                      | 4   | 7   |   | 142  | 1.5   |
| Narrow-body:                        |   |   |   |   |  |   |
| MD-90                               | 9                                       | 2   |   | 7   | 157  | 5.9   |
| MD-82                               | 3                                       |   | 3   |   | 147  | 13.1  |
| A320                                | 30                                      | 13  | 10  | 7   | 158  | 2.5   |
| A319                                | 10                                      |   | 10  |   | 122  | 2.9   |
| Boeing 737-300                      | 6                                       |   | 3   | 3   | 138  | 6.6   |
| <b>Total Jet Passenger Aircraft</b> | <b>89</b>                               | <b>25</b>                                   | <b>38</b>   | <b>26</b>   | <b>179</b>                                 | <b>4.7</b>  |
| Turbo prop:                         |   |   |   |   |  |   |
| Y5B                                 | 3                                       | 3   |   |   |  | 8.1   |
| YN7                                 | 2                                       | 2   |   |   | 48   | 13.8  |
| CRJ-200                             | 2                                       |   | 2   |   | 50   | 1.8   |
| <b>Total Passenger Aircraft</b>     | <b>96</b>                               | <b>30</b>                                   | <b>40</b>   | <b>26</b>   | <b>173</b>                                 | <b>4.7</b>  |
| Cargo Aircraft:                     |   |   |   |   |  |   |

|                            |     |    |    |    |      |
|----------------------------|-----|----|----|----|------|
| MD-11F                     | 6   | 6  | —  | —  | 10.5 |
|                            | —   | —  | —  | —  |      |
| Total Fleet <sup>(2)</sup> | 102 | 36 | 40 | 26 | 5.0  |
|                            | —   | —  | —  | —  |      |

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(1) The average aircraft age is weighted by the number of available seats.

(2) Excludes fleet of China Eastern Airlines Wuhan Limited and two Boeing 737-300 aircraft leased to China Eastern Airlines Wuhan Limited in early 2003.

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In 2003, our average daily aircraft utilization rate decreased by 0.6 hours to 8.0 hours per day, primarily due to the expansion of our fleet and the adoption of stricter safety standards. The table below sets forth the daily average utilization rates of our jet passenger aircraft for each of the three years ended December 31, 2003:

|                | <u>2001</u> | <u>2002</u> | <u>2003</u> |
|----------------|-------------|-------------|-------------|
|                | (in hours)  |             |             |
| Wide-body:     |             |             |             |
| MD-11          | 10.2        | 10.9        | 9.8         |
| A340-600       |             |             | 9.9         |
| A340-300       | 10.7        | 11.2        | 11.9        |
| A300-600R      | 7.7         | 7.4         | 6.3         |
| Boeing 737-700 |             | 10.0        | 9.0         |
| Narrow-body:   |             |             |             |
| MD-90          | 8.1         | 7.7         | 6.9         |
| MD-82          | 7.9         | 6.6         | 5.4         |
| A320           | 9.3         | 8.8         | 7.8         |
| A319           |             | 9.1         | 8.4         |
| Boeing 737-300 | 10.1        | 10.0        | 8.6         |

Most of our jet passenger aircraft were manufactured by either Airbus or Boeing. Our Airbus A340-300 and Airbus A340-600 aircraft are primarily used for our routes to the United States, Europe, Hong Kong, Japan and other international destinations, including Bangkok, Seoul and Singapore, and on major domestic routes to cities such as Beijing and Guangzhou. Our Airbus A320, MD-90 and Boeing B737 aircraft are suitable for middle and short distance flights and are primarily used for our domestic routes. MD-82 aircraft are primarily used for shorter distance domestic routes on which it is not possible to achieve high load factors with wide-body aircraft and on routes connecting to certain domestic airports which cannot accommodate the landing of wide-body aircraft. Revenues from commuter and general aviation services are immaterial to our results of operations.

Our MD-11F aircraft are used for our cargo operations and carry cargo to Japan, Europe and the United States. Our general aviation services customers include provincial authorities in charge of agriculture, forestry and geology.

*Future Fleet Development.* Our aircraft acquisition program focuses on aircraft that will modernize and rationalize our fleet to better meet the anticipated requirements of our route structure, taking into account aircraft size and fuel efficiency. Our aircraft acquisition program, however, is subject to the approval of the CAAC and the State Development and Reform Commission. The following table summarizes our currently anticipated jet aircraft deliveries from 2004 to 2005:

|          | <u>2004</u> | <u>2005</u> | <u>Total</u> |
|----------|-------------|-------------|--------------|
| Aircraft |             |             |              |
| A320     | 5           | 5           | 10           |
| A321     | 2           | 2           | 4            |
| A340-600 | 2           | 0           | 2            |
| B737-800 | 0           | 3           | 3            |
|          | <hr/>       | <hr/>       | <hr/>        |
| Total    | 9           | 10          | 19           |



The actual acquisition of any of these aircraft or any additional aircraft may depend on such factors as the general economic conditions, our operating results and other capital requirements. We believe that our aircraft acquisition plan will help us accomplish our expansion plans while maintaining an efficient fleet and ensuring alternative sources of supply.

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On June 11, 2004, our company signed a legally non-binding memorandum of understanding with Airbus Company in Paris, France. This memorandum of understanding sets forth our company's intention to purchase 20 Airbus A330-300 aircraft from Airbus Company. We are still discussing with Airbus Company on detailed terms and conditions of the definitive purchase agreement, including the consideration for the proposed purchase. We are also in the process of applying for approvals from the relevant Chinese approving authorities in connection with the purchase. We plan to gradually replace our Airbus A300 aircraft with the new aircraft if we proceed with the proposed purchase in order to enhance our operating capabilities and respond to the increased market demand.

*Fleet Financing Arrangements.* We generally acquire aircraft through either long-term capital leases or operating leases. To take advantage of the low interest rate for long-term loans in 2002, we also purchased certain number of aircraft and finance it by borrowing long-term loans from banks in China. Under the terms of most capital leases, we generally are obligated to make lease payments that finance most of the purchase price of the aircraft over the lease term. Upon the expiration of the lease term, we must either purchase the aircraft at a specified price or pay any amount by which such price exceeds the proceeds from the disposition of the aircraft to third parties. Alternatively, some capital leases provide for ownership of the aircraft to pass to us upon satisfaction of the final lease payment. Under capital leases, aircraft are generally leased for approximately the whole of their estimated working life, and the leases are either non-cancelable or cancelable only on a payment of a major penalty by the lessee. As a result, we bear substantially all of the economic risks and rewards of ownership of the aircraft held under capital leases. Operating leases, however, are customarily cancelable by the lessee on short notice and without major penalty. Under operating leases, substantially all the risks and rewards of ownership of the aircraft remain with the lessor.

We intend to increase the use of operating leases to improve the flexibility of our operations. However, each decision on our financing alternatives will depend on an evaluation of the following factors:

our aircraft requirements and anticipated future deliveries;

capital structure and cash flow situation;

prevailing interest rates; and

other market conditions in effect at the time of any such acquisition or financing.

All of our payment obligations under current aircraft leases have been guaranteed by banks in China.

## **Operating Facilities**

Our corporate headquarters, base maintenance center and other primary airport facilities in Shanghai, occupying an area of approximately 412,422 square meters of land, are located at Hong Qiao International Airport. We also own office buildings, cargo operating buildings and a maintenance center at Pudong International Airport. The total gross floor area of all of our buildings and facilities is approximately 341,000 square meters.

We own all of the buildings and facilities located at Hong Qiao International Airport, with the exception of the office buildings where our corporate headquarters are located. We lease from the CEA Holding our corporate headquarter office buildings and the land on which our corporate headquarters are located. We have acquired buildings and ancillary facilities at Pudong International Airport with a total gross floor area of approximately 147,000 square meters.

Our company also owns additional land of approximately 205,706 square meters at Luogang Airport where we maintain the base for our Anhui provincial hub operations.





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Our operations in the nine provincial hubs of Jiangsu, Shandong, Shanxi, Hebei, Anhui, Jiangxi, Zhejiang and Hubei are located in the airports in Nanjing, Qingdao, Jinan, Taiyuan, Shijiazhuang, Hefei, Nanchang, Ningbo and Wuhan, respectively. In Nanjing, we lease all the buildings and facilities our company occupies from the airport authority. In Qingdao, Hefei and Nanchang, we have the right to use such buildings and facilities constructed and maintained by our company. However, the right to use such buildings and facilities cannot be transferred or leased to third parties. In Taiyuan and Shijiazhuang, we own our maintenance facilities and lease office building from CEA Holding and other facilities from the local airport authorities.

### **Item 5. Operating and Financial Review and Prospects.**

You should read the following discussion in conjunction with our audited consolidated financial statements, together with the related notes, included elsewhere in this annual report. Our consolidated financial statements have been prepared in accordance with IFRS. For a discussion of certain differences between IFRS and U.S. GAAP, see Note 40 to our consolidated financial statements.

#### **Overview**

Our primary business is the provision of domestic, Hong Kong regional and international passenger and cargo airline services. Our overall capacity on an available tonne kilometer, or ATK, basis increased by 9.3%, from 4,366.6 million ATKs in 2002 to 4,774.5 million ATKs in 2003, and our passenger capacity on an available seat kilometer, or ASK, basis increased by 6.5%, from 27,962.5 million ASKs in 2002 to 29,780.0 million ASKs in 2003. Total traffic on a revenue tonne kilometer, or RTK, basis increased by 9.6%, from 2,652.2 million RTKs in 2002 to 2,907.7 million RTKs in 2003.

The historical results of operations discussed in this annual report may not be indicative of our future operating performance. Like those of other airlines, our operations substantially depend on overall passenger and cargo traffic volume and are subject to seasonal and other variations that may influence passenger travel demand and cargo volume and may not be under our control, including unusual political events and other unforeseen events. Our operations will be affected by, among other things, fluctuation of the aviation fuel price, aircraft acquisition and leasing costs, maintenance expenses, take-off and landing charges, wages, salaries and benefits, other operating expenses and the rates of income taxes paid. We expect depreciation expenses and operating lease expenses to increase as new aircraft and related flight equipment are acquired. Maintenance expenses may also increase as a result of acquisitions of new aircraft, although we expect to benefit from certain maintenance and fuel cost savings as older aircraft are retired and replaced.

From November 2002 to June 2003, China and certain other countries and regions experienced the outbreak of SARS, which materially adversely affected our operations in 2003. On July 5, 2003, the World Health Organization declared that the SARS outbreak had been contained. However, new cases of SARS were reported in China since April 22, 2004. Any future outbreak of SARS or similar contagious epidemic will, among other things, significantly reduce demand for our services and will have a material adverse effect on our financial condition and results of operations.

Our financial performance is also significantly affected by factors associated with operating in a highly regulated industry, as well as a number of other external variables, including political and economic conditions in China, competition, foreign exchange fluctuations and public perceptions of the safety of air travel with Chinese airlines. Because nearly every aspect of our airline operations is subject to the regulation of the CAAC, our operating revenues and expenses are directly affected by the CAAC regulations with respect to, among other things, domestic airfare, level of commissions paid to sales agents, aviation fuel price, take-off and landing charges and route allocations. The

nature and extent of airline

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competition and the ability of Chinese airlines to expand are also significantly affected by various CAAC regulations and policies. Changes in the CAAC's regulatory policies, or in the implementation of such policies, are therefore likely to have a significant impact on our future operations.

**Certain Financial Information by Geographic Region**

The following table sets forth passenger revenues, passenger traffic and passenger yield by geographic region for the years ended December 31, 2001, 2002 and 2003.

|  | <b>Year Ended December 31,</b> |             |             |
|--|--------------------------------|-------------|-------------|
|  | <b>2001</b>                    | <b>2002</b> | <b>2003</b> |
| Passenger Revenues (millions of RMB)                 |                                |             |             |
| Domestic   | 4,701                          | 4,670       | 5,592       |
| Hong Kong  | 1,921                          | 1,911       | 1,627       |
| International  |                                |             |             |
| Japan  | 1,145                          | 1,279       | 978         |
| U.S. and Europe                                      | 827                            | 1,250       | 785         |
| Other  | 992                            | 928         | 1,279       |
|  | <hr/>                          | <hr/>       | <hr/>       |
| Total Passenger Revenues                             | 9,586                          | 10,038      | 10,261      |
|  | <hr/>                          | <hr/>       | <hr/>       |
| Passenger Traffic (millions of passenger-kilometers) |                                |             |             |
| Domestic   | 7,512                          | 8,516       | 10,302      |
| Hong Kong  | 2,028                          | 2,234       | 1,934       |
| International  | 6,371                          | 7,457       | 5,767       |
|  | <hr/>                          | <hr/>       | <hr/>       |
| Total Passenger Traffic                              | 15,911                         | 18,207      | 18,003      |
|  | <hr/>                          | <hr/>       | <hr/>       |
| Passenger Yield (RMB per passenger-kilometer)        |                                |             |             |
| Domestic   | 0.63                           | 0.55        | 0.54        |
| Hong Kong  | 0.95                           | 0.86        | 0.84        |
| International  | 0.48                           | 0.46        | 0.53        |
|  | <hr/>                          | <hr/>       | <hr/>       |
| Total Passenger Yield                                | 0.60                           | 0.55        | 0.57        |
|  | <hr/>                          | <hr/>       | <hr/>       |

**Operating Results****2003 Compared to 2002**

**Revenues.** Our total operating revenues increased from RMB13,079 million in 2002 to RMB14,277 million in 2003, or 9.2%, reflecting increase in our domestic passenger and cargo revenues. These revenues were net of the applicable PRC sales tax and civil aviation infrastructure levies.

Revenues from our passenger and cargo and mail transportation business increased from RMB12,482 million in 2002 to RMB13,448 million in 2003, or 7.7%. Compared to 2002, the average aircraft daily utilization decreased by 0.6 hours to 8.0 hours in 2003.

Passenger revenues, which accounted for 76.3% of our total transportation revenues in 2003, increased from RMB10,038 million in 2002 to RMB10,261 million in 2003, or 2.2%, reflecting increase in domestic passenger revenues driven by the recovery of the domestic passenger market during the second half of 2003. Passenger revenues in the second half of 2003 were RMB6,555 million, representing an increase of 21.3% from RMB5,405 million in the second half of 2002.

Our domestic passenger revenues, which accounted for 54.4% of our total passenger revenues, increased from RMB4,670 million in 2002 to RMB5,592 million in 2003, or 19.7%, primarily because we took advantage of the opportunities created by the recovery of the domestic passenger market during the second half of 2003 and attracted more customers. Domestic passenger revenues in the second half of 2003

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were RMB3,651 million, representing an increase of 46.9% from RMB2,485 million in the second half of 2002. Compared to 2002, our domestic passenger traffic increased by 21.0% in 2003, and our domestic passenger load factor increased from 63.1% in 2002 to 64.8% in 2003. In response to the market demand, we increased capacity on our domestic routes by 17.9% in 2003. Our domestic passenger yield decreased slightly from RMB0.55 in 2002 to RMB0.54 in 2003 per passenger-kilometer, primarily due to competition in the domestic market.

Hong Kong passenger revenues, which accounted for 15.9% of our total passenger revenues, decreased from RMB1,911 million in 2002 to RMB1,627 million in 2003, or 14.9%, primarily due to the adverse effect on the traffic volume on our Hong Kong regional routes by the outbreak and spread of a highly contagious form of atypical pneumonia, also known as severe acute respiratory syndrome, or SARS, in Hong Kong and other areas in China. Hong Kong passenger traffic decreased by 13.4% in 2003 over that of 2002. In order to increase our market share and in response to competition on our Hong Kong routes, we increased the passenger capacity on our Hong Kong routes by 1.2% in 2003. Our Hong Kong passenger load factor decreased from 61.2% in 2002 to 52.4% in 2003, and our Hong Kong passenger yield decreased from RMB0.86 in 2002 to RMB0.84 in 2003 per passenger-kilometer. The decrease in passenger load factor and passenger yield on Hong Kong routes was also attributable to competition from other airlines.

International passenger revenues, which accounted for 29.7% of our total passenger revenues, decreased from RMB3,457 million in 2002 to RMB3,042 million in 2003, or 12.0%. The decrease in international passenger revenues mainly reflected decreased international passenger traffic caused by SARS. Starting from the end of 2002 until mid June 2003, most areas of China were affected by SARS. The SARS-related travel advice issued by the World Health Organization as well as governmental agencies and private companies of other countries significantly discouraged business travelers and tourists to travel to China. Other factors such as the Iraq war and the terrorist activities also affected the international traffic. As a result, international passenger traffic decreased by 22.7% in 2003 over that of 2002. Our international passenger capacity decreased by 5.9% in 2003 compared to 2002. Our international passenger load factor decreased from 68.9% in 2002 to 56.7% in 2003. However, our international passenger yield increased from RMB0.46 in 2002 to RMB0.53 in 2003 per passenger-kilometer primarily because the increase in customers who fly business class on our international routes and the appreciation of certain foreign currencies against Renminbi in 2003.

We generate cargo and mail revenues from the transportation of cargo and mail on our designated cargo aircraft as well as from the carriage of cargo and mail on passenger aircraft. Revenues from cargo and mail operations, which accounted for 23.7% of our total transportation revenues in 2003, increased from RMB2,445 million in 2002 to RMB3,187 million in 2003, or 30.4%. The increase in our cargo revenues was primarily the result of our increased freight charges in response to the increased demand. The demand was driven by increased importation and exportation after China's admission to the World Trade Organization, or WTO. Our cargo and mail traffic (as measured in revenue freight tonne-kilometers, or RFTKs) increased from 1,023 million RFTKs in 2002 to 1,297 million RFTKs in 2003, or 26.7%. In response to the rapid growth in our cargo and mail operations, we successively remodeled three MD-11 passenger aircraft into freighters in the second half of 2003. Cargo yield increased from RMB2.39 in 2002 to RMB2.46 in 2003 per cargo tonne-kilometer primarily as a result of increased market demand.

Other operating revenues are primarily generated from airport ground services and ticket handling services. Airport ground services include loading and unloading, aircraft cleaning, fueling and ground transportation of cargo and passenger luggage for airlines operating to or from Hong Qiao International Airport and Pudong International Airport. We are currently the principal provider of airport ground services at both Hong Qiao International Airport and Pudong International Airport. Other operating revenues increased from RMB596 million in 2002 to RMB829 million in 2003, or 39.0%, which is higher than the 25.8% growth rate achieved in 2002. The increase in other operating revenues in 2003 was mainly due to



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increase in our airport ground service revenues as a result of increased volume of imported and exported goods after China's admission to the WTO. It is also attributable to the increase in our commission revenues generated from our ticket handling services provided to other airlines.

**Operating Expenses.** Our total operating expenses increased from RMB12,242 million in 2002 to RMB14,058 million in 2003, or 14.8%, reflecting mainly increase in aviation fuel expenses, wages, salaries and benefits, other depreciation, amortization and operating lease expenses, aircraft maintenance expenses, commissions and take-off and landing charges. Our total operating expenses as a percentage of our total operating revenues increased from 93.6% in 2002 to 98.5% in 2003.

Aviation fuel expenses increased from RMB2,564 million in 2002 to RMB3,045 million in 2003, or 18.8%, primarily as a result of increased fuel prices and the expansion of our fleet. In 2003, we consumed a total of 1,023,700 tonnes of aviation fuel, representing an increase of 8.8% compared to 2002. In 2003, due to the Iraqi war, the weighted average domestic and international fuel prices paid by our company increased by approximately 10.6% and 3.6%, respectively.

Aircraft depreciation and operating lease expenses increased from RMB2,455 million in 2002 to RMB2,851 million in 2003, or 16.1%. Other depreciation, amortization and operating lease expenses increased from RMB400 million in 2002 to RMB495 million in 2003, or 23.7%, primarily due to the expansion of our fleet.

The wages, salaries and benefits increased from RMB1,036 million in 2002 to RMB1,449 million in 2003, or 39.9%, mainly because our work force increased by approximately 5% compared to 2002, and in order to meet the requirements of our fleet expansion, most of our newly hired staff are pilots and cabin crew that are paid relatively high compared to our average salaries. In addition, in accordance with relevant government regulations and with reference to the policies implemented by enterprises in nearby regions, we formulated a staff housing allowance plan in 2003. The housing allowance standards under the new housing plan are higher than the standards to which we made references in 2000 in making provisions. Moreover, the number of employees who are qualified to receive housing allowance also increased in 2003. As a result, we recognized provisions of RMB340 million as of December 31, 2003, which amount is RMB260 million higher than the provisions of RMB80 million that we made in 2000. The increased amount of the provisions was fully charged to our income statement for our fiscal year ended December 31, 2003.

Take-off and landing charges increased from RMB1,988 million in 2002 to RMB2,254 million in 2003, or 13.4%, which accounted for 16.0% of our total operating expenses in 2003, primarily due to the mandatory increase in the take-off and landing charges for domestic flights by the CAAC, effective September 1, 2002, and a 20.1% increase in 2003 in our domestic flight take-offs and landings compared to 2002.

Aircraft maintenance expenses were RMB1,329 million in 2003, compared to RMB1,078 million in 2002, an increase of 23.3%. This increase is mainly due to increased number of aircraft and engines that were subject to overhaul in 2003, and increased maintenance of aircraft that were temporarily out of service during the period of SARS.

Commission expenses increased from RMB380 million in 2002 to RMB465 million in 2003, or 22.5%, primarily due to commission payments to China Eastern Air Northwest Company and China Eastern Air Yunnan Company that began to sell our passenger tickets since March 2003.

Food and beverage expenses decreased from RMB606 million in 2002 to RMB542 million in 2003, or 10.6%, primarily due to decreased provision of food and beverage during the period of SARS, and our





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effective control over purchases and provision of food and beverage, which is partially offset by the increased expenses resulted from the increased traffic volume on domestic routes.

Other operating expenses increased from RMB520 million in 2002 to RMB570 million in 2003, or 9.7%. Other operating expenses included provision for obsolescence of flight equipment spare parts, maintenance expenses of other fixed assets, computer and telecommunications expenses and other expenses. The increase was mainly attributable to increase in provision for obsolescence of flight equipment spare parts and maintenance expenses for our office building in Pudong.

**Fixed assets.** Our company had approximately RMB26.8 billion of fixed assets as of December 31, 2003, including aircraft and flight equipment with a value of approximately RMB23.8 billion. Fixed assets are initially recognized at cost and are subsequently stated at revalued amount, being its fair value at the date of revaluation less any subsequent accumulated depreciation.

Valuation of fixed assets is based on market conditions and global economic factors that we may not control. The determination of fair market value requires significant judgment, including judgment on valuations by our management and/or by independent professional appraisers. Our directors have reviewed the carrying value of our fixed assets as of December 31, 2003 and are of the opinion that the carrying amount is not materially different from the fair value of our fixed assets.

**Net Losses.** The net losses attributable to shareholders was RMB950 million for the fiscal year ended December 31, 2003.

## **2002 Compared to 2001**

**Revenues.** Our total revenues increased from RMB12,153 million in 2001 to RMB13,079 million in 2002, or 7.6%, reflecting increases in international passenger and cargo revenues. These revenues were net of the applicable PRC sales tax and civil aviation infrastructure levies.

Passenger revenues, which accounted for 76.7% of our total revenues in 2002, increased from RMB9,586 million in 2001 to RMB10,038 million in 2002, or 4.7%, reflecting increase in international passenger revenues, including continuous revenue increase on Japanese and Korean routes.

Our domestic passenger revenues, which accounted for 46.5% of our passenger revenues, decreased from RMB4,701 million in 2001 to RMB4,670 million in 2002, or 0.7%, primarily because we significantly lowered our average airfare for our domestic flights due to increased competition. In 2002, we replaced low traffic and low-yielding domestic routes with new routes and increased capacity on selected high traffic and high-yielding domestic routes by increasing flight frequencies on these routes with a view towards improving our competitiveness. We also added six Boeing 737 aircraft and two Airbus 319 aircraft on our domestic routes. As a result, our domestic passenger traffic increased by 14.5% in 2002 and our domestic passenger load factor increased from 58% in 2001 to 63% in 2002. However, our domestic passenger yield decreased from RMB0.63 in 2001 to RMB0.55 in 2002 per passenger-kilometer, primarily due to intensified competition in the domestic market.

Hong Kong passenger revenues, which accounted for 19.0% of our passenger revenues, decreased from RMB1,921 million in 2001 to RMB1,911 million in 2002, or 0.5%, reflecting increased competition on our Hong Kong routes, which prompted us to lower our average airfare. Hong Kong passenger traffic increased by 10.1% in 2002 over that of 2001 as a result of our competitive prices and improved services on our Hong Kong routes. The passenger capacity on our Hong Kong routes increased by 1.1%. Our Hong Kong passenger load factor increased from 56% in 2001 to 61% in 2002 and our Hong Kong passenger



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yield decreased from RMB0.95 in 2001 to RMB0.86 in 2002 per passenger-kilometer. The decrease in passenger load factor and passenger yield on Hong Kong routes was due to competition from other airlines.

International passenger revenues, which accounted for 34.4% of our passenger revenues, increased from RMB2,965 million in 2001 to RMB3,457 million in 2002, or 16.6%. The increase in international passenger revenues reflected increased international passenger traffic. International passenger traffic increased by 17.0% in 2002 over that of 2001 as a result of higher passenger demand on our Japanese and Korean routes. The increase also reflected increased business traffic on our European routes. The increase in passenger traffic on our international routes may or may not continue in the following years due to seasonal and other variations that influence passenger traffic. Our international passenger capacity increased by 16.5% in 2002, international passenger load factor increased slightly from 68.7% in 2001 to 68.9% in 2002. However, our international passenger yield decreased slightly from RMB0.48 in 2001 to RMB0.46 in 2002 per passenger-kilometer primarily because we lowered our average airfare for our Japanese routes in order to maintain our competitive position and market share.

We generate cargo and mail revenues from the transport of cargo and mail on our designated cargo aircraft as well as from the carriage of cargo and mail on passenger aircraft. Revenues from cargo and mail operations, which accounted for 18.7% of our total revenues, increased from RMB2,092 million in 2001 to RMB2,445 million in 2002, or 16.9%. The increase in cargo revenues was primarily the result of the increase in the volume of importation and exportation after China's accession to the World Trade Organization, or WTO, on our international routes. Our cargo volume also increased partially due to the west coast port strike in the United States during the second half of 2002. Our cargo and mail traffic (as measured in revenue freight tonne-kilometers, or RFTKs) increased from 950 million RFTKs in 2001 to 1,023 million RFTKs in 2002, or 7.7%, primarily due to the increase of our international cargo and mail traffic. To meet the increased cargo and mail traffic demand, we wetleased a Boeing 747 aircraft in the second half of 2002 to operate on our international cargo routes. Cargo yield increased from RMB2.20 in 2001 to RMB2.39 in 2002 per cargo tonne-kilometer primarily as a result of increased market demand.

Other operating revenues are primarily generated from airport ground services and ticket handling services. Airport ground services include loading and unloading, aircraft cleaning, fueling and ground transportation of cargo and passenger luggage for airlines operating to or from Hong Qiao International Airport and Pudong International Airport. Other operating revenues increased from RMB474 million in 2001 to RMB596 million in 2002, or 25.8%, which is much higher than the 5% growth rate achieved in 2001. The increase in other operating revenues in 2002 was mainly due to increased volume of importation and exportation after China's accession to the WTO. The increased freight handling fees charged by China Cargo Airlines Limited for its new storage house at Pudong International Airport opened in 2001 also contributed to the increase in our other operating revenues. We are currently the principal provider of airport ground services at both Hong Qiao International Airport and Pudong International Airport.

**Operating Expenses.** Our total operating expenses increased from RMB11,283 million in 2001 to RMB12,242 million in 2002, or 8.5%, reflecting increase in aircraft maintenance expenses, takeoff and landing charges, wages, salaries and benefits, as well as office and administration expenses. Operating expenses as a percentage of revenues increased from 92.8% in 2001 to 93.6% in 2002.

Aircraft fuel expenses decreased from RMB2,613 million in 2001 to RMB2,564 million in 2002, or 1.9%, primarily as a result of decreased weighted average domestic and international fuel prices. In 2002, the weighted average domestic and international fuel prices paid by our company decreased by approximately 11% and 3%, respectively. The weighted average fuel prices paid by our company decreased by approximately 7%.

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Aircraft depreciation and operating lease expenses increased from RMB2,404 million in 2001 to RMB2,455 million in 2002, or 2.2%. Other depreciation and operating lease expenses increased from RMB358 million in 2001 to RMB400 million in 2002, or 11.8%, primarily due to the expansion of our fleet.

Take-off and landing charges increased from RMB1,703 million in 2001 to RMB1,988 million in 2002, or 16.7%, primarily due to increased flights and the mandatory increase in the takeoff and landing charges for domestic flights by the CAAC, effective September 1, 2002. Take-off and landing charges accounted for 16.2% of our total operating expenses in 2002.

Aircraft maintenance expenses were RMB1,078 million in 2002, compared to RMB967 million in 2001, an increase of 11.5%. This increase is mainly due to increased number of aircraft subject to overhaul in 2002.

Commission expenses decreased from RMB487 million in 2001 to RMB380 million in 2002, or 22.0%, primarily because revenues received by our company from sales and travel agents for domestic flight tickets are net of commissions.

Wages, salaries and benefits increased from RMB773 million in 2001, which included a one-time write-back of approximately RMB96 million as a result of the curtailment of our company's obligations to provide medical benefits to retirees, to RMB1,036 million in 2002, or 34.0%. This increase was primarily attributable a 7% increase in the number of our employees as a result of the expansion of our fleets and establishment of our Ningbo branch. Moreover, our company increased wage and benefit expenses due to an approximate 6.4% increase in hours flown in 2002, as well as an increase in the average salaries of important employees to maintain stable human resources in a competitive market. Due to the adverse effect of SARS, we have suspended our recruiting of new employees in 2003.

Food and beverage expenses increased from RMB567 million in 2001 to RMB606 million in 2002, or 6.8%, primarily due to our expanded operations and increased flights.

Office and administration expenses increased from RMB849 million in 2001 to RMB1,044 million in 2002, or 23.0%. The increase was attributable to an increase in our training expenses in 2002 to prepare for further expansion of our fleet in 2003. It was also due to the expansion of our general operations, including the opening of our local office in Delhi, and increase in expenses relating to our overseas sales and the expenses of our overseas offices.

Other operating expenses decreased from RMB562 million in 2001 to RMB520 million in 2002, or 7.5%. Other operating expenses included provision for obsolescence of flight equipment spare parts, maintenance expenses of other fixed assets, computer and telecommunications expenses and other expenses. The decrease was attributable to our effective cost management.

**Fixed assets.** Our company had approximately RMB20.5 billion of fixed assets as of December 31, 2002, including aircraft and flight equipment with a value of approximately RMB17.8 billion. Fixed assets are initially recognized at cost and are subsequently stated at revalued amount, being its fair value at the date of revaluation less accumulated depreciation.

In view of recent volatility in the global aviation industry and change in market value for aircraft, on December 31, 2002, our company conducted a revaluation on its fixed assets pursuant to the requirements of IFRS. As a result of the revaluation, our company recognized a net revaluation surplus of RMB137 million in the revaluation reserve and a revaluation deficit of RMB172 million in the income statement.

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Valuation of fixed assets is based on market conditions and global economic factors that we may not control. The determination of fair market value requires significant judgment, including judgment on valuations by our management and/or by independent professional appraisers.

The revaluation deficit on fixed assets as recognized in 2002 is a non-cash charge and has no impact on our company's cash flows. It is not an indication of any impairment of our company's fleet.

***Net Interest Expense and Net Other Income.*** Net interest expenses was RMB731 million in 2002, compared to RMB814 million in 2001. The 10.2% decrease was mainly due to the decreased principal amount and interests under aircraft finance leases as a result of expiration of three aircraft leases in 2002. Net other income increased from RMB128 million in 2001 to RMB226 million in 2002, or 77.4%. The increase in other income reflects net proceeds from sale of two Airbus A310 aircraft in 2002.

## **Liquidity and Capital Resources**

We finance our working capital requirements through a combination of funds generated from operations and bank loans. As a result, our liquidity would be adversely affected to the extent there is a significant decrease in demand for our services, or any delay in obtaining bank loans. As of December 31, 2002 and 2003, we had cash and cash equivalents of RMB1,945 million and RMB1,583 million, respectively. In 2002 and 2003, our net cash inflows generated from operating activities were RMB2,160 million and RMB3,267 million, respectively, while our net cash outflows used in investment activities were RMB4,543 million and RMB7,409 million, respectively. In the past two years, our primary cash requirements were for the acquisitions and upgrades of aircraft and flight equipment and debt repayments.

In 2002 and 2003, payment of advances on aircraft and flight equipment were RMB2,600 million and RMB1,296 million, respectively, while additions of aircraft and flight equipment were RMB1,004 million and RMB5,560 million, respectively. We financed the additions to our aircraft and flight equipment primarily through lease arrangements, bank loans, and funds generated from operations. Funds generated from disposal of old aircraft and flight equipment and other fixed assets and equipment (including by way of exchange) totaled RMB150 million and RMB92 million in 2002 and 2003, respectively. Our net cash inflow generated from financing activities was RMB3,764 million in 2003, primarily from short-term loans.

Pursuant to certain of our finance or operating leases, we are required to indemnify the lessors against any withholding or similar taxes that may be imposed on the lessors by taxing authorities in China with regard to payments made under these leases. Pursuant to a regulation issued in 2000 by the State Tax Bureau of China, lease payments made by Chinese airlines to foreign enterprises in respect of lease arrangements entered into prior to September 1, 1999 are exempt from the payment of any withholding tax. Withholding tax payable in respect of the lease arrangements entered into on or after September 1, 1999 are charged to our income statement as incurred.

We generally operate with a working capital deficit. As of December 31, 2003, our current liabilities exceeded our current assets by RMB9,941 million, while our current liabilities exceeded our current assets by RMB7,437 million as of December 31, 2002. The increase in working capital deficit in 2003 was due to increase in short-term bank loans and the portion of long-term bank loans payable within one year. Short-term loans outstanding totaled RMB4,527 million and RMB4,632 million as of December 31, 2002 and 2003, respectively. Long-term loans outstanding totaled RMB6,495 million and RMB11,223 million as of December 31, 2002 and 2003, respectively. Long-term loans payable within two years, from three to five years and beyond five years were RMB4,689 million, RMB4,164 million and RMB2,370 million, respectively, as of December 31, 2003, as compared to RMB2,971 million, RMB2,368 million and RMB1,156 million, respectively, as of December 31, 2002. The total lease obligations outstanding under



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our finance leases as of December 31, 2002 and 2003 were RMB8,184 million and RMB7,101 million, respectively. Our lease obligations payable within two years, from three to five years and beyond five years were RMB2,679 million, RMB4,039 million and RMB383 million, respectively, as of December 31, 2003, as compared to RMB3,082 million, RMB4,005 million and RMB1,097 million, respectively, as of December 31, 2002.

We have, and in the future may continue to have, substantial debts. As of December 31, 2002 and 2003, our long-term debt to equity ratio was 1.8 and 2.6, respectively. The interest expenses associated with these debts might impair our future profitability and cause our earnings to be subject to a higher degree of volatility. We expect that cash from operations and bank borrowings will be sufficient to meet our operating cash flow requirements, although events that materially affect our operating results can also have a negative impact on liquidity. We have entered into credit facility agreements with Chinese banks to meet our future working capital needs. We have arranged, and we believe that we will continue to be able to arrange, short-term bank loans with domestic and foreign-funded banks in China as necessary to meet our working capital requirements. However, our ability to obtain financing may be affected by our financial position and leverage, as well as by prevailing economic conditions and the cost of financing generally. If we are unable to obtain financing for a significant portion of our capital requirements, our ability to acquire new aircraft or to expand our operations could be impaired.

**Capital Expenditures**

Our aircraft orders as of December 31, 2003 included commitments to acquire two Airbus A340-600 aircraft, four Airbus A321 aircraft, ten Airbus A320 aircraft and three Boeing B737-800 aircraft to be delivered in 2004 and 2005. We expect our capital expenditures for aircraft and related equipment, including deposits, through 2005 to be in aggregate approximately RMB7,669 million, including RMB5,130 million in 2004 and RMB2,539 million in 2005, in each case subject to contractually stipulated increases or any increase relating to inflation. We generally finance our purchase of aircraft through operating leases and bank loans secured by our assets. As of December 31, 2003, the total value of our mortgaged assets increased by 197.5%, from RMB3,272 million as of December 31, 2002 to RMB9,735 million as of December 31, 2003. Construction of our facilities at the Pudong International Airport and the purchase of maintenance equipment and other property and equipment will continue to require additional capital expenditures in 2004. In addition, we plan to increase our investment on technology upgrade and other projects in response to technological development in the aviation industry. We plan to finance our other capital commitments through a combination of funds generated from operations, existing credit facilities, bank loans, leasing arrangements and other external financing arrangements.

*Contractual Obligations and Commercial Commitments*

The following tables set forth our outstanding contractual and commercial commitments as of December 31, 2003.

| <b>Contractual<br/>Obligations</b> | <b>Total</b> | <b>Payments Due by Period<br/>(RMB millions)</b> |                      |                      |                          |
|------------------------------------|--------------|--|----------------------|----------------------|--------------------------|
|                                    |              | <b>Less<br/>Than 1<br/>Year</b>                  | <b>1-3<br/>Years</b> | <b>4-5<br/>Years</b> | <b>After 5<br/>Years</b> |
| Long-Term Debt                     | 11,223       | 2,251  | 4,520                | 2,082                | 2,370                    |
| Finance Leases                     | 7,101        | 1,692  | 2,435                | 2,591                | 383                      |
| Operating Leases                   | 6,177        | 1,113  | 2,013                | 1,894                | 1,157                    |



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|                                    |                   |                   |                   |                   |                   |
|------------------------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
| Unconditional Purchase Obligations | 8,791             | 6,252             | 2,539             |                   |                   |
| Other Long-Term Obligations        | 142               | 30                | 60                | 52                |                   |
|                                    | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |

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| <b>Contractual Obligations</b> | <b>Total</b> | <b>Payments Due by Period<br/>(RMB millions)</b> |                  |                  |                      |
|--------------------------------|--------------|--|------------------|------------------|----------------------|
|                                |              | <b>Less Than 1 Year</b>                          | <b>1-3 Years</b> | <b>4-5 Years</b> | <b>After 5 Years</b> |
| Total                          | 33,434       | 11,338   | 11,567           | 6,619            | 3,910                |

| <b>Other Commercial Commitments</b>         | <b>Total Amounts Committed</b> | <b>Amount of Commitment Expiration Per Period<br/>(RMB millions)</b> |                  |                  |                      |
|---|--------------------------------|--|------------------|------------------|----------------------|
|   |                                | <b>Less Than 1 Year</b>  | <b>1-3 Years</b> | <b>4-5 Years</b> | <b>After 5 Years</b> |
| Line of Credit                              | 49,050                         | 5,350  | 14,100           | 0                | 29,600               |
| Standby Letters of Credit                   |                                |  |                  |                  |                      |
| Guarantees                                  | 150                            | 150  |                  |                  |                      |
| Standby Repurchase Obligations              |                                |  |                  |                  |                      |
| Other Commercial Commitments <sup>(1)</sup> |                                |  |                  |                  |                      |
| Total                                       | 49,200                         | 5,500  | 14,100           | 0                | 29,600               |

**Critical Accounting Policies**

Critical accounting policies are defined as those that are reflective of significant judgments and uncertainties and potentially result in materially different results under different assumptions and conditions.

Our consolidated financial statements have been prepared in accordance with IFRS. Our principal accounting policies are set forth in Note 2 to our consolidated financial statements. IFRS requires that we adopt the accounting policies and make estimates that our directors believe are most appropriate in the circumstances for the purposes of giving a true and fair view of our results and financial condition. However, different policies, estimates and assumptions in critical areas could lead to materially different results. The critical accounting policies adopted and estimates made in the preparation of these financial statements are identified as follows:

**Revenue recognition** As discussed in Note 2(d) to our consolidated financial statements, passenger, cargo and mail revenues are recognized as traffic revenues when the transportation services are provided. The value of sold but unused tickets is included in the current liabilities as sales in advance of carriage. Management performs periodic

evaluations of sales in advance of carriage, and any adjustments made as a result of such evaluations, which can be significant, are included in the results of operations for the periods in which the evaluations are completed. These adjustments result from differences between the estimates of certain revenue transactions and the related sales price, and are impacted by various factors, including a complex pricing structure and interline agreements throughout the industry, which affect the timing of revenue recognition.

**Fixed assets** We had approximately RMB26.8 billion of fixed assets as of December 31, 2003, including aircraft and flight equipment with a value of approximately RMB24 billion. As discussed in Note 2(j) to our consolidated financial statements, fixed assets are initially recognized at cost and are subsequently stated at revalued amount less accumulated depreciation. Independent valuations are conducted at least every five years or sooner if considered necessary by our directors. In the intervening years, our directors would review the carrying value of the fixed assets from time to time and make adjustments if the carrying value is materially different from the fair value. Their recorded value is impacted by management judgment, including valuations performed by the management and/or independent professional valuers, estimates of useful lives, residual value and impairment charges.

**Maintenance and overhaul costs** Following the adoption of IFRS 37 Provisions, Contingent Liabilities and Contingent Assets in the year ended December 31, 2000, major overhaul expenses for owned assets and assets under capital leases are no longer accrued but charged against operating profits as

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and when incurred. In respect of major overhauls for aircraft and engines under operating leases, the estimated costs of such overhauls are accrued and charged to operating profits over the estimated period between overhauls using the ratios of actual flying hours/cycles and estimated flying hours/cycles between overhauls. The amount of overhaul costs charged to the operating profits is impacted by management's estimates of the expected overhaul costs, which are largely based on past experience of overhauls of the same or similar models of aircraft and engines.

**Retirement benefits** We participate in defined contribution retirement schemes organized by the municipal governments of respective provinces. We also operate and maintain defined retirement benefit plans which provides retirees with benefits including transportation subsidies, social activity subsidies as well as other welfare. As discussed in Note 2(f) to our consolidated financial statements, the cost of providing the aforementioned benefits in the defined retirement benefit plan is actuarially determined and recognized over the employees' service period by utilizing various actuarial assumptions and using the projected unit credit method. These assumptions include, without limitation, the selection of discount rate, annual rate of increase of per capita benefit payment and employees' turnover rate. The discount rate is based on the management's review of local high quality corporate bonds. The annual rate of increase of benefit payment is based on the general local economic conditions. The employees' turnover rate is based on historical trends of our company. See Note 30 to our consolidated financial statements for additional information regarding the retirement benefit plans.

**Staff housing allowances** A new staff housing policy, or the New Staff Housing Policy, was approved by our board of directors in October 2003. Under the New Staff Housing Policy, our staff who have not been allocated with any housing quarters or who have not been allocated with a quarter up to the minimum area as set out in the New Staff Housing Policy are entitled to a cash allowance. An eligible staff's entitlement is calculated based on the years of services, area of quarter entitled and the unit price as set out in the New Staff Housing Policy. The total entitlement is principally vested over a period of 20 years. Upon the establishment of the New Staff Housing Policy, employees are entitled to a portion of the total entitlement already accrued based on his or her past service period. We recognized a provision of Renminbi 341 million as related to our present obligation for our employees' staff housing entitlements in 2003. See Note 31(b) to our consolidated financial statements for additional information regarding the staff housing allowances.

**Deferred taxation** Deferred income tax is provided in full, using the liability method, for all significant temporary differences arising between the tax base of assets and liabilities and their carrying amounts in the financial statements. Currently applicable tax rates are used to determine deferred income tax. Deferred tax assets as related to tax losses was recognized to the extent that future taxable profit will be available against which the temporary differences can be utilized. See Note 7 to our consolidated financial statements for additional information regarding the deferred taxation.

## **Foreign Currency Transactions**

We have debts denominated in U.S. dollars, Japanese yen or Euro in addition to our debts denominated in Renminbi. We generate a significant amount of foreign currency revenues, including U.S. dollar, Japanese yen, Euro, Korean won, Hong Kong dollar, Singapore dollar, Australian dollar, and Thailand baht revenues, from ticket sales made in overseas offices. Pursuant to current foreign exchange regulations in China, we may retain our foreign currency earnings subject to the approval of SAFE, which are generally sufficient to satisfy our foreign currency liabilities payable within one year. We have also designated certain personnel to manage the foreign currency risks through derivative financial products such as forward foreign exchange contracts and interest rate swaps. We use interest rate swaps to reduce risks related to changes in market interest rates. As of December 31, 2003, the notional amount of the outstanding interest rate swap agreements was approximately US\$164 million, compared to US\$96 million as of December 31, 2002. These interest rate swap agreements will expire between 2004 and 2010. In addition, we use forward contracts to reduce risks related to changes in currency exchange rates in respect of ticket sales and expenses denominated in foreign currencies. These currency forward contracts will expire between 2004 and

2010.

Pursuant to IFRS, our monetary assets and liabilities denominated in foreign currencies are required to be translated into Renminbi at the year end at exchange rates announced by People's Bank of China. The net exchange gains or losses are recognized and reflected in the income statement for the relevant year. Any fluctuation of the exchange rates between Renminbi and foreign currencies may materially adversely affect our financial condition and results of operations. The exchange rate between Renminbi and Japanese yen or Euro had experienced a significant level of fluctuation over the past two years. For example, due to the appreciation of Japanese yen and Euro against the Renminbi in 2003, we had

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a net exchange loss of RMB70 million in 2003, compared to a net exchange loss of RMB38 million in 2002 due to the appreciation of Japanese yen against Renminbi.

### **Taxation**

Since we changed our registered address to Pudong district in Shanghai on July 1, 2001, we are subject to income tax at the rate of 15%. Our effective tax rate, however, may be higher than the rate of 15% because some of our subsidiaries were incorporated in jurisdictions where the applicable income tax rate is 33% rather than 15%. We had carried forward tax losses of approximately RMB1,163 million and RMB2,086 million as of December 31, 2002 and 2003, which can be used to set off against future taxable income and will expire between 2006 and 2008.

### **Inflation**

In recent years, China has not experienced significant inflation. In 2003, inflation did not have a significant effect on our business. According to the National Bureau of Statistics of China, China's overall national inflation rate, as represented by the general consumer price index, was approximately 0.7% and 1.2% in 2001 and 2003, respectively. In 2002, China experienced a slight deflation at a rate of 0.8%. Although neither the inflation nor the deflation in the past had any material adverse impact on our results of operations, we cannot assure you that the deflation or inflation of the Chinese economy in the future would not materially adversely affect our financial condition and results of operations.

### **U.S. GAAP Reconciliation**

Our audited consolidated financial statements are prepared in accordance with IFRS, which differs in certain material respects from U.S. GAAP. Note 40 to our audited consolidated financial statements provide a description of the principal differences between IFRS and U.S. GAAP as they relate to our company, and a reconciliation to U.S. GAAP of profit attributable to shareholders for the years ended, and owners' equity as of December 31, 2002 and 2003.

### **New Pronouncements**

#### *SFAS No. 132 (Revised)*

In December 2003, the Financial Accounting Standards Board, or FASB, issued SFAS No.132 (Revised), or SFAS No.132R, "Employer's Disclosure about Pensions and Other Postretirement Benefits" as amendment of FASB statements No. 87, 88 and 106, and a replacement of FASB Statement No.132. SFAS No.132R retains disclosure requirements of the original SFAS No.132 and requires additional disclosures relating to assets, obligations, cash flows, and net periodic benefit cost. The measurement and recognition guidance under original SFAS 132 has not changed. SFAS No.132R is effective for fiscal years ending after December 15, 2003, except that certain disclosures are effective of fiscal years ending after June 15, 2004. Our management has adopted the disclosure provisions of SFAS No.132.

#### *SFAS No. 143*

In June 2001, FASB issued SFAS No.143 "Accounting for Asset Retirement Obligations" which addresses accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. SFAS No.143 is effective for fiscal years beginning after

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June 15, 2002. The adoption of SFAS No.143 did not have a material effect on our company's financial position or results of operations.

*SFAS No. 149*

In April 2003, the FASB issued SFAS No.149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities. SFAS No.149 amends and clarifies accounting for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities under SFAS No.133. SFAS No.149 is applied prospectively and is effective for contracts entered into or modified after June 30, 2003, except for SFAS No.133 implementation issues that have been effective for fiscal quarters that began prior to June 15, 2003, and certain provisions relating to forward purchases or sales of when issued securities or other securities that do not yet exist. The adoption of SFAS No.149 did not have any significant impact on our company's results of operations.

*SFAS No. 150*

In June 2003, the FASB issued SFAS No.150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity. SFAS No.150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or as an asset in some circumstances). It is effective for financial instruments entered into or modified after May 31, 2003 and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. It is to be implemented by reporting the cumulative effect of a change in an accounting principle for financial instruments created before the issuance date of SFAS No.150 and still in existence at the beginning of the interim period of adoption. Restatement is not permitted. The adoption of SFAS No.150 did not have a material effect on our company's financial position or results of operations.

*FIN 45*

In November 2002, Financial Interpretation No. ( FIN ) 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, including Indirect Guarantees of Indebtedness of Others, or FIN 45, was issued. FIN 45 requires that at the time a company issues a guarantee, the company must recognize an initial liability for the fair value, or market value, of the obligations it assumes under that guarantee. This interpretation is applicable on a prospective basis to guarantees issued or modified after December 31, 2002. FIN 45 also contains disclosure provisions surrounding existing guarantees, which are effective for financial statements with periods ending after December 15, 2002.

*FIN 46*

In January 2003, the FASB issued FIN 46 Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51. FIN 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN 46 is effective for all new variable interest entities created or acquired after January 31, 2003. In December 2003, the FASB issued a revision to FIN No. 46, Consolidation of Variable Interest Entities, and Interpretation of ARB No. 51, or FIN 46R.

Among other changes, the revisions of FIN 46R (a) clarified some requirements of the original FIN 46, (b) eased some implementation problems, and (c) added new scope exceptions. FIN 46R deferred the effective date of the Interpretation for public companies, to the end of the first reporting period ending after March 15, 2004, except that all public companies must at a minimum apply the provisions of the





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Interpretation to entities that were previously considered special-purpose entities under the FASB literature prior to the issuance of FIN 46R by the end of the first reporting period ending after December 15, 2003. Our management does not expect that the adoption of FIN 46R will have a material effect on our company's financial position or results of operations.

*EITF Issue No. 00-21*

In November 2002, the Emergency Issue Task Force reached a consensus on Issue No. 00-21, Revenue Arrangements with Multiple Deliverables, or EITF No.00-21. This issue addresses how revenue arrangements with multiple deliverables should be divided into separate units of accounting and how the arrangement consideration should be allocated to the identified separate accounting units. EITF No. 00-21 is effective for fiscal periods beginning after June 15, 2003. We do not believe that this EITF will have a significant impact on our financial statements.

**Item 6. Directors, Senior Management and Employees.**

**A. Directors and Senior Management**

The following table sets forth certain information concerning our directors, executive officers and supervisors as of June 22, 2004. None of our directors, supervisors or members of our senior management was selected or chosen as a result of our arrangement or understanding with customers, suppliers or others. There is no family relationship between any director, supervisor or executive officer and any other director, supervisor or executive officer of our company.

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| <b>Name</b>                 | <b>Age</b> | <b>Shares Owned</b> | <b>Position</b>                       |
|-----------------------------|------------|---------------------|---------------------------------------|
| Ye Yigan                    | 61         | 0                   | Chairman of the Board of Directors    |
| Li Fenghua                  | 54         | 0                   | Director and President                |
| Wan Mingwu                  | 57         | 0                   | Director and Vice President           |
| Cao Jianxiong               | 45         | 2,800 A shares      | Director                              |
| Zhong Xiong                 | 58         | 2,800 A shares      | Director                              |
| Luo Zhuping                 | 51         | 2,800 A Shares      | Director and Company Secretary        |
| Chen Quanxin <sup>(1)</sup> | 62         | 2,800 A shares      | Director                              |
| Hu Honggao                  | 50         | 0                   | Independent Non-executive Director    |
| Peter Lok                   | 67         | 0                   | Independent Non-executive Director    |
| Wu Baiwang                  | 61         | 0                   | Independent Non-executive Director    |
| Zhou Ruijin                 | 65         | 0                   | Independent Non-executive Director    |
| Xie Rong                    | 52         | 0                   | Independent Non-executive Director    |
| Li Wenxin                   | 55         | 0                   | Chairman of the Supervisory Committee |
| Ba Shengji                  | 45         | 2,800 A Shares      | Supervisor                            |
| Zhou Rongcai <sup>(2)</sup> | 59         | 0                   | Supervisor                            |
| Yang Xingen                 | 51         | 0                   | Supervisor                            |
| Yang Jie                    | 34         | 0                   | Supervisor                            |
| Liu Jiashun                 | 47         | 0                   | Supervisor                            |
| Wu Yulin                    | 55         | 2,800 A Shares      | Vice President                        |
| Wu Jiuhong                  | 52         | 0                   | Vice President                        |
| Yang Xu                     | 43         | 0                   | Vice President                        |
| Zhou Liguo                  | 55         | 0                   | Vice President                        |
| Zhang Jiangzhong            | 49         | 0                   | Vice President                        |
| Luo Weide                   | 48         | 0                   | Chief Financial Officer               |

(1) Mr. Chen served as a director of our company as of June 18, 2004.

(2) Mr. Zhou served as a supervisor of our company as of June 18, 2004.

**Directors and Executive Officers**

Mr. Ye Yigan is currently the Chairman of our board of directors. Mr. Ye is also the President and the deputy party secretary of CEA Holding. Mr. Ye joined the civil aviation industry in 1965. He served as a deputy chief engineer of the aircraft repair factory of the CAAC Shanghai Bureau in 1983 and was head of the same factory after 1985. In December 1987, he became a deputy director of the CAAC Eastern China Bureau. In 1992, he became the president and the deputy party secretary of CASC. In June 1996, he became the director and the party secretary of the CAAC Eastern China Bureau. From April 2001 to September 2002, he served as the president and the party secretary of EA Group. Mr. Ye became the Chairman of our board of directors since June 2001. In October 2002, he became the president and the deputy party secretary of CEA Holding. Mr. Ye graduated from China Civil Aviation Institute in Tianjin with a major in aircraft instrument maintenance. Mr. Ye holds the title of Senior Engineer.

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Mr. Li Fenghua is currently an executive director and the President of our company. Mr. Li joined the civil aviation industry in 1968. Mr. Li served as the deputy director, and subsequently the director, of the 26th Fleet of the CAAC from 1987 to 1992. From 1992 to 1996, Mr. Li was the vice president, and then the president, of the Hubei branch of China Southern Airlines (Group). From 1996 to 2000, Mr. Li was the vice president of China Southern Airlines Company Limited and the vice president of China Southern Airlines (Group). From 2000 to October 2002, Mr. Li served as the party secretary and the vice president of China Southern Airlines Company Limited. Since October 10, 2002, Mr. Li served as the President of our company and the vice president of CEA Holding. Mr. Li graduated from China Civil Aviation Senior Aviation School and holds the title of First Class Pilot.

Mr. Wan Mingwu is currently an executive director and a Vice President of our company. Mr. Wan joined the civil aviation industry in 1968. From 1983 to 1990, he was the deputy section chief and the section chief of the cadre section of the political department of the CAAC Shenyang Bureau. From 1990 to 1992, he was the section chief of the personnel division of China Northern Airlines. From 1992 to 1995, he was the deputy party secretary of China Northern Airlines. From 1995 to 2000, he was the party secretary of China Northern Airlines. Since December 2000, he has been the party secretary and Vice President of our company. Mr. Wan graduated from Civil Aviation Mechanics Vocational School and holds the title of Senior Political Work Instructor.

Mr. Cao Jianxiong is currently a director of our company. Mr. Cao is also a Vice President of CEA Holding. Mr. Cao joined the civil aviation industry in 1982 and became the president of Shanghai Eastern Airlines Development Company in 1992. He became the president of Eastern Airlines Futures Brokerage Company in 1994. In early 1996, he became the assistant president of China Eastern Airlines. In 1997, he became the vice president and the chief financial officer of our company. In December 1999, he became the vice president of EA Group. In October 2002, he became the vice president of CEA Holding. He became the party secretary of China Northwest Airlines Company in December 2002. Mr. Cao graduated from the labor economics department of the Civil Aviation Management Institute and received a Master's degree in global economics from Eastern China Normal University's Department of International Finance. Mr. Cao holds the title of Economist.

Mr. Zhong Xiong is currently a director of our company. Mr. Zhong joined the civil aviation industry in 1970. From 1986 to 1988, he was the vice president of Transportation Services Company of the CAAC Shanghai Bureau and was the president of the sales and transportation department of China Eastern Airlines from 1988 to 1992. From 1992 to April 1995, he was a Vice President of China Eastern Airlines. From May 1995 to April 2002, Mr. Zhong served as a Vice President of our company. He became the chairman of the workers' union of CEA Holding since April 2002. He graduated in 1970 from the English Department of Liaoning Teacher's College and holds the title of Economist.

Mr. Chen Quanxin was a director of our company as of June 18, 2004. Mr. Chen joined the civil aviation industry in 1965. From 1983 until 1987, he was the deputy manager and became the manager of Transportation Services Company of the CAAC Shanghai Bureau in 1987. From the end of 1987 to 1992, Mr. Chen was the director of the administrative office of China Eastern Airlines. In 1992, Mr. Chen became the chairman of the workers' union of China Eastern Airlines. From the end of 1996 to April 2002, he was the chairman of the workers' union of CEA Holding. From 1997 to June 2004, Mr. Chen served as the chairman of the workers' union of our company.

Mr. Luo Zhuping is an executive director, the company secretary and the head of the secretariat of the board of directors of our company. Mr. Luo joined China Eastern Airlines in 1988. He was the deputy chief and then the chief of the enterprise management department of China Eastern Airlines from 1992 to 1997. He was the deputy head of the share system office from 1993 to 1996. In 1997, he became our company secretary and the head of the secretariat of our board of directors. Mr. Luo participated the



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restructuring and privatization of our predecessor since 1993. Mr. Luo graduated from the Faculty of Philosophy and the Faculty of Law of Anhui University in 1979 and 1985, respectively. In 1994, Mr. Luo received a Master's degree from the Economics Department of Eastern China Normal University, majoring in global economics. In 1998, he participated in the training program for senior managers of large state-owned enterprises organized in the U.S. by the State Economic and Trade Commission and Morgan Stanley.

Mr. Hu Honggao is currently an independent non-executive director of our company. He is the vice-dean and professor of law at Fu Dan University School of Law, the head of the Civil and Commercial Law Research Center of Fu Dan University and a tutor of Ph.D. students majoring in civil law and commercial law at Fu Dan University. He is also a senior counsel of the Shanghai Shen Yang Law Office. Mr. Hu is a member of the Legislative Consultation Committee of the Shanghai Municipal Government, a member of the Legislative Profession Consultation Committee of the Shanghai Standing Committee of the People's Congress, and an arbitrator of the Shanghai Arbitration Committee. Mr. Hu also serves as a managing director of China Commercial Law Research Society, a managing director of China Economic Law Research Society and the vice chairman of the Shanghai Economic Law Research Society.

Mr. Peter Lok is currently an independent non-executive director of our company. Mr. Lok went to the College of Air Traffic Control in England for further studies after joining the Hong Kong Civil Aviation Department in December 1956. He studied air transport, air accident investigation and administration and management of civil aviation in England from 1968 to 1973. In 1982, he became the assistant director of the Hong Kong Civil Aviation Department. From 1985, during his tenure at the air services division of the Hong Kong Civil Aviation Department, he participated in negotiations with various countries regarding air traffic rights. He became the deputy director in 1988, and subsequently the director in 1990, of the Hong Kong Civil Aviation Department. Mr. Lok retired in 1996 and is currently a consultant to the Flight Standards Department of the CAAC. Mr. Lok is the first Chinese director of the Hong Kong Civil Aviation Department and was at one time an instructor of the College of Air Traffic Control of Hong Kong.

Mr. Wu Baiwang is currently an independent non-executive director of our company. Mr. Wu joined the civil aviation industry in 1959 and was the deputy head and subsequently the head of the 12th Fleet of the CAAC from 1976 to 1984. From 1984 to 1992, Mr. Wu was the deputy head and subsequently became the head of the CAAC Jilin Bureau. From 1992 to 1995, Mr. Wu was the head and the party secretary of the CAAC Northeastern Bureau. From September 1995 to 1998, he served as the president of China General Aviation Corporation. He was the party secretary and a vice president of Guangzhou Baiyun International Airport Group Company and the chairman of the board of directors of Guangzhou Baiyun International Airport Company Limited from 1998 to September 2003. Mr. Wu graduated from Chinese Civil Aviation School in 1965 and holds the title of First Class Pilot.

Mr. Zhou Ruijin is currently an independent non-executive director of our company. Mr. Zhou was the deputy editor-in-chief and the East China regional director of the People's Daily. From 1988 to 1993, Mr. Zhou was the party secretary and the deputy editor-in-chief of the Liberation Daily. From April 1993 to 1996, he was the deputy editor-in-chief of the People's Daily, and from 1996 to 2000, he was the deputy editor-in-chief and the East China regional director of the People's Daily. After his retirement from the People's Daily, Mr. Zhou served as the vice chairman of China Productivity Council and the chairman of Shanghai Productivity Council. Mr. Zhou graduated from the Journalism Department of Fu Dan University in 1962.

Mr. Xie Rong is currently an independent non-executive director of our company. Mr. Xie is a certified accountant in China. Mr. Xie serves as the deputy director of Shanghai National Accounting Institute since October 2002. From December 1985 to March 1997, Mr. Xie was an assistant professor, and then a professor of accounting and the deputy dean of the faculty at Shanghai University of Finance and



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Economics. From December 1997 to October 2002, Mr. Xie was a partner at KPMG Huazhen. Mr. Xie graduated from Shanghai University of Finance and Economics and received a doctorate degree in Economics.

Mr. Wu Yulin is a Vice President of our company. Mr. Wu joined the civil aviation industry in 1966. From 1975 to 1985, he was the deputy head, and from 1985 to 1988 the head, of the 5th Fleet of the CAAC. In 1998, Mr. Wu became the head of China Eastern Airlines Shanghai Fleet. From 1989 to 1994, Mr. Wu was the deputy chief, and from 1994 to 1995, the chief, of the Aviation Skills and Management Department of China Eastern Airlines. He was the director of China Eastern Airlines Safety Supervision Department from 1995 to 1997, the deputy pilot and the chief of the Safety Supervision Department of our company from 1997 to 1998 and the president and the party secretary of the Hebei Branch Office of our company from 1998 to 1999. Mr. Wu became a Vice President of our company in December 1999. Mr. Wu graduated from Chinese Civil Aviation School and holds the title of First Class Pilot.

Mr. Wu Jiuhong is a Vice President of our company since April 4, 2002. He joined the civil aviation industry in 1961. From 1971 to 1973, he was a flight engineering student at the Civil Aviation Flight Institute. From 1973 to 1981, he worked in Regiment 18 of the second Civil Aviation General Flight Regiment. From 1981 to 1988, he was the secretary of the Youth League Committee and the deputy chief of the political department of Civil Aviation's Jiangxi provincial branch. From 1988 to 1995, he was the deputy secretary of the communist party and the secretary of the discipline department of our company's cabinet service division. From 1995 to 1997, he was the director of our company's political department. From 1997 to April 2002, he served as the party secretary and the executive deputy general manager of our company's Jiangxi branch. From April 2002, Mr. Wu serves as a Vice President of our company. Mr. Wu holds a Master's degree and is a qualified senior political cadre.

Mr. Yang Xu is a Vice President of our company since April 4, 2002. Mr. Yang joined the civil aviation industry in 1982. Mr. Yang was the president of the aircraft repair and maintenance department of China Eastern Airlines from 1993 to 1997, the vice president of the aircraft repair and maintenance base of our company from 1997 to 1998, and president and the deputy party secretary of our aircraft repair and maintenance department from 1998 to 1999. Mr. Yang became the Chief Engineer of our company in December 1999. Mr. Yang graduated from the Aircraft Production Sector of the Nanjing Aviation School and holds the title of Senior Engineer.

Mr. Zhou Liguo is a Vice President of our company since April 5, 2004. He joined the civil aviation industry in 1981, and attended the Air Force Changchun First Reserve Pilot School from 1966 to 1967 and the Harbin First Navigation School from 1967 to 1969. Mr. Zhou performed his military service with the 34th Division of the Air Force from 1969 to 1981, and served as a squadron leader in the 5th Fleet of the Civil Aviation from 1984 to 1988. Mr. Zhou was the deputy fleet leader of China Eastern Airlines Shanghai Fleet from 1988 to 1992, and the leader of the said fleet from 1992 to 1997. From 1997 to 2000, he served as the general manager and the deputy party secretary of our company's General Flight Department. In 2000, he became the assistant president of our company, and from 2000 to 2003, he served as the president and deputy party secretary of China Cargo Airlines Limited. Mr. Zhou became our company's chief economic official in December 2003. Mr. Zhou received university education and holds the title of First Class Pilot.

Mr. Zhang Jianzhong is a Vice President of our company since June 18, 2004. Mr. Zhang joined the civil aviation industry in 1982. He served as an assistant at the department of planning of the CAAC Shanghai Office from April 1982 to December 1987, and the vice director of the department of planning of Shanghai Hong Qiao International Airport from December 1987 to April 1990. He served as the director of the department of planning of China Eastern Airlines. Mr. Zhang became a manager at our company's marketing department from January 1996 to April 1999. He served as the assistant to general manager from





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April 1999 to April 2003, and in the meantime, he served as the director of the department of strategy study from September 2000 to December 2001, and the general manager of our company's computer and information center from December 2001 to May 2003. He became our chief economic official since April 2003, and the general manager of our marketing and sales department since May 2003. Mr. Zhang graduated from the Department of Machinery of Zhejiang University and received a master degree of economic management from Fudan University.

Mr. Luo Weide is our company's Chief Financial Officer. In 1976, Mr. Luo began his military service at the Air Force in Liuan Airport. From 1986 to 1991, he successively served as the secretary of the general party branch and the deputy bureau director of the Putuo Branch of Shanghai Municipal Tax Bureau. From 1991 to 1993, he concurrently served as the head of the finance bureau and the state asset bureau of Putuo District, Shanghai. From 1993 to 1998, he successively served as the deputy chief accountant, chief accountant and the executive deputy general manager of Shanghai Jinqiao (Group) Co., Ltd. From 1998 to 2000, he was the vice president of Shanghai Pudong Development (Group) Co., Ltd. and the chairman of the board and the general manager of Pudong Finance Company. Since 2000 he has been the chief financial officer of our company. Mr. Luo graduated from the Sino-European International Business School in 1999 with a Master's degree in business administration. He holds the titles of Senior Accountant and Senior Economist.

## **Supervisory Committee**

As required by the PRC Company Law and our articles of association, our company has a supervisory committee, or the Supervisory Committee, whose primary duty is the supervision of our senior management, including our board of directors, managers and senior officers. The Supervisory Committee consists of five supervisors.

Mr. Li Wenxin is currently the Chairman of our company's Supervisory Committee. Mr. Li joined the civil aviation industry in 1970. From 1992 to 1995, he was the secretary of the disciplinary committee of China General Aviation Corporation. From 1995 to 1996, he was a deputy party secretary of China General Aviation Corporation. From 1996 to 1998, he was the deputy president of China General Aviation Corporation and, from February 1998 to June 2002, he was the party secretary and an executive deputy president of the Shanxi branch of our company. From June 2000 to September 2002, he served as the deputy party secretary and the secretary of the disciplinary committee of EA Group. Since October 2002, he served as the party secretary and a vice president of CEA Holding. Mr. Li received university education and is a qualified Senior Political Work Instructor.

Mr. Ba Shengji is currently a supervisor of our company. Mr. Ba joined the civil aviation industry in 1978. In 1980, Mr. Ba became an accountant at the Department of Finance of the CAAC Shanghai Bureau. In 1988, he became the section head of the department of finance of China Eastern Airlines. In 1993, Mr. Ba became the deputy head of the department of finance of China Eastern Airlines. In March 1997, Mr. Ba became the chief officer of the auditing office of our company. From December 1997 to September 2002, he served as the head of EA Group's auditing department. In October 2002, he became the head of CEA Holding's auditing department. Since January 2003, he also served as the chief of CEA Holding's disciplinary committee's administrative office. Mr. Ba is currently the chief officer of our auditing office. Mr. Ba received university education and is a qualified auditor.

Mr. Yang Xingen is currently a supervisor of our company. Mr. Yang was the deputy political committee member of the 1<sup>st</sup> flying battalion and the political member of the 2<sup>nd</sup> battalion of 105<sup>th</sup> Regiment, 35<sup>th</sup> Division from July 1980 to July 1986. From July 1986 to October 1997, he was the branch party secretary and the manager of China Eastern Airlines Advertisement Service Company. From October 1997 to April 2000, he was the deputy party secretary, the secretary of the disciplinary committee and the

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political director of the Shanghai flying squadron of China Eastern Airlines. From April 2000 to August 2002, he was the deputy secretary of the disciplinary committee and the director of the supervision office. From April 2002, he served as the deputy secretary of the disciplinary committee of China Eastern Airlines. Mr. Yang graduated from the faculty of mechanics of the Second Aviation Mechanics School of the Air Force.

Mr. Zhou Rongcai was a supervisor of our company as of June 18, 2004. Mr. Zhou joined the civil industry in 1972. From 1979 to 1987 he was an instructor with the 5th Fleet (3rd Team) of the CAAC. From 1987 to 1992 he was an instructor and a deputy political commissar with the Shanghai Fleet (3rd Team) of China Eastern Airlines. From 1992 to 1996 he was the deputy department head of the organization department of China Eastern Airlines. From 1996 to 1997, he was the head of the general office of the China Eastern workers union. From 1997 to June 2004, he was the head of the general office and the vice chairman of the workers unions of our company and CEA Holding. Mr. Zhou graduated from the Shanghai Air Force Political Academy.

Ms. Yang Jie is currently a supervisor of our company. Ms. Yang joined the civil aviation industry in 1992. From 1996 to 1998, she was the electronic technology supervisor of the technology office and the Communist Youth League secretary of the overhaul department at the aircraft maintenance base of our company. From 1998 to September 2000, she was the Communist Youth League deputy secretary of the aircraft maintenance base of our company. She served as the deputy secretary of our company's Communist Youth League from September 2000 to July 2002 and the secretary of our company's Communist Youth League from August 2002. Since January 2003, she also served as the secretary of the Communist Youth League of CEA Holding. Ms. Yang graduated with a major in aviation electronics from China Civil Aviation Academy. She also received a Master's degree in business management from Sunny Management Academy at Donghua University. She is a qualified engineer.

Mr. Liu Jiashun is currently a supervisor of our company. From 1993 to 1999, Mr. Liu was the party secretary, a deputy president and the secretary of the disciplinary committee of China Aviation Fuel Hainan Company. He also served as the chairman of the board and the president of Hainan Nanyang Air Transport Co., Ltd. From 1997 to 1999, he was also in charge of fuel supply engineering at the Meilan Airport of Haikou, Hainan Province, and served as the director of Meilan Airport Co., Ltd. and the vice chairman of the board and the president of Meilan Industrial Co., Ltd. From 1999 to 2000, he was the deputy party secretary of China Aviation Fuel East China Company. He is currently the deputy party secretary and the secretary of the disciplinary committee of the Eastern China branch of China Aviation Fuel Company. Mr. Liu is a graduate student and has qualifications as a political work instructor.

## **B. Compensation**

The aggregate amount of cash compensation paid by us to our directors, supervisors and the senior management during 2003 for services performed as directors, supervisors and officers or employees of our company was approximately RMB613,000. In addition, directors and supervisors who are also officers or employees of our company receive certain other in-kind benefits which are provided to all of our employees. Our company does not have any bonus or profit sharing plan or any stock option plan.

## **C. Board Practices**

All directors and supervisors serve a term of three years or until such later date as their successors are elected or appointed. The directors and supervisors may serve consecutive terms. Two of the supervisors are employee representatives appointed by our employees, and the rest are appointed by the shareholders. The following table sets forth the number of years our directors, executive officers and supervisors have held their position and the expiration of their current term.



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| <b>Name</b>      | <b>Held Position Since</b> | <b>Expiration of Term</b> |
|------------------|----------------------------|---------------------------|
| Ye Yigan         | June 30, 2001              | June 18, 2007             |
| Li Fenghua       | June 20, 2003              | June 18, 2007             |
| Wan Mingwu       | June 30, 2001              | June 18, 2007             |
| Cao Jianxiong    | June 30, 2001              | June 18, 2007             |
| Zhong Xiong      | June 30, 2001              | June 18, 2007             |
| Luo Zhuping      | June 18, 2004              | June 18, 2007             |
| Chen Quanxin     | June 30, 2001              | June 18, 2004             |
| Hu Honggao       | June 30, 2001              | June 18, 2007             |
| Peter Lok        | June 30, 2001              | June 18, 2007             |
| Wu Baiwang       | June 30, 2001              | June 18, 2007             |
| Zhou Ruijin      | June 30, 2001              | June 18, 2007             |
| Xie Rong         | June 20, 2003              | June 18, 2007             |
| Li Wenxing       | June 30, 2001              | June 18, 2007             |
| Ba Shengji       | June 30, 2001              | June 18, 2007             |
| Zhou Rongcai     | June 30, 2001              | June 18, 2004             |
| Yang Xingen      | June 18, 2004              | June 18, 2007             |
| Yang Jie         | June 30, 2001              | June 18, 2007             |
| Liu Jiashun      | June 30, 2001              | June 18, 2007             |
| Wu Yulin         | June 30, 2001              | June 18, 2007             |
| Wu Jiuhong       | April 4, 2002              | June 18, 2007             |
| Yang Xu          | April 4, 2002              | June 18, 2007             |
| Zhou Liguao      | April 5, 2004              | June 18, 2007             |
| Zhang Jiangzhong | June 18, 2004              | June 18, 2007             |
| Luo Weide        | June 30, 2001              | June 18, 2007             |

None of our directors, supervisors or members of our senior management has entered into any agreement or reached any understanding with us requiring our company to pay any benefits as a result of termination of their services.

Our board of directors established the audit committee in August 2000 in accordance with the listing rules of the Hong Kong Stock Exchange. The audit committee currently consists of Mr. Xie Rong, an independent non-executive director and the chairman of the audit committee, Mr. Cao Jianxiong, a representative of CEA Holding, and Mr. Hu Honggao, an independent non-executive director of our company. The audit committee is authorized to, among other things, examine our internal control system and review auditing procedures and financial reports with our auditors. Subject to the approval of the shareholders' meeting, the audit committee of our company is also directly responsible for the appointment, compensation, retention and oversight of our outside auditors, including resolving disagreements between management and the auditor regarding financial reporting. The outside auditors report directly to the audit committee. The audit committee holds at least two meetings each year. The audit committee has established procedures for the receipt, retention and treatment of complaints received by our company regarding accounting, internal accounting controls or auditing matters, and procedures for the confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters. The audit committee has the authority to engage independent counsel and other advisors, as it determines necessary to carry out its duties. Our company provides appropriate funding, as determined by the audit committee, for payment of compensation to the outside auditors, advisors employed by the audit committee, if any, and ordinary administrative expenses of the audit committee that are necessary or appropriate in carrying out its duties.



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Our investment committee, established by our board of directors in August 1999, consists of Mr. Wu Baiwang, Mr. Zhong Xiong and Mr. Cao Jianxiong. The investment committee is authorized to review our annual and long-term investment plans and individual investments and report to our board of directors. It is also responsible for the review and supervision of the implementation of our investment plans.

**D. Employees**

Through arrangements with CEA Holding and others, we provide certain benefits to our employees, including housing, retirement benefits and hospital, maternity, disability and dependent medical care benefits. Our company does not have any bonus or profit sharing plan or any stock option plan. See Notes 30 and 31 to our audited consolidated financial statements. Our employees are members of a labor association which represents employees with respect to labor disputes and certain other employee matters. We believe that we maintain good relations with our employees and with their labor association. The table below sets forth the number of our employees as of December 31, 2001, 2002 and 2003, respectively:

|                      | <b>As of December 31,</b> |             |             |
|----------------------|---------------------------|-------------|-------------|
|                      | <b>2001</b>               | <b>2002</b> | <b>2003</b> |
| Pilots               | 1,345                     | 1,423       | 1,516       |
| Flight attendants    | 1,596                     | 1,531       | 1,817       |
| Maintenance personal | 2,696                     | 2,826       | 2,696       |
| Sales and marketing  | 1,945                     | 1,799       | 2,172       |
| Other                | 7,371                     | 8,140       | 8,234       |
| Total                | 14,953                    | 15,719      | 16,435      |

**E. Share Ownership**

See Item 6.A and Item 6.B above.

**Item 7. Major Shareholders and Related Party Transactions.****A. Major Shareholders**

The following table sets forth certain information regarding ownership of our capital stock as of December 31, 2003 by all persons who were known to us to be the beneficial owners of 5% or more of our capital stock:

| <b>Title of Class</b> | <b>Identity of Person<br/>or Group</b> | <b>Amount<br/>Owned</b> | <b>Percent<br/>of<br/>Class</b> | <b>Percent of<br/>Total<br/>Shares</b> |
|-----------------------|--|-------------------------|---------------------------------|--|
| Domestic Shares       | CEA Holding<br>HKSCC Nominees          | 3,000,000,000           | 90.91%                          | 61.64%                                 |
| H Shares              | Limited <sup>(1)</sup>                 | 1,468,833,363           | 93.74%                          | 30.18%                                 |

(1) As custodian of the Depositary for American Depositary Shares representing H Shares.

CEA Holding has held 61.64% of our issued and outstanding capital stock since its establishment in October 2002, and neither it nor HKSCC Nominees Limited has any voting rights different from those of other shareholders. We are not aware of any arrangement which may at a subsequent date result in a change of control of our company.

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As of December 31, 2003 and June 22, 2004, there were 1,566,950,000 H shares issued and outstanding. As of December 31, 2003 and June 22, 2004, there were, respectively, 77 and 74 registered holders of American depository receipts evidencing 1,097,660 and 1,200,040 ADSs. Since certain of the ADSs are held by nominees, the above number may not be representative of actual number of U.S. beneficial holders of ADSs or the number of ADSs beneficially held by U.S. persons.

Our company is currently a majority-owned subsidiary of CEA Holding. CEA Holding itself is a wholly state-owned enterprise under the administrative control of the CAAC. The CAAC has no direct shareholding or equity interest in our company or CEA Holding. CEA Holding's shareholding in our company is in the form of ordinary domestic shares, through which it, under the supervision of the CAAC, enjoys the shareholders' rights and benefits on behalf of the Chinese government.

### **B. Related Party Transactions**

#### **Relationship with the CAAC and its Affiliates**

We have from time to time conducted transactions, as described below, with the CAAC and its affiliates and may continue to do so.

(i) We pay take-off and landing fees to airports in China. For the years ended December 31, 2001, 2002 and 2003, we paid take-off and landing fees in China of approximately RMB937 million, RMB982 million and RMB1,373 million, respectively.

(ii) We purchase domestic aviation fuel from CAOSC at prices determined by the CAAC. For the years ended December 31, 2001, 2002 and 2003, we paid CAOSC approximately RMB1,739 million, RMB1,616 million and RMB2,129 million, respectively, in connection with purchases of the domestic aviation fuel.

(iii) We pay commissions to the CAAC and other Chinese airlines with respect to our air tickets sold by the CAAC's sales offices and such airlines at a rate of 3% for domestic tickets and 9% for international tickets of the price of the tickets sold. For the years ended December 31, 2001, 2002 and 2003, we paid commissions of approximately RMB52 million, RMB48 million and RMB41 million, respectively.

(iv) We receive commission income from other Chinese airlines in connection with their air tickets sold by us at a rate of 3% for domestic tickets and 9% for international tickets of the price of tickets sold. For the years ended December 31, 2001, 2002 and 2003, we received commission income of approximately RMB9.9 million, RMB6.5 million and RMB4.1 million, respectively.

(v) We pay domestic aviation infrastructure levies collected on behalf of the CAAC, which are calculated based on our annual gross traffic revenue. The total amounts of these levies collected by us on behalf of the CAAC were approximately RMB370 million, RMB431 million and RMB130 million as of December 31, 2001, 2002 and 2003, respectively. Certain of these levies remain payable to the CAAC. Those payables are unsecured, interest-free and have no fixed terms of repayment. See Note 35 to our consolidated financial statements for more details.

(vi) We pay insurance premium through the CAAC who entered into the insurance policy on behalf of our company. For the years ended December 31, 2001, 2002 and 2003, the total amounts of these payments were approximately RMB83 million, RMB179 million and RMB157 million, respectively.



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**Relationship With CEA Holding and Associated Companies**

We enter into transactions from time to time with CEA Holding and its subsidiaries.

*(A) Demerger Agreement*

EA Group and our company entered into a demerger agreement on April 14, 1995, or the Demerger Agreement, for the purpose of defining and allocating the assets and liabilities between EA Group and our company. To give effect to the intent and provisions of the Demerger Agreement, EA Group and our company have entered into a Supplemental Agreement to the Demerger Agreement, dated December 5, 1996, whereby the parties agreed to indemnify each other in respect of all claims arising from or in respect of the assets and liabilities which they have respectively assumed pursuant to the restructuring and by reference to the division of assets and liabilities determined as of January 1, 1994. After the establishment of CEA Holding in October 2002, CEA Holding has assumed the rights and liabilities of EA Group under the Demerger Agreement.

*(B) Related Business Transactions*

As our company and EA Group and its subsidiaries were a single group prior to the restructuring in 2002, certain arrangements among us have continued after the restructuring and the establishment of CEA Holding. Each of these agreements is non-exclusive, although we do not currently intend to enter into any equivalent contracts with third parties.

*(i) Eastern Aviation Import and Export Company, or EAIEC, a 55% owned subsidiary of CEA Holding.*

Our company and EAIEC have extended our agreement dated January 7, 1997 regarding the import and export of aircraft-related accessories, machinery and equipment for a term of ten years commencing from June 30, 1999. For the years ended December 31, 2001, 2002 and 2003, the amounts paid by us to EAIEC for the import and export of aircraft-related accessories, machinery and equipment were approximately RMB1,137 million, RMB3,435 million and RMB3,101 million, respectively, inclusive of handling charges of 0.1% to 2% above the contract prices paid to EAIEC.

We have certain balances with EAIEC, which are unsecured, interest-free and have no fixed terms of repayment. See Note 35 to our consolidated financial statements for more details.

*(ii) Eastern Aviation Advertising Service Company, or Eastern Advertising, a 55% owned subsidiary of CEA Holding.*

Our company and Eastern Advertising have extended our agreement dated December 30, 1996 regarding the provision of advertising services for a term of ten years commencing from June 30, 1999. For the years ended December 2001, 2002 and 2003, the amounts paid by us to Eastern Advertising for advertising services were approximately RMB7 million, RMB4.8 million and RMB2.7 million, respectively.

*(iii) Shanghai Eastern Air Catering Co. Ltd., or Eastern Catering, a 60% subsidiary of CEA Holding. The remaining 40% is owned by Hong Kong Shanghai Air Catering Co. Ltd., an independent third party.*

Our company and Eastern Catering have extended our agreement dated December 30, 1996 regarding the sale and purchase of in-flight meals for flights originating in Shanghai for a term of ten years



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commencing from June 30, 1999. For the years ended December 31, 2001, 2002 and 2003, the amounts paid by us to Eastern Catering for the supply of in-flight meals were approximately RMB101 million, RMB117 million and RMB97 million, respectively.

*(iv) Eastern Air Group Finance Co. Ltd., or Eastern Finance, which is 75% owned and controlled by CEA Holding and other subsidiaries of CEA Holding.*

Our company has extended our agreement with Eastern Finance dated January 8, 1997 regarding the provision of banking and other financial services such as credit facilities, financial guarantees and credit references for a term of ten years commencing from June 30, 1999. Pursuant to this agreement, we may place deposits with, and obtain loans from, Eastern Finance. We had short-term deposits placed with Eastern Finance as of December 31, 2001, 2002 and 2003 amounting to RMB281 million, RMB95 million and RMB214 million, respectively, which paid interest at the rates of 0.99% per annum, 0.72 per annum and 0.72 per annum, respectively.

Under this agreement, it has been agreed that (a) all funds that we deposit with Eastern Finance will be deposited by Eastern Finance with the Bank of Industry and Commerce, Bank of Communications, Bank of Agriculture, China Construction Bank or other banks of superior creditworthiness and (b) Eastern Finance will not at any time have outstanding loans to other subsidiaries in the CEA Holding in excess of the amount representing the aggregate of (i) deposits received from entities other than us, (ii) Eastern Finance's shareholders' equity and (iii) capital reserves.

*(v) Shanghai Eastern General Corporation, or Eastern General, a wholly-owned subsidiary of CEA Holding.*

Our company and Eastern General have extended our agreement dated December 31, 1996 regarding the provision of in-flight hygiene and cleaning services for a term of ten years commencing from June 30, 1999. For the years ended December 31, 2001, 2002 and 2003, the amounts paid by us to Eastern General for in-flight hygiene and cleaning services were approximately RMB15.3 million, RMB1.7 million and RMB20.6 million, respectively.

*(vi) Shanghai Eastern Air Industrial Corporation, or Eastern Industrial, a wholly-owned subsidiary of CEA Holding.*

Our company and Eastern Industrial have extended our agreement dated December 30, 1996 regarding the provision of maintenance services, cabin supplies and food and beverage supplies for a term of ten years commencing from June 30, 1999. For the years ended December 31, 2001, 2002 and 2003, the amounts paid by us to Eastern Industrial for such services were approximately RMB24 million, RMB35 million and RMB20 million, respectively.

*(vii) TravelSky, which is 33% owned by CEA Holding.*

We pay ticket reservation service charges to TravelSky, which is 33% owned by CEA Holding, in connection with our use of its computer reservation system. For the years ended December 31, 2001, 2002 and 2003, we paid ticket reservation service charges to TravelSky of approximately RMB56 million, RMB73 million and RMB72 million, respectively.

*(viii) Qilu Eastern Air Catering Co. Limited, or Qilu, a 65% subsidiary of CEA Holding.*

Our company and Qilu have extended our agreement dated December 31, 1996 regarding the sale and purchase of in-flight meals and beverages for flights originating in Shandong province for a term of ten

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years commencing from June 30, 1999. For the years ended December 31, 2001, 2002 and 2003, the amounts paid by us to Qilu for the purchase of in-flight meals and beverages were approximately RMB6 million, RMB9 million and RMB5 million, respectively.

*(ix) Shanghai Eastern Aviation Equipment Manufacturing Corporation, or SEAEMC, a wholly-owned subsidiary of CEA Holding.*

Our company and SEAEMC have extended our agreement dated December 31, 1996 regarding the sale and purchase of aviation equipment for a term of ten years commencing from June 30, 1999. SEAEMC was established in 1996. SEAEMC's predecessor was Shanghai Civil Aviation Maintenance and Engineering Company. For the years ended December 31, 2001, 2002 and 2003, the amounts paid by us to SEAEMC for the sale and purchase of aviation equipment were approximately RMB6 million, RMB8 million and RMB3 million, respectively.

### *(x) Ticket Sales*

We have entered into arrangements for the sale of our air tickets with several subsidiaries of CEA Holding. In accordance with the industry practice, we have not previously entered into any agreement with such companies in relation to the provision of such agency services. The agents charge a commission at a rate prescribed by the CAAC and the International Aviation Transportation Association, as applicable, for each of our air ticket sold, that is, 3% for domestic tickets and 9% for international tickets. In addition to these agents, we have other air ticket sales agents in China who charge the same amount of commission. These agents also act as air ticket sales agents for other Chinese airlines and charge the same rates of commission as in our case.

### *(C) Leases*

Our company and EA Group had entered into an office lease agreement dated January 7, 1997 in respect of office premises located at 2550 Hong Qiao Road, Shanghai, China. The lease term is one year and renewable by the parties, subject to mutual agreement with respect to rental terms. The total rental payment is approximately RMB158,342 per month. In addition, our company and EA Group had entered into a staff dormitory lease agreement dated December 31, 1996, pursuant to which EA Group had agreed to enter into lease arrangements with our employees for dormitories in Shanghai, Anhui Province, Shandong Province and Jiangxi Province. The term of the lease and the rental payments are set in accordance with Chinese regulations and the rate prescribed by the Shanghai Municipal Government. CEA Holding has assumed EA Group's rights and liabilities under those lease agreements after its establishment.

## **C. Interests of Experts & Counsel**

Not applicable.

## **Item 8. Financial Information.**

### **A. Financial Statements**

You should read **Item 18-Financial Statements** for information regarding our consolidated financial statements and other financial information.

**Table of Contents****B. Legal Proceedings**

We are involved in routine litigation and other proceedings in the ordinary course of our business. We do not believe that any of these proceedings are likely to be material to our business operations, financial condition or results of operations. We are not aware of any material proceedings currently pending against our company.

**C. Dividends and Dividend Policy**

With respect to the fiscal year ended December 31, 2001, our shareholders' meeting approved the payment of a cash dividend of RMB0.02 per share (including tax). For the fiscal year ended December 31, 2002 and 2003, our board of directors recommended no dividend. The declaration and payment of dividends for years following 2003 will depend upon our financial results, our shareholders' interests, general business conditions and strategies, our capital requirements, contractual restrictions on the payment of dividends by us to our shareholders, and other factors our directors may deem relevant. Holders of our H shares will receive the equivalent amount of cash dividend declared in Renminbi, if any, based on the foreign exchange conversion rate published by the People's Bank of China, or PBOC, on the date of the distribution of the cash dividend.

**D. Significant Post Financial Statements Events**

In February 2004, our company contributed 2,450,000 U.S. dollars to the registered capital of Collins Aviation Maintenance Service Shanghai Limited pursuant to the joint venture agreement with Rockwell Collins International Inc. entered into by the parties in September 2002. Collins Aviation Maintenance Service Shanghai Limited is a joint venture principally engaged in the provision of repair and maintenance services for avionics and aircraft entertaining facilities in the PRC. The registered capital of the joint venture is RMB57,943,000. Our company and Rockwell Collins International Inc. hold a 35% and 65% equity interest in the joint venture, respectively.

**Item 9. The Offer and Listing.**

The principal trading market for our H shares is the Hong Kong Stock Exchange. The ADSs, each representing 100 H shares, have been issued by The Bank of New York as the Depositary and are listed on the New York Stock Exchange under the symbol "CEA". Prior to our initial public offering and subsequent listings on the New York Stock Exchange and the Hong Kong Stock Exchange on February 4 and 5, 1997, respectively, there was no market for our H shares or ADSs.

The table below sets forth certain market information relating to our H shares and ADSs in respect of the period from February 4, 1997 to May 31, 2004.

|                     | Price per H Share<br>(HK\$) |      | Price per ADS<br>(US\$) |       |
|---------------------|-----------------------------|------|-------------------------|-------|
|                     | High                        | Low  | High                    | Low   |
| 1999                | 1.21                        | 0.39 | 15.44                   | 5.00  |
| 2000                | 1.62                        | 0.68 | 20.00                   | 8.50  |
| 2001                | 1.41                        | 0.66 | 17.75                   | 8.75  |
| First Quarter 2002  | 1.18                        | 0.98 | 14.53                   | 12.50 |
| Second Quarter 2002 | 1.40                        | 1.20 | 17.66                   | 13.50 |

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|                     |      |      |       |       |
|---------------------|------|------|-------|-------|
| Third Quarter 2002  | 1.48 | 1.02 | 18.50 | 13.05 |
| Fourth Quarter 2002 | 1.08 | 0.80 | 13.60 | 11.00 |
| 2002                | 1.48 | 0.80 | 18.50 | 11.00 |
| First Quarter 2003  | 1.15 | 0.88 | 14.37 | 11.60 |

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|                     | Price per H Share<br>(HK\$) |      | Price per ADS<br>(US\$) |       |
|---------------------|-----------------------------|------|-------------------------|-------|
|                     | High                        | Low  | High                    | Low   |
| Second Quarter 2003 | 1.12                        | 0.74 | 14.39                   | 9.6   |
| Third Quarter 2003  | 1.27                        | 0.95 | 15.65                   | 12.5  |
| Fourth Quarter 2003 | 1.39                        | 1.14 | 18.33                   | 15.01 |
| December 2003       | 1.38                        | 1.29 | 18.01                   | 16.97 |
| January 2004        | 1.48                        | 1.28 | 19.22                   | 17.38 |
| February 2004       | 1.84                        | 1.31 | 23.22                   | 17.03 |
| March 2004          | 1.74                        | 1.36 | 22.49                   | 17.83 |
| April 2004          | 1.63                        | 1.35 | 21.27                   | 17.82 |
| May 2004            | 1.64                        | 1.28 | 20.28                   | 16.74 |

As of December 31, 2003 and June 22, 2004, there were 1,566,950,000 H shares issued and outstanding. As of December 31, 2003 and June 22, 2004, there were, respectively, 77 and 74 registered holders of American depositary receipts evidencing 1,097,660 and 1,200,040 ADSs. Since certain of the ADSs are held by nominees, the above number may not be representative of actual number of U.S. beneficial holders of ADSs or the number of ADSs beneficially held by U.S. persons. The depository for the ADSs is The Bank of New York. A total of 3,300,000,000 domestic shares were also outstanding as of June 22, 2004. As domestic shares can only be held by Chinese domestic investors, there were no non-Chinese holders of record.

**Item 10. Additional Information.****A. Share Capital**

Not applicable.

**B. Memorandum and Articles of Association**

The section entitled Description of Capital Stock contained in our registration statement on Form F-1 (File No. 333-6260) filed with the Securities and Exchange Commission is hereby incorporated by reference.

**C. Material Contracts**

For a summary of any material contract entered into by our company or any of its consolidated subsidiaries outside of the ordinary course of business during the last two years, see Item 4. Information on the Company, Item 5. Operating and Financial Review and Prospects and Item 7. Major shareholders and Related Party Transactions. In addition, we also entered into an aircraft purchase agreement with Airbus, as the seller, and EAIEC, as the import agent, on March 26, 2002, which was filed as an exhibit to our 20-F annual report for the year ended December 31, 2001.

**D. Exchange Controls**

Renminbi currently is not a freely convertible currency. SAFE, under the authority of PBOC, controls the conversion of Renminbi into foreign currency. Prior to January 1, 1994, Renminbi could be converted to foreign currency through the Bank of China or other authorized institutions at official rates fixed daily by SAFE. Renminbi could also be converted at swap centers open to Chinese enterprises and foreign invested enterprises, or FIEs, subject

to SAFE approval of each foreign currency trade, at exchange rates negotiated by the parties for each transaction. Effective January 1, 1994, a unitary exchange rate system was introduced in China, replacing the dual-rate system previously in effect. In connection with the creation of a unitary exchange rate, the Chinese government announced the establishment of an inter-bank



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foreign exchange market, the China Foreign Exchange Trading System, or CFETS, and the phasing out of the swap centers. Effective December 1, 1998, the swap centers were abolished by the Chinese government.

In general, under existing foreign exchange regulations, domestic enterprises operating in China must price and sell their goods and services in China in Renminbi. Any foreign exchange received by such enterprises must be sold to authorized foreign exchange banks in China. A significant portion of our revenue and operating expenses are denominated in Renminbi, while a portion of our revenue, capital expenditures and debts are denominated in U.S. dollars and other foreign currencies. Renminbi is currently freely convertible under the current account, which includes dividends, trade and service-related foreign currency transactions, but not under the capital account, which includes foreign direct investment, unless the prior approval of the SAFE, is obtained. As a foreign investment enterprise approved by the MOC, we can purchase foreign currency without the approval of SAFE for settlement of current account transactions, including payment of dividends, by providing commercial documents evidencing these transactions. We can also retain foreign exchange in our current accounts, subject to a maximum amount approved by SAFE, to satisfy foreign currency liabilities or to pay dividends. However, the relevant Chinese government authorities may limit or eliminate our ability to purchase and retain foreign currencies in the future. Foreign currency transactions under the capital account are still subject to limitations and require approvals from SAFE. This may affect our ability to obtain foreign exchange through debt or equity financing, including by means of loans or capital contributions. We cannot assure you that we will be able to obtain sufficient foreign exchange to pay dividends or satisfy our foreign exchange liabilities.

### **E. Taxation**

The taxation of income and capital gains of holders of H shares or ADSs is subject to the laws and practices of China and of jurisdictions in which holders of H shares or ADSs are resident or otherwise subject to tax. The following summary of certain relevant taxation provisions is based on current law and practice, is subject to change and does not constitute legal or tax advice. The discussion does not deal with all possible tax consequences relating to an investment in the H shares or ADSs. In particular, the discussion does not address the tax consequences under state, local and other laws, such as non-U.S. federal laws. Accordingly, you should consult your own tax adviser regarding the tax consequences of an investment in the H shares and ADSs. The discussion is based upon laws and relevant interpretations in effect as of the date of this annual report, all of which are subject to change.

#### **Taxation Hong Kong**

The taxation of income and capital gains of holders of ordinary shares or ADSs is subject to the laws and practices of Hong Kong and of jurisdictions in which holders of ordinary shares or ADSs are resident or otherwise subject to tax. The following summary of certain relevant taxation provisions under Hong Kong law is based on current law and practice, is subject to changes therein and does not constitute legal or tax advice. The discussion does not deal with all possible tax consequences relating to an investment in the ordinary shares or ADSs. Accordingly, each prospective investor (particularly those subject to special tax rules, such as banks, dealers, insurance companies, tax-exempt entities and holders of 10% or more of our voting capital stock) should consult its own tax advisor regarding the tax consequences of an investment in the ordinary shares and ADSs. The discussion is based upon laws and relevant interpretations thereof in effect as of the date of this annual report, all of which are subject to change.

##### ***Tax on Dividends***

Under the current practices of the Hong Kong Inland Revenue Department, no tax is payable in Hong Kong in respect of dividends received by the recipient.



**Table of Contents*****Profits Tax***

No tax is imposed in Hong Kong in respect of capital gains from the sale of property (such as the H shares and ADSs). Trading gains from the sale of property by persons carrying on a trade, profession or business in Hong Kong where such gains are derived from or arise in Hong Kong from such trade, profession or business will be chargeable to Hong Kong profits tax which is currently imposed at the rate of 17.5% on corporations and on individuals at a maximum rate of 16.0% with effect from April 1, 2004. Gains from sales of the ordinary shares effected on the Hong Kong Stock Exchange may be considered to be derived from or arise in Hong Kong. Liability for Hong Kong profits tax may thus arise in respect of trading gains from sales of ordinary shares or ADSs realized by persons carrying on a business of trading or dealing in securities in Hong Kong.

***Stamp Duty***

Hong Kong stamp duty, currently charged at the rate of HK\$1 per HK\$1,000 or part thereof on the higher of the consideration for or the value of the ordinary shares, will be payable by the purchaser on every purchase and by the seller on every sale of ordinary shares (i.e., a total of HK\$2 per HK\$1,000 or part thereof is currently payable on a typical sale and purchase transaction involving ordinary shares). In addition, a fixed duty of HK\$5 is currently payable on any instrument of transfer of ordinary shares. The withdrawal of ordinary shares upon the surrender of ADSs, and the issuance of ADSs upon the deposit of ordinary shares, will also attract stamp duty at the rate described above for sale and purchase transactions unless the withdrawal or deposit does not result in a change in the beneficial ownership of the ordinary shares under Hong Kong law, in which case only a fixed duty of HK\$5 is payable on the transfer. The issuance of the ADSs upon the deposit of ordinary shares issued directly to the depository or for the account of the depository does not attract stamp duty. No Hong Kong stamp duty is payable upon the transfer of ADSs outside Hong Kong.

***Estate Duty***

The ordinary shares are Hong Kong property under Hong Kong law, and accordingly such ordinary shares may be subject to estate duty on the death of the beneficial owner of the ordinary shares (regardless of the place of the owner's residence, citizenship or domicile). Hong Kong estate duty is imposed on a progressive scale from 5% to 15%. The rate of and the threshold for estate duty has, in the past, been adjusted on a fairly regular basis. No estate duty is payable when the aggregate value of the dutiable estate does not exceed HK\$7.5 million, and the maximum rate of duty of 15% applies when the aggregate value of the dutiable estate exceeds HK\$10.5 million.

**Taxation China**

The following is a general summary of certain Chinese tax consequences of the acquisition, ownership and disposition of the H Shares and ADSs. This summary does not purport to address all material tax consequences of the ownership of Shares or ADSs, and does not take into account the specific circumstances of any particular investors. This summary is based on the tax laws of China as in effect on the date of this annual report, as well as on the U.S.-China Treaty, all of which are subject to change (or changes in interpretation), possibly with retroactive effect.

In general, and taking into account the earlier assumptions, for Chinese tax purposes, holders of ADRs evidencing ADSs will be treated as the owners of the H Shares represented by those ADSs, and exchanges of H Shares for ADSs, and ADSs for H Shares, will not be subject to Chinese tax.

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### **Taxation of Dividends by China**

*Individual Investors.* The Provisional Regulations of China Concerning Questions of Taxation on Enterprises Experimenting with the Share System, or the Provisional Regulations, provide that dividends from Chinese companies are ordinarily subject to a Chinese withholding tax levied at a flat rate of 20%. However, the Chinese State Tax Bureau issued, on July 21, 1993, a Notice Concerning the Taxation of Gains on Transfer and Dividends from Shares (Equities) Received by Foreign Investment Enterprises, Foreign Enterprises and Foreign Individuals, or the Tax Notice, which provides that dividends from a Chinese company on shares listed on an overseas stock exchange, or Overseas Shares, such as H Shares (including H Shares represented by ADSs), would not be subject to Chinese withholding tax. The relevant tax authority has not collected withholding tax on dividend payments on Overseas Shares.

Amendments to the individual Income Tax Law of the PRC, or the Amendments, were promulgated on October 31, 1993 and became effective on January 1, 1994. The Amendments provide that any provisions of prior administrative regulations concerning individual income tax which contradict the Amendments are superseded by the Amendments. The Amendments and the amended Individual Income Tax Law can be interpreted to mean that foreign individuals are subject to a withholding tax on dividends received from a Chinese company at a rate of 20% unless such income is specifically exempted from individual income tax by the financial authority of the State Council. However, in a letter dated July 26, 1994 to the State Commission for Restructuring the Economic System, the State Securities Commission and the China Securities Regulatory Commission, the State Tax Bureau confirmed the temporary tax exemption set forth in the Tax Notice for dividends received from a Chinese company listed overseas. In the event this letter is withdrawn, a 20% tax may be withheld on dividends in accordance with the Provisional Regulations, the Amendments, and the Individual Income Tax law of China. Such withholding tax may be reduced pursuant to an applicable double taxation treaty.

*Enterprises.* The Provisional Regulations provide that dividends from Chinese companies are ordinarily subject to a Chinese withholding tax levied at a flat rate of 20%. However, according to the Tax Notice, a foreign enterprise with no permanent establishment in China receiving dividends paid on a Chinese company's Overseas Shares temporarily will not be subject to the 20% withholding tax. If such withholding tax becomes applicable in the future, the rate could be reduced or eliminated pursuant to an applicable double taxation treaty.

*Tax Treaties.* Non-Chinese investors resident in countries which have entered into double-taxation treaties with China may be entitled to a reduction of the withholding tax imposed on the payment of dividends to non-Chinese investors of our company. China currently has double-taxation treaties with a number of other countries, including Australia, Canada, France, Germany, Japan, Malaysia, the Netherlands, Singapore, the United Kingdom and the United States.

Under the U.S.-China Treaty, China may tax a dividend paid by our company to a U.S. holder of H shares or ADSs only up to a maximum of 10% of the gross amount of such dividend.

### **Taxation of Capital Gains by China**

The Tax Notice provides that gains realized upon the sale of Overseas Shares are not subject to taxes on capital gains. Although the Ministry of Finance has been empowered to collect a tax of 20% on gains derived from the sale of equity shares, a joint notice issued in March 1996 by the Ministry of Finance and the State Tax Bureau indicated that no capital gains tax would be imposed on gains from the sale of shares until the Ministry of Finance and the State Tax Bureau promulgate new rules. Therefore, during 1996 to 2001, holders of H Shares or ADSs were not subject to taxation on gains realized upon the sale or



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disposition of such shares. After 2001, holders of H Shares or ADSs could become subject to a 20% capital gains tax, unless reduced or eliminated pursuant to an applicable double taxation treaty.

Under the U.S.-China Treaty, China may only tax gains from the sale or disposition by a U.S. holder of H shares or ADSs representing an interest in the company of 25% or more.

***Chinese Stamp Tax***

Chinese stamp tax imposed on the transfer of shares of Chinese publicly traded companies under the Share System Tax Regulations should not apply to the acquisition or disposition by non-Chinese investors of H Shares or ADSs outside of China by virtue of the Provisional Regulations of The People's Republic of China Concerning Stamp Tax, which provides that Chinese stamp tax is imposed only on documents executed or received within China or that should be considered as having been executed or received within China.

**United States Federal Income Taxation.**

***United States Federal Income Taxation***

This section describes the material United States federal income tax consequences of the acquisition, ownership and disposition of H shares or ADSs. It applies to you only if you are a U.S. holder, as described below, and you hold your H shares or ADSs as capital assets for United States federal income tax purposes. This section does not apply to you if you are a member of a special class of holders subject to special rules, including:

- a bank;
- a dealer in securities or currencies;
- a trader in securities that elects to use a mark-to-market method of accounting for your securities holdings;
- a tax-exempt organization;
- an insurance company;
- a person liable for alternative minimum tax;
- a person that actually or constructively owns 10% or more of our voting stock;
- a person that holds H shares or ADSs that are a hedge or that are hedged against currency risks or as part of a straddle or a conversion transaction; or

a U.S. holder (as defined below) whose functional currency is not the U.S. dollar.

This section is based on the Internal Revenue Code of 1986, as amended, its legislative history, existing and proposed regulations, published rulings and court decisions, all as currently in effect. These laws are subject to change, possibly on a retroactive basis. In addition, this section is based in part upon the representations of the Depositary and the assumption that each obligation in the deposit agreement and any related agreement will be performed in accordance with its terms.

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You are a U.S. holder if you are a beneficial owner of H shares or ADSs and you are:

a citizen or resident of the United States;

a domestic corporation;

an estate whose income is subject to United States federal income tax regardless of its source; or

a trust if a United States court can exercise primary supervision over the trust's administration and one or more United States persons are authorized to control all substantial decisions of the trust.

You are a non-U.S. holder if you are beneficial owner of H shares or ADSs and are, for United States federal income tax purposes:

a nonresident alien individual;

a foreign corporation; or

a foreign partnership.

You should consult your own tax advisor regarding the United States federal, state and local tax consequences of owning and disposing of H shares and ADSs in your particular circumstances.

This discussion addresses only United States federal income taxation.

In general, and taking into account the earlier assumptions, for United States federal income tax purposes, if you hold ADRs evidencing ADSs, you will be treated as the owner of H shares represented by those ADSs. Exchanges of H shares for ADSs, and ADSs for H shares, generally will not be subject to United States federal income tax.

***Taxation of Dividends***

*U.S. Holders.* Under the United States federal income tax laws, and subject to the passive foreign investment company, or PFIC, rules discussed below, if you are a U.S. holder, you must include in your gross income the gross amount of any dividend paid by us out of our current or accumulated earnings and profits (as determined for United States federal income tax purposes). If you are a noncorporate U.S. holder, dividends paid to you in taxable years beginning before January 1, 2009 that constitute qualified dividend income will be taxable to you at a maximum rate of 15% provided that you hold H shares or ADSs for more than 60 days during the 120-day period beginning 60 days before the ex-dividend date and meet other holding period requirements. On February 19, 2004, the IRS announced that it will permit taxpayers to apply a proposed legislative change to the holding period requirement described in the preceding sentence as if such change were already effective. This legislative technical correction would change the minimum required holding period, retroactive to January 1, 2003, to more than 60 days during the 121-day period beginning 60 days before the ex-dividend date. Dividends we pay with respect to H shares or ADSs generally will be qualified dividend income. You must include any Chinese tax withheld from the dividend payment in this gross amount even though you do not in fact receive it. You must include the dividend in income when you, in the case of H shares, or the depository, in the case of ADSs, receive the dividend, actually or constructively. The dividend will not be eligible for the dividends-received deduction generally

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allowed to United States corporations in respect of dividends received from other United States corporations.

The amount of the dividend distribution that you must include in your income as a U.S. holder will be the U.S. dollar value of the Hong Kong Dollar payments made, determined at the Hong Kong dollar/U.S. dollar spot rate on the date the dividend distribution is includible in your income, regardless of whether the payment is in fact converted into U.S. dollars. Generally, any gain or loss resulting from currency exchange fluctuations during the period from the date you include the dividend payment in income to the date you convert the payment into U.S. dollars will be treated as ordinary income or loss. The gain or loss generally will be income from sources within the United States for foreign tax credit limitation purposes. Distributions in excess of current and accumulated earnings and profits, as determined for United States federal income tax purposes, will be treated as a non-taxable return of capital to the extent of your basis in the H shares or ADSs and thereafter as capital gain.

Dividends will be income from sources outside the United States, but generally will be passive income or financial services income, which is treated separately from other types of income for purposes of computing the foreign tax credit allowable to you.

The rules relating to foreign tax credits are extremely complex and the availability of a foreign tax credit depends on numerous factors. You should consult with your own tax advisor concerning the application of the U.S. foreign tax credit rules to your particular situation.

*Non-U.S. Holders.* If you are a non-U.S. holder, dividends paid to you in respect of H shares or ADSs will not be subject to United States federal income tax unless the dividends are effectively connected with your conduct of a trade or business within the United States and the dividends are attributable to a permanent establishment that you maintain in the United States if that is required by an applicable income tax treaty as a condition for subjecting you to United States taxation on a net income basis. In such cases you generally will be taxed in the same manner as a U.S. holder. If you are a corporate non-U.S. holder, effectively connected dividends may, under certain circumstances, be subject to an additional branch profits tax at a 30% rate or at a lower rate if you are eligible for the benefits of an income tax treaty that provides for a lower rate.

***Taxation of Capital Gains***

*U.S. Holders.* Subject to the PFIC rules discussed below, if you are a U.S. holder and you sell or otherwise dispose of your H shares or ADSs, you will recognize capital gain or loss for United States federal income tax purposes equal to the difference between the U.S. dollar value of the amount that you realize and your tax basis, determined in U.S. dollars, in your H shares or ADSs. Capital gain of a noncorporate U.S. holder is generally eligible for a reduced rate of taxation. The gain or loss will generally be income or loss from sources within the United States for foreign tax credit limitation purposes. Your ability to deduct capital losses is subject to limitations. Any Hong Kong stamp duty that you pay will not be a creditable tax for United States federal income tax purposes, but you may be able to deduct such stamp duty subject to limitations under the Code.

*Non-U.S. Holders.* If you are a non-U.S. holder, you will not be subject to United States federal income tax on gain recognized on the sale or other disposition of your H shares or ADSs unless:

the gain is effectively connected with your conduct of a trade or business in the United States and the gain is attributable to a permanent establishment that you maintain in the United States if that is required by an applicable income tax treaty as a condition for subjecting you to United States taxation on a net income basis,  
or



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you are an individual, you are present in the United States for 183 or more days in the taxable year of the sale and certain other conditions exist.

If you are a corporate non-U.S. holder, effectively connected gains that you recognize may also, under certain circumstances, be subject to an additional branch profits tax at a 30% rate or at a lower rate if you are eligible for the benefits of an income tax treaty that provides for a lower rate.

*PFIC Rules.* We believe that we should not be treated as a PFIC for United States federal income tax purposes, but this conclusion is a factual determination that is made annually and thus may be subject to change.

In general, if you are a U.S. holder, we will be a PFIC with respect to you if for any taxable year in which you held your H shares or ADSs:

at least 75% of our gross income for the taxable year is passive income; or

at least 50% of the value, determined on the basis of a quarterly average, of our assets is attributable to assets that produce or are held for the production of passive income.

Passive income generally includes dividends, interest, royalties, and rents (not including certain rents and royalties derived in the active conduct of a trade or business), annuities and gains from assets that produce passive income. If a foreign corporation owns directly or indirectly at least 25% by value of the stock of another corporation, the foreign corporation is treated for purposes of the PFIC tests as owning its proportionate share of the assets of the other corporation, and as receiving directly its proportionate share of the other corporation's income.

If we are treated as a PFIC, and you are a U.S. holder that does not make a mark-to-market election, as described below, you will be subject to special rules with respect to:

any gain you realize on the sale or other disposition of your H shares or ADSs; and

any excess distribution that we make to you (generally, any distribution to you during a single taxable year that is greater than 125% of the average annual distributions received by you in respect of the H shares or ADSs during the three preceding taxable years or, if shorter, your holding period for the H shares or ADSs).

Under these rules:

the gain or excess distribution will be allocated ratably over your holding period for the H shares or ADSs;

the amount allocated to the taxable year in which you realized the gain or excess distribution will be taxed as ordinary income;

the amount allocated to each prior year, with certain exceptions, will be taxed at the highest tax rate in effect for that year; and

the interest charge generally applicable to underpayments of tax will be imposed in respect of the tax attributable to each such year.



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Special rules apply for calculating the amount of the foreign tax credit with respect to excess distributions by a PFIC.

If you own H shares or ADSs in a PFIC that are treated as marketable stock, you may make a mark-to-market election. If you make this election, you will not be subject to the PFIC rules described above. Instead, in general, you will include as ordinary income each year the excess, if any, of the fair market value of your H shares or ADSs at the end of the taxable year over your adjusted basis in your H shares or ADSs. You will also be allowed to take an ordinary loss in respect of the excess, if any, of the adjusted basis of your H shares or ADSs over their fair market value at the end of the taxable year (but only to the extent of the net amount of previously included income as a result of the mark-to-market election). Your basis in the H shares or ADSs will be adjusted to reflect any such income or loss amounts. In addition, notwithstanding any election you make with regard to H shares or ADSs, dividends that you receive from us will not constitute qualified dividend income to you if we are a PFIC either in the taxable year of the distribution or the preceding taxable year. Dividends that you receive that do not constitute qualified dividend income are not eligible for taxation at the 15% maximum rate applicable to qualified dividend income. Instead, you must include the gross amount of any such dividend paid by us out of our accumulated earnings and profits (as determined for United States federal income tax purposes) in your gross income, and it will be subject to tax at rates applicable to ordinary income.

If you own H shares or ADSs during any year that we are a PFIC, you must file Internal Revenue Service Form 8621.

### **F. Dividends and Paying Agents**

Not applicable.

### **G. Statement by Experts**

Not applicable.

### **H. Documents on Display**

You may read and copy documents referred to in this annual report on Form 20-F that have been filed with the U.S. Securities and Exchange Commission at the SEC's public reference room located at 450 Fifth Street, NW, Washington, D.C. 20549. Please call the SEC at 1-800-SEC-0330 for further information on the public reference rooms and their copy charges. The SEC also maintains a web site at <http://www.sec.gov> that contains reports, proxy statements and other information regarding registrants that file electronically with the SEC.

The SEC allows us to incorporate by reference the information we file with the SEC. This means that we can disclose important information to you by referring you to another document filed separately with the SEC. The information incorporated by reference is considered to be part of this annual report on Form 20-F.

### **I. Subsidiary Information**

Not applicable.

**Table of Contents****Item 11. Quantitative and Qualitative Disclosures About Market Risk.****Interest Rate Risk**

The interest rates of our loans are fixed and therefore the risk of fluctuation of interest rates is not significant. However, the fluctuation of the interest rates would affect the estimated fair value of our long-term and other loans as of December 31, 2003. We use interest rate swaps to reduce risks related to changes in market interest rates. As of December 31, 2003, the notional amount of the outstanding interest rate swap agreements was approximately US\$164 million. These interest rate swap agreements will expire between 2004 and 2010. The carrying amounts, the estimated fair value and the effect as a result of the change of the average interest rate on our long-term and other loans as of December 31, 2003 are set forth as follows:

|  | <b>RMB 000</b> |
|--|----------------|
| Carrying amounts   | 11,222,923     |
| Estimated fair value   | 10,131,805     |
| Decrease in the estimated fair value resulting from an increase of the average interest rate by 1% | 221,015        |
| Increase in the estimated fair value resulting from a decrease of the average interest rate by 1%  | 232,702        |

**Foreign Currency Exchange Rate Risk**

Although we derive most of our income from China in Renminbi, our financial lease obligations as well as certain bank loans are denominated in US dollars, Japanese yen or Euro. Pursuant to current foreign exchange regulations in China, we may retain our foreign currency earnings generated from ticket sales made in our overseas offices subject to the approval of SAFE, which are generally sufficient to satisfy our foreign currency liabilities payable within one year. We use forward contracts to reduce risks related to changes in currency exchange rates in respect of ticket sales and expenses denominated in foreign currencies. These currency forward contracts will expire between 2004 and 2010.

Pursuant to IFRS, our monetary assets and liabilities denominated in foreign currencies are required to be translated into Renminbi at the year end at exchange rates announced by PBOC. Any fluctuation of the exchange rates between Renminbi and foreign currencies may materially adversely affect our financial condition and results of operations. China adopts a floating rate exchange system with control. The exchange rate between Renminbi and US dollars had been comparatively stable in the past. However, the exchange rate between Renminbi and Japanese yen or Euro had experienced a significant level of fluctuation over the past two years. This is the major reason for the significant exchange loss recognized by our company for the year ended December 31, 2003. The following table shows the effect on our profit and loss account as a result of the impact on our non-Renminbi denominated monetary assets and liabilities as of December 31, 2003 as a consequence of a fluctuation in value of the following major foreign currencies.

|   | <b>Profit and Loss<br/>Account<br/>Decrease/increase by<br/>RMB 000</b> |
|---|---|
| US dollar appreciates/ (depreciates) by 1%    | 33,211  |
| Japanese yen appreciates/ (depreciates) by 1% | 4,827   |

Euro appreciates/ (depreciates) by 1%

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**Item 12. Description of Securities Other than Equity Securities.**

Not applicable.

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**PART II**

**Item 13. Defaults, Dividend Arrearages and Delinquencies.**

None.

**Item 14. Material Modifications to the Rights of Security Holders and Use of Proceeds.**

**Material Modifications to the Rights of Security Holders**

At our annual general shareholders meeting held on June 18, 2004 in Shanghai, China, resolutions with respect to amendments to our articles of association have been passed.

*Amendments to Article 65.* Pursuant to the amendments, if a shareholder is a recognized clearing house within the meaning of the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong) and any amendments thereto or re-enactment thereof, it may authorise such person or persons as it thinks fit to act as its representative (or representatives) at any shareholders general meeting or any meeting of any class of shareholders provided that, if more than one person is so authorised, the authorisation must specify the number and class of shares in respect of which each such person is so authorised. The person so authorised will be entitled to exercise the same power on behalf of the recognised clearing house as that clearing house (or its nominees) could exercise if it were an individual shareholder of our company.

*New Article 70(A).* This new article provides that directors will be elected at shareholders general meetings through cumulative voting. When directors are elected through cumulative voting at shareholders general meetings, the number of total votes that a shareholder can exercise is the product of (i) the number of shares held by such shareholder, and (ii) the number of directors to be elected. A shareholder can give all his or her votes to one director candidate or divide his or her votes among several director candidates. Directors are elected at the shareholders general meetings based on the number of votes the director candidates receive.

*Amendments to Article 71 and Article 90.* Pursuant to the amendments, if any shareholder (including his or her proxy) who is required under relevant rules governing the listing of securities to abstain from voting on any particular resolution or is restricted to vote only for or against any particular resolutions fails to comply with any such requirement or restriction, his or her vote shall not be counted towards the voting results.

*Amendments to Article 95.* Pursuant to the amendments, the director candidates shall be nominated by the board of directors or shareholders. The notice of nomination of directors and the notice by a director candidate of his or her willingness to be elected shall be given to and lodged with our company on, at the earliest, the day after the despatch of the relevant notice of shareholders general meeting appointed for the election and seven days before the date of the shareholders general meeting.

**Table of Contents****Use of Proceeds**

Not applicable.

**Item 15. Controls and Procedures.**

Our President and Chief Financial Officer have evaluated the effectiveness of our company's disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, as amended) as of the end of the period covered by this annual report. They have concluded that, as of the date of evaluation, our company's disclosure controls and procedures were effective to ensure that material information relating to the company was made known to them by others within our company.

**Item 16A. Audit Committee Financial Expert.**

Our board of directors has determined that Mr. Xie Rong, the chairman of our audit committee, is the independent financial expert serving on our audit committee.

**Item 16B. Code of Ethics**

We have adopted a code of ethics that applies to our directors, supervisors, President, Chief Financial Officer and other senior managers of our company. We have filed this code of ethics as an exhibit to this annual report.

**Item 16C. Principal Accountant Fees and Services**

The following table sets forth the aggregate audit fees, audit-related fees, tax fees of our principal accountants and all other fees billed for products and services provided by our principal accountants other than the audit fees, audit-related fees and tax fees for each of the two years ended December 31, 2003:

|      | <u>Audit Fees</u> | <u>Audit-Related Fees</u> | <u>Tax Fees</u> | <u>Other Fees</u> |
|------|-------------------|---------------------------|-----------------|-------------------|
|      | (RMB)             | (RMB)                     | (RMB)           | (RMB)             |
| 2002 | 5,374,200         | 0                         | 0               | 0                 |
| 2003 | 5,674,200         | 0                         | 0               | 0                 |

Before our principal accountants were engaged by our company or our subsidiaries to render audit or non-audit services, the engagement was approved by our audit committee.

**Item 16D. Exemptions from the Listing Standards for Audit Committees.**

Not applicable.

**Item 16E. Purchase of Equity Securities by the Issuer and Affiliated Purchasers.**

Not applicable.

**PART III**

**Item 17. Financial Statements.**

We have elected to provide the financial statements and related information specified in Item 18 in lieu of Item 17.

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**Item 18. Financial Statements.**

Reference is made to pages F-1 to F-58.

**Item 19. Exhibits.**

(a) See Item 18 for a list of the financial statements filed as part of this annual report.

(b) Exhibits to this annual report:

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**Table of Contents****Exhibit Index**

| <b>Exhibits</b> | <b>Description</b>  |
|-----------------|---|
| 1.1             | Articles of Association (English translation).  |
| 2.1             | Specimen Certificate for the H Shares. <sup>(1)</sup>   |
| 2.2             | Form of Deposit Agreement among the Registrant, The Bank of New York, as depositary, and Owners and Beneficial Owners from time to time of American Depositary Receipts. <sup>(2)</sup> |
| 4.1             | Office Space Lease Agreement between the Company and Eastern Air Group Company (together with English translation). <sup>(1)</sup>  |
| 4.8             | Employee Housing Lease Agreement between the Company and Eastern Air Group Company (together with English translation). <sup>(1)</sup>  |
| 8.1             | List of subsidiaries of the Registrant.   |
| 11.1            | Code of Ethics (English translation).   |
| 12.1            | Certification of President pursuant to Rule 13a-14(a).  |
| 12.2            | Certification of CFO pursuant to Rule 13a-14(a).  |
| 13.1            | Certification of President pursuant to Rule 13a-14(b).  |
| 13.2            | Certification of CFO pursuant to Rule 13a-14(b).  |

(1) Incorporated by reference to our Registration Statement on Form F-1 (File No. 333-6260), filed with the Securities and Exchange Commission on January 9, 1997.

(2) Incorporated by reference to our Registration Statement on Form F-6 (File No. 333-6284), filed with the Securities and Exchange Commission with respect to American Depositary Shares representing our H shares.

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**SIGNATURES**

The registrant hereby certifies that it meets all of the requirements for filing on Form 20-F and that it has duly caused and authorized the undersigned to sign this annual report on its behalf.

CHINA EASTERN AIRLINES CORPORATION  
LIMITED

By: /s/ Ye Yigan  
Name: Ye Yigan  
Title: Chairman of the Board of Directors

Date: June 28, 2004

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**INDEX TO CONSOLIDATED FINANCIAL STATEMENTS**

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| Consolidated Statements of Income for the years ended December 31, 2001, 2002 and 2003                    | F-2                |
| Consolidated Balance Sheets as of December 31, 2002 and 2003  | F-3                |
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| Notes to the Consolidated Financial Statements  | F-7                |

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**REPORT OF INDEPENDENT AUDITORS**

The Board of Directors and Shareholders of  
China Eastern Airlines Corporation Limited

We have audited the accompanying consolidated balance sheets of China Eastern Airlines Corporation Limited (the Company) and its subsidiaries as of December 31, 2002 and 2003, and the related consolidated statements of income, changes in owner's equity and cash flows for each of the three years in the period ended December 31, 2003. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Standards on Auditing and Standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of 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 management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of China Eastern Airlines Corporation Limited and its subsidiaries at December 31, 2002 and 2003, and the results of their operations, changes in owner's equity and their cash flows for each of the three years ended December 31, 2003, in conformity with International Financial Reporting Standards.

International Financial Reporting Standards vary in certain significant respects from generally accepted accounting principles in the United States of America. Application of generally accepted accounting principles in the United States of America would have affected the results of the operations for the three years ended December 31, 2003 and the determination of consolidated owner's equity as of December 31, 2002 and 2003, to the extent summarized in Note 40 to the consolidated financial statements.

**PricewaterhouseCoopers**  
*Certified Public Accountants*  
Hong Kong  
April 5, 2004



**Table of Contents****CHINA EASTERN AIRLINES CORPORATION LIMITED**

**CONSOLIDATED STATEMENTS OF INCOME**  
**For the Years Ended December 31, 2001, 2002 and 2003**  
**(Amounts in thousands except for per share data)**

|   | Note   | Year Ended December 31, |              |              |                           |
|---|--------|-------------------------|--------------|--------------|---------------------------|
|   |        | 2001<br>RMB             | 2002<br>RMB  | 2003<br>RMB  | 2003<br>US\$<br>(note 2a) |
| Traffic revenues                                      |        |                         |              |              |                           |
| Passenger   |        | 9,586,941               | 10,037,830   | 10,261,027   | 1,239,749                 |
| Cargo and mail  |        | 2,091,669               | 2,444,667    | 3,186,984    | 385,055                   |
| Other operating revenues                              |        | 474,198                 | 596,492      | 829,147      | 100,178                   |
|   |        | <hr/>                   | <hr/>        | <hr/>        | <hr/>                     |
| Turnover  | 3 & 34 | 12,152,808              | 13,078,989   | 14,277,158   | 1,724,982                 |
| Other operating income, net                           | 4      | 127,608                 | 226,373      | 2,442        | 295                       |
| Operating expenses                                    |        |                         |              |              |                           |
| Wages, salaries and benefits                          | 5      | (772,896)               | (1,035,853)  | (1,449,054)  | (175,076)                 |
| Take-off and landing charges                          |        | (1,702,899)             | (1,987,835)  | (2,254,456)  | (272,386)                 |
| Aircraft fuel   |        | (2,613,187)             | (2,563,701)  | (3,044,956)  | (367,895)                 |
| Food and beverages                                    |        | (567,168)               | (605,894)    | (541,669)    | (65,445)                  |
| Aircraft depreciation and operating leases            |        | (2,403,752)             | (2,455,403)  | (2,851,047)  | (344,467)                 |
| Other depreciation, amortization and operating leases |        | (358,120)               | (400,291)    | (495,079)    | (59,816)                  |
| Aircraft maintenance                                  |        | (966,750)               | (1,077,764)  | (1,329,304)  | (160,608)                 |
| Commissions   |        | (487,009)               | (379,674)    | (465,147)    | (56,200)                  |
| Office and administration                             |        | (849,217)               | (1,044,113)  | (1,057,500)  | (127,768)                 |
| Revaluation deficit of fixed assets                   |        |                         | (171,753)    |              |                           |
| Other   |        | (562,319)               | (519,614)    | (569,925)    | (68,859)                  |
|   |        | <hr/>                   | <hr/>        | <hr/>        | <hr/>                     |
| Total operating expenses                              |        | (11,283,317)            | (12,241,895) | (14,058,137) | (1,698,520)               |
|   |        | <hr/>                   | <hr/>        | <hr/>        | <hr/>                     |
| Operating profit                                      |        | 997,099                 | 1,063,467    | 221,463      | 26,757                    |
| Finance costs, net                                    | 6      | (814,375)               | (731,389)    | (712,458)    | (86,080)                  |
| Exchange gain/(loss), net                             |        | 126,313                 | (37,518)     | (70,325)     | (8,497)                   |
| Share of results before tax of associates             | 16     | 4,546                   | (31,666)     | (28,511)     | (3,444)                   |
|   |        | <hr/>                   | <hr/>        | <hr/>        | <hr/>                     |
| Profit/(loss) before taxation                         |        | 313,583                 | 262,894      | (589,831)    | (71,264)                  |
| Taxation  | 7(a)   | 261,454                 | (54,438)     | (247,554)    | (29,910)                  |
|   |        | <hr/>                   | <hr/>        | <hr/>        | <hr/>                     |

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|   |    |                 |                  |                   |                    |
|---|----|-----------------|------------------|-------------------|--------------------|
| Profit/(loss) after taxation                |    | 575,037         | 208,456          | (837,385)         | (101,174)          |
| Minority interests                          | 29 | <u>(33,324)</u> | <u>(122,087)</u> | <u>(112,431)</u>  | <u>(13,584)</u>    |
| Profit/(loss) attributable to shareholders  |    | <u>541,713</u>  | <u>86,369</u>    | <u>(949,816)</u>  | <u>(114,758)</u>   |
| Basic and diluted earnings/(loss) per share | 8  | <u>RMB0.111</u> | <u>RMB0.018</u>  | <u>(RMB0.195)</u> | <u>(US\$0.024)</u> |

The accompanying notes are an integral part of these financial statements.

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**Table of Contents****CHINA EASTERN AIRLINES CORPORATION LIMITED****CONSOLIDATED BALANCE SHEETS****As of December 31, 2002 and 2003****(Amounts in thousands)**

|  |             | <b>December 31,</b> |                     |                                    |
|--|-------------|---------------------|---------------------|------------------------------------|
|  | <b>Note</b> | <b>2002<br/>RMB</b> | <b>2003<br/>RMB</b> | <b>2003<br/>US\$<br/>(note 2a)</b> |
| <b>ASSETS</b>  |             |                     |                     |                                    |
| Current assets   |             |                     |                     |                                    |
| Flight equipment spare parts less allowance for obsolescence<br>(2002: RMB347,198; 2003: RMB400,534) |             | 556,376             | 552,172             | 66,714                             |
| Trade receivables less allowance for doubtful accounts<br>(2002: RMB69,141; 2003: RMB83,663)         | 10          | 965,226             | 1,325,677           | 160,170                            |
| Prepayments and other receivables  | 11          | 815,049             | 1,262,173           | 152,497                            |
| Short-term investments   | 12          | 290,000             |                     |                                    |
| Short-term deposits with an associate  | 35(a)(iii)  | 94,502              | 214,241             | 25,885                             |
| Cash and bank balances   |             | 1,889,647           | 1,477,409           | 178,502                            |
|  |             | <hr/>               | <hr/>               | <hr/>                              |
| Total current assets   |             | 4,610,800           | 4,831,672           | 583,768                            |
| Fixed assets   | 13          | 20,465,950          | 26,838,903          | 3,242,706                          |
| Construction in progress   | 14          | 413,812             | 219,788             | 26,555                             |
| Lease prepayments  | 15          | 867,368             | 847,319             | 102,374                            |
| Investments in associates  | 16          | 331,570             | 626,084             | 75,644                             |
| Goodwill and negative goodwill   | 17          | 40,707              | 38,505              | 4,652                              |
| Advances on aircraft and flight equipment  | 18          | 3,227,720           | 2,239,893           | 270,626                            |
| Other long-term receivables and investments  | 19          | 2,223,768           | 1,962,362           | 237,095                            |
| Deferred tax assets  | 7(d)        | 569,997             | 399,771             | 48,301                             |
| Derivative assets  | 37          | 9,891               | 2,814               | 340                                |
|  |             | <hr/>               | <hr/>               | <hr/>                              |
| Total assets   |             | 32,761,583          | 38,007,111          | 4,592,061                          |
|  |             | <hr/>               | <hr/>               | <hr/>                              |
| <b>LIABILITIES AND EQUITY</b>  |             |                     |                     |                                    |
| Current liabilities  |             |                     |                     |                                    |
| Trade payables   | 20          | 64,523              | 109,242             | 13,199                             |
| Sales in advance of carriage   |             | 700,714             | 926,453             | 111,935                            |
| Other payables and accrued expenses  | 21          | 2,791,033           | 4,299,989           | 519,530                            |
| Current portion of obligations under finance leases  | 23          | 2,247,059           | 1,692,084           | 204,439                            |
| Current portion of long-term bank loans  | 24          | 1,261,902           | 2,250,734           | 271,936                            |
| Notes payable  |             | 411,250             | 756,490             | 91,400                             |

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|   |       |                             |                             |                             |
|---|-------|-----------------------------|-----------------------------|-----------------------------|
| Tax payable                                   |       | 44,560                      | 106,113                     | 12,821                      |
| Short-term bank loans                         | 25    | 4,526,509                   | 4,631,918                   | 559,633                     |
|   |       | <u>                    </u> | <u>                    </u> | <u>                    </u> |
| Total current liabilities                     |       | 12,047,550                  | 14,773,023                  | 1,784,893                   |
| Obligations under finance leases              | 23    | 5,936,907                   | 5,408,802                   | 653,497                     |
| Long-term bank loans                          | 24    | 5,232,729                   | 8,972,189                   | 1,084,030                   |
| Deferred tax liabilities                      | 7(d)  | 802,822                     | 740,112                     | 89,421                      |
| Accrued aircraft overhaul expenses            | 22    | 243,684                     | 191,384                     | 23,123                      |
| Long-term portion of other payable            | 28    | 142,250                     | 121,860                     | 14,723                      |
| Post-retirement benefit obligations           | 30(b) | 528,924                     | 545,771                     | 65,941                      |
| Long-term portion of staff housing allowances | 31(b) |                             | 254,669                     | 30,770                      |
| Derivative liabilities                        | 37    | 43,097                      | 94,437                      | 11,410                      |
|   |       | <u>                    </u> | <u>                    </u> | <u>                    </u> |
| Total liabilities                             |       | 24,977,963                  | 31,102,247                  | 3,757,808                   |
| Commitments and contingent liabilities        | 33    |                             |                             |                             |
| Minority interests                            | 29    | 404,517                     | 522,713                     | 63,155                      |
|   |       | <u>                    </u> | <u>                    </u> | <u>                    </u> |
| Owner's equity                                |       | 7,379,103                   | 6,382,151                   | 771,098                     |
|   |       | <u>                    </u> | <u>                    </u> | <u>                    </u> |
| Total liabilities and owner's equity          |       | 32,761,583                  | 38,007,111                  | 4,592,061                   |
|   |       | <u>                    </u> | <u>                    </u> | <u>                    </u> |

The accompanying notes are an integral part of these financial statements.

**Table of Contents****CHINA EASTERN AIRLINES CORPORATION LIMITED**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**For the Years Ended December 31, 2001, 2002 and 2003**  
**(Amounts in thousands)**

|  | Year Ended December 31, |             |             |                           |
|--|-------------------------|-------------|-------------|---------------------------|
|  | 2001<br>RMB             | 2002<br>RMB | 2003<br>RMB | 2003<br>US\$<br>(note 2a) |
| Cash flows from operating activities   |                         |             |             |                           |
| Profit/(loss) attributable to shareholders   | 541,713                 | 86,369      | (949,816)   | (114,758)                 |
| Adjustments to reconcile profit/(loss) attributable to shareholders to net cash from operating activities: |                         |             |             |                           |
| Depreciation of fixed assets   | 1,719,777               | 1,710,811   | 1,974,462   | 238,557                   |
| (Gains)/losses on disposals of aircraft and flight equipment   | (1,866)                 | (115,904)   | 28,767      | 3,476                     |
| Losses on disposals of other fixed assets  | 10,643                  | 27,129      | 4,811       | 581                       |
| Gain on disposal of short-term investments   |                         |             | (21,920)    | (2,648)                   |
| Amortization of lease prepayments  | 26,615                  | 20,128      | 20,049      | 2,422                     |
| Amortization of bond discount  | (37,355)                | (40,358)    | (43,603)    | (5,268)                   |
| Amortization of value added tax capitalized  | 15,832                  | 16,017      | 12,245      | 1,479                     |
| Write back of provision for post-retirement benefits upon curtailment of medical benefits                  | (95,975)                |             |             |                           |
| Provision for post-retirement benefits   | 78,953                  | 23,614      | 20,844      | 2,519                     |
| Amortization of goodwill and negative goodwill   | 3,641                   | 2,202       | 2,202       | 266                       |
| Revaluation deficit of fixed assets  |                         | 171,753     |             |                           |
| Foreign exchange (gains)/losses  | (122,614)               | 52,207      | 77,850      | 9,406                     |
| Share of results after tax of associates   | (3,163)                 | 32,613      | 32,738      | 3,955                     |
| Minority interests   | 33,324                  | 122,087     | 112,431     | 13,584                    |
| Movements in:  |                         |             |             |                           |
| Flight equipment spare parts   | (65,786)                | (91,543)    | 4,204       | 508                       |
| Trade receivables  | 519,734                 | (179,392)   | (360,451)   | (43,550)                  |
| Prepayments and other receivables  | (1,060)                 | (176,609)   | 184,761     | 22,323                    |
| Trade payables   | (83,784)                | 16,406      | 44,719      | 5,403                     |
| Sales in advance of carriage   | (90,927)                | 55,088      | 225,739     | 27,274                    |
| Other payables and accrued expenses  | 328,607                 | 346,336     | 1,759,628   | 212,600                   |
| Interest accrued on a long-term payable  | 6,693                   | 10,802      | 9,610       | 1,161                     |
| Tax payable  | 14,810                  | 37,611      | 61,553      | 7,437                     |
| Deferred taxation  | (267,754)               | (17,570)    | 118,797     | 14,353                    |
| Long-term portion of accrued aircraft overhaul expenses  | (31,302)                | 50,681      | (52,300)    | (6,319)                   |
|  | 1,957,043               | 2,074,109   | 4,217,136   | 509,519                   |

|   |                             |                             |                             |                             |
|---|-----------------------------|-----------------------------|-----------------------------|-----------------------------|
|   | <u>                    </u> | <u>                    </u> | <u>                    </u> | <u>                    </u> |
| Net cash inflow from operating activities | <u>2,498,756</u>            | <u>2,160,478</u>            | <u>3,267,320</u>            | <u>394,761</u>              |

Supplemental disclosure of cash flow information is set out in note 32.

The accompanying notes are an integral part of these financial statements.

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**CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)**  
**For the Years Ended December 31, 2001, 2002 and 2003**  
**(Amounts in thousands)**

|   | Note | Year Ended December 31, |                    |                    |                           |
|---|------|-------------------------|--------------------|--------------------|---------------------------|
|   |      | 2001<br>RMB             | 2002<br>RMB        | 2003<br>RMB        | 2003<br>US\$<br>(note 2a) |
| Cash flows from investing activities:   |      |                         |                    |                    |                           |
| Additions of aircraft and flight equipment  |      | (1,024,205)             | (1,004,136)        | (5,560,406)        | (671,814)                 |
| Instalment payment for acquisition of a passenger carriage business                       |      | (30,000)                | (30,000)           | (30,000)           | (3,625)                   |
| Cash acquired from a passenger carriage business  |      | 54,008                  |                    |                    |                           |
| Proceeds on disposals of aircraft, flight equipment, other fixed assets and equipment     |      | 73,358                  | 149,818            | 91,940             | 11,108                    |
| Additions of buildings, other fixed assets and equipment                                  |      | (229,703)               | (206,595)          | (216,211)          | (26,123)                  |
| Additions of construction in progress   |      | (370,647)               | (287,179)          | (249,737)          | (30,173)                  |
| Additions of lease prepayments  |      | (64,673)                | (30,680)           |                    |                           |
| Investments in associates   |      | (106,364)               | (254,656)          | (327,252)          | (39,539)                  |
| Advances on aircraft and flight equipment   |      | (991,800)               | (2,599,610)        | (1,295,656)        | (156,543)                 |
| Repayments of advances on aircraft and flight equipment                                   |      | 61,514                  | 20,722             |                    |                           |
| Decrease/(increase) in long-term bank deposits  |      | 74,358                  | (20,992)           | (64,255)           | (7,763)                   |
| Purchase of short-term investments  |      |                         | (290,000)          |                    |                           |
| Proceeds from disposals of short-term investments   |      |                         |                    | 311,920            | 37,687                    |
| Net (increase)/decrease in short-term deposits with original maturities over three months |      | (228)                   | 10,388             | (69,246)           | (8,366)                   |
|   |      | <u>(2,554,382)</u>      | <u>(4,542,920)</u> | <u>(7,408,903)</u> | <u>(895,151)</u>          |
| Net cash used in investing activities   |      |                         |                    |                    |                           |
| Cash flows from financing activities:   |      |                         |                    |                    |                           |
| Repayment of amount due to ultimate holding company                                       |      | (15,598)                |                    |                    |                           |
| Short-term bank loans   |      | 2,037,642               | 6,349,141          | 10,920,917         | 1,319,477                 |
| Repayments of short-term bank loans   |      | (1,350,000)             | (3,110,274)        | (10,815,508)       | (1,306,742)               |
| Long-term bank loans  |      | 1,305,643               | 2,855,152          | 5,606,107          | 677,336                   |
| Repayments of long-term bank loans  |      | (824,284)               | (1,661,088)        | (898,022)          | (108,500)                 |

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|  |       |                   |                   |                   |                   |
|--|-------|-------------------|-------------------|-------------------|-------------------|
| Principal repayments of finance lease obligations    |       | (1,157,179)       | (1,958,143)       | (1,400,749)       | (169,240)         |
| Receipts of amounts due under subleases              |       | 84,246            |                   |                   |                   |
| Loans from an associate                              |       | 50,000            | 15,000            |                   |                   |
| Repayments of loans from an associate                |       | (50,000)          | (15,000)          |                   |                   |
| Increase in notes payable                            |       |                   | 411,250           | 345,240           | 41,712            |
| Dividend paid  |       | (97,339)          | (97,339)          |                   |                   |
| Capital injection from a minority shareholder        |       |                   |                   | 5,765             | 697               |
| Advances from minority shareholders                  |       |                   | 167,730           |                   |                   |
|  |       | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |
| Net cash (used in)/from financing activities         |       | <u>(16,869)</u>   | <u>2,956,429</u>  | <u>3,763,750</u>  | <u>454,740</u>    |
|  |       |                   |                   |                   |                   |
| Net (decrease)/increase in cash and cash equivalents |       | (72,495)          | 573,987           | (377,833)         | (45,650)          |
| Cash and cash equivalents at January 1               |       | 1,422,891         | 1,330,980         | 1,944,525         | 234,940           |
| Exchange adjustment                                  |       | (19,416)          | 39,558            | 16,088            | 1,943             |
|  |       | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |
| Cash and cash equivalents at December 31             | 32(a) | <u>1,330,980</u>  | <u>1,944,525</u>  | <u>1,582,780</u>  | <u>191,233</u>    |

Supplemental disclosure of cash flow information is set out in note 32.

The accompanying notes are an integral part of these financial statements.

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**CONSOLIDATED STATEMENTS OF CHANGES IN OWNER S EQUITY**  
**For the Years Ended December 31, 2001, 2002 and 2003**  
**(Amounts in thousands)**

|   | <b>Share<br/>capital<br/>(note 26)</b> | <b>Other<br/>reserves<br/>(note 27)</b> | <b>Retained<br/>profits<br/>(note 27)</b> | <b>Total</b> |
|---|--|---|---|--------------|
| In RMB  |  |   |   |              |
| Balance at January 1, 2001  | 4,866,950                              | 904,741                                 | 1,098,847                                 | 6,870,538    |
| Net gains/(losses) not recognized in the income statement                                   |  |   |   |              |
| Unrealized gain on cashflow hedges (note 37)  |  | 5,396                                   |   | 5,396        |
| Dividends relating to 2000 (note 9)   |  |   | (97,339)                                  | (97,339)     |
| Profit attributable to shareholders   |  |   | 541,713                                   | 541,713      |
| Transfer from retained profits to other reserves  |  | 3,362                                   | (3,362)                                   |              |
|   | <hr/>                                  | <hr/>                                   | <hr/>                                     | <hr/>        |
| Balance at December 31, 2001  | 4,866,950                              | 913,499                                 | 1,539,859                                 | 7,320,308    |
|   | <hr/>                                  | <hr/>                                   | <hr/>                                     | <hr/>        |
| Balance at January 1, 2002  | 4,866,950                              | 913,499                                 | 1,539,859                                 | 7,320,308    |
| Net gains/(losses) not recognized in the income statement                                   |  |   |   |              |
| Revaluation surplus of fixed assets, net of tax   |  | 418,006                                 |   | 418,006      |
| Revaluation surplus shared by minority shareholders (note 29)                               |  | (12,981)                                |   | (12,981)     |
| Revaluation deficit offset against previous revaluation surplus of fixed assets, net of tax |  | (301,639)                               |   | (301,639)    |
| Unrealized losses on cashflow hedges (note 37)  |  | (33,621)                                |   | (33,621)     |
|   | <hr/>                                  | <hr/>                                   | <hr/>                                     | <hr/>        |
|   |  | 69,765                                  |   | 69,765       |
| Dividends relating to 2001 (note 9)   |  |   | (97,339)                                  | (97,339)     |
| Profit attributable to shareholders   |  |   | 86,369                                    | 86,369       |
| Transfer from retained profits to other reserves  |  | 21,391                                  | (21,391)                                  |              |
|   | <hr/>                                  | <hr/>                                   | <hr/>                                     | <hr/>        |
| Balance at December 31, 2002  | 4,866,950                              | 1,004,655                               | 1,507,498                                 | 7,379,103    |
|   | <hr/>                                  | <hr/>                                   | <hr/>                                     | <hr/>        |
| Balance at January 1, 2003  | 4,866,950                              | 1,004,655                               | 1,507,498                                 | 7,379,103    |
| Net gains/(losses) not recognized in the income statement                                   |  |   |   |              |

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|  |           |           |           |           |
|--|-----------|-----------|-----------|-----------|
| Unrealized losses on cashflow hedges (note 37)             |           | (49,654)  |           | (49,654)  |
| Release of reserves upon disposals of aircraft, net of tax |           | (14,269)  | 16,787    | 2,518     |
|  |           |           |           |           |
|  |           | (63,923)  | 16,787    | (47,136)  |
| Loss attributable to shareholders                          |           |           | (949,816) | (949,816) |
| Transfer from retained profits to other reserves           |           | 72,510    | (72,510)  |           |
|  |           |           |           |           |
| Balance at December 31, 2003                               | 4,866,950 | 1,013,242 | 501,959   | 6,382,151 |
|  |           |           |           |           |
| In US\$(note 2a)   |           |           |           |           |
| Balance at December 31, 2003                               | 588,030   | 122,421   | 60,647    | 771,098   |

The accompanying notes are an integral part of these financial statements.



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**CHINA EASTERN AIRLINES CORPORATION LIMITED  
NOTES TO THE FINANCIAL STATEMENTS**

**1 CORPORATE INFORMATION**

China Eastern Airlines Corporation Limited (the Company) was established in the People's Republic of China (PRC) as a joint stock company limited by shares on 14 April 1995. The Company is majority owned by China Eastern Air Holding Company (CEA Holding), a state-owned enterprise. The Company and its subsidiaries (the Group) are principally engaged in the operation of civil aviation, air cargo, postal delivery and other extended transportation services.

**2 PRINCIPAL ACCOUNTING POLICIES**

**(a) Basis of Preparation**

The consolidated financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS) and the disclosure requirements of the Hong Kong Companies Ordinance. This basis of accounting differs in certain material respects from that used in the preparation of the Group's statutory accounts in the PRC. The statutory accounts of the Group have been prepared in accordance with the accounting principles and the relevant regulations applicable to PRC joint stock limited companies (PRC Accounting Regulations). In preparing these financial statements, appropriate restatements have been made to the Group's statutory accounts to conform with IFRS.

This basis of accounting under IFRS differs from generally accepted accounting principles in the United States of America (U.S. GAAP). Differences between IFRS and U.S. GAAP and their effect on profit attributable to shareholders for the three years ended December 31, 2001, 2002, 2003, and, on the owner's equity as of December 31, 2002 and 2003, are set out in note 40. The financial statements incorporate additional disclosures customary in filings with the Securities and Exchange Commission of the United States of America (the SEC).

The consolidated financial statements have been prepared under historical cost convention as modified by the revaluation of fixed assets, short-term investments and derivative financial instruments.

The preparation of financial statements in conformity with generally accepted accounting principles requires the use of estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Although these estimates are based on management's best knowledge of current event and actions, actual results ultimately may differ from those estimates.

The financial information has been prepared in Renminbi (RMB), the national currency of the PRC. Solely for the convenience of the reader, the December 31, 2003 financial statements have been translated into United States dollars (US\$) at the rate of US\$1.00 = RMB8.2767, being the noon buying rate in New York City for cable transfers in foreign currencies as certified for customs purposes by the Federal Reserve Bank of New York on December 31, 2003. No representation is made that the RMB amounts could have been, or could be, converted into United States dollars at that rate or at any other certain rate on December 31, 2003 or at any other certain date.

**Table of Contents****CHINA EASTERN AIRLINES CORPORATION LIMITED  
NOTES TO THE FINANCIAL STATEMENTS****2 PRINCIPAL ACCOUNTING POLICIES (CONT D)****(b) Group accounting**

The consolidated financial statements include the financial statements of the Company and its subsidiaries made up to 31 December.

**(i) Subsidiaries**

Subsidiaries, which are those entities in which the Group has an interest of more than one half of the voting rights or otherwise has power to govern the financial and operating policies are consolidated.

Subsidiaries are consolidated from the date on which control is transferred to the Group and are no longer consolidated from the date that control ceases. The purchase method of accounting is used to account for the acquisition of subsidiaries. The cost of an acquisition is measured as the fair value of the assets given up, shares issued or liabilities undertaken at the date of acquisition plus costs directly attributable to the acquisition. The excess of the cost of acquisition over the fair value of the net assets of the subsidiary acquired is recorded as goodwill. See note 2(m) for the accounting policy on goodwill. Intercompany transactions, balances and unrealized gains on transactions between group companies are eliminated; unrealized losses are also eliminated unless it cannot be recovered. Where necessary, accounting policies of subsidiaries have been changed to ensure consistency with the policies adopted by the Group.

Minority interests represent the interests of outside members in the operating results and net assets of subsidiaries.

Particulars of the principal subsidiaries, all of which are limited companies established and operating in the PRC, as of December 31, 2003 are as follows:-

| Company  | Place and date of establishment | Paid-up Capital |         | Attributable equity interest |      | Principal activities                        |
|--|---------------------------------|-----------------|---------|------------------------------|------|---|
|  |                                 | 2002            | 2003    | 2002                         | 2003 |   |
|  |                                 | RMB 000         | RMB 000 |                              |      |   |
| China Cargo Airlines Co., Ltd.                 | PRC<br>July 22, 1998            | 500,000         | 500,000 | 70%                          | 70%  | Provision of cargo carriage services        |
| China Eastern Airlines Jiangsu Co., Ltd.       | PRC<br>May 3, 1993              | 236,579         | 236,579 | 55%                          | 55%  | Provision of airline services               |
| Eastern Airlines Hotel Co., Ltd.               | PRC<br>March 18, 1998           | 70,000          | 70,000  | 86%                          | 86%  | Provision of hotel services to crew members |
| Shanghai Eastern Flight Training Co., Ltd.     | PRC<br>December 18, 1995        | 358,800         | 473,000 | 95%                          | 95%  | Provision of flight training services       |
| Shanghai Eastern Airlines Investment Co., Ltd. | PRC<br>May 8, 2002              | 300,000         | 412,500 | 98%                          | 99%  | Investment holding                          |



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**CHINA EASTERN AIRLINES CORPORATION LIMITED  
NOTES TO THE FINANCIAL STATEMENTS**

**2 PRINCIPAL ACCOUNTING POLICIES (CONT D)**

**(ii) Associates**

Investments in associates are accounted for by the equity method of accounting. Under this method the Company's share of the post-acquisition profits or losses of associates is recognized in the income statement and its share of post-acquisition movements in reserves is recognized in reserves. The cumulative post-acquisition movements are adjusted against the cost of the investment. Associates are entities over which the Group generally has between 20% and 50% of the voting rights, or over which the Group has significant influence, but which it does not control.

Unrealized gains on transactions between the Group and its associates are eliminated to the extent of the Group's interest in the associates; unrealized losses are also eliminated unless the transaction provides evidence of an impairment of the asset transferred. The Group's investment in associates includes goodwill (net of accumulated amortization) on acquisition. When the Group's share of losses in an associate equals or exceeds its interest in the associate, the Group does not recognize further losses, unless the Group has incurred obligations or made payments on behalf of the associates.

**(c) Foreign currency translation**

The Group maintains its books and records in RMB which is the measurement currency of the Group. Transactions in foreign currencies are translated at the applicable rates of exchange prevailing at the dates of the transactions, quoted by the People's Bank of China. Monetary assets and liabilities denominated in foreign currencies are translated into RMB at the rates prevailing at the balance sheet date as quoted by the People's Bank of China. Exchange differences are included in the income statement, except when deferred in equity as qualifying cashflow hedges.

**(d) Revenue recognition and sales in advance of carriage**

Passenger, cargo and mail revenues are recognized as traffic revenues when the transportation services are provided. The value of sold but unused tickets is included in the current liabilities as sales in advance of carriage.

Revenues from other operating businesses, including income derived from the provision of ground services and commission income are recognized when services are rendered. Commission income includes amounts earned from other carriers in respect of sales made by the Group's agents. The related commission payable to such agents are included as commission expenses in the income statement. Rental income from leasing office premises and cargo warehouses is recognized on a straight-line basis over the lease term.

Revenues are presented net of business tax and civil aviation infrastructure levies.

Interest income is recognized on a time-proportion basis.

Rental income from subleases is recognized on a straight-line basis over the terms of the respective leases.

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**CHINA EASTERN AIRLINES CORPORATION LIMITED  
NOTES TO THE FINANCIAL STATEMENTS**

**2 PRINCIPAL ACCOUNTING POLICIES (CONT D)**

**(e) Segment reporting**

In accordance with the Group's internal financial reporting, the Group has determined that business segments be presented as the primary reporting format and geographical as the secondary reporting format.

In respect of the geographical segment, the analysis of turnover and operating profit by geographical segment is based on the following criteria:

- (i) Traffic revenue from domestic services within the PRC (excluding Hong Kong Special Administrative Region ( Hong Kong )) is attributed to the domestic operation. Traffic revenue from inbound and outbound services between the PRC and Hong Kong or overseas markets is attributed to the geographical area in which the relevant overseas origin or destination lies.
- (ii) Other operating revenues from ticket handling services, airport ground services and other miscellaneous services are attributed on the basis of where the services are performed.

**(f) Retirement benefits**

The Group participates in defined contribution retirement schemes regarding pension and medical benefit for employees organized by the municipal governments of respective provinces. The contributions to the schemes are charged to the income statement as and when incurred.

In addition, the Group provides retirees with post-retirement benefits including retirement subsidies, transportation subsidies, social function activity subsidies as well as other welfare. The cost of providing the aforementioned post-retirement benefits under the Group's defined benefit plan is actuarially determined and recognized over the employees' service period by using the projected unit credit method. Post-retirement benefit expenses recognized in the income statement include, if applicable, current service cost, interest cost, amortized actuarial gains and losses, the effect of any curtailment or settlement and past service cost.

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**CHINA EASTERN AIRLINES CORPORATION LIMITED  
NOTES TO THE FINANCIAL STATEMENTS**

**2 PRINCIPAL ACCOUNTING POLICIES (CONT D)**

**(g) Maintenance and overhaul costs**

In respect of aircraft and engines under operating leases, the Group has the responsibility to fulfill certain return conditions under relevant leases. In order to fulfill 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 overhaul comprise mainly labor and materials. Differences between the estimated cost and the actual cost of the overhaul 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 charged to the income statement as and when incurred.

All other routine repairs and maintenance costs incurred in restoring such fixed assets to their normal working condition are charged to the income statement as and when incurred.

Improvements are capitalized and depreciated over their expected useful lives to the Group.

**(h) Government grant**

Grants from the government are recognized at their fair value where there is a reasonable assurance that the grant will be received and the Group will comply with all attached conditions.

Government grants relating to costs are deferred and recognized in the income statement over the period necessary to match them with the costs they are intended to compensate.

Government grants relating to the fixed assets are included in non-current liabilities as other liabilities and are credited to the income statement on a straight-line basis over the expected lives of the related assets.

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**CHINA EASTERN AIRLINES CORPORATION LIMITED  
NOTES TO THE FINANCIAL STATEMENTS**

**2 PRINCIPAL ACCOUNTING POLICIES (CONT D)**

**(i) Taxation**

The Group provides for taxation on the basis of the results for the year as adjusted for items which are not assessable or deductible for income tax purposes. Taxation of the Group is determined in accordance with the relevant tax rules and regulations applicable in the jurisdictions where the Group operates.

Deferred income tax is provided in full, using the liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the financial statements. Currently enacted tax rates are used in the determination of deferred income tax.

Deferred tax assets are recognized to the extent that it is probable that future taxable profit will be available against which the temporary differences can be utilized.

**(j) Fixed assets**

- (i) Fixed assets are recognized initially at cost which comprises purchase price, costs transferred from construction in progress and any directly attributable costs of bringing the assets to the condition for their intended use.

Subsequent to the initial recognition, fixed assets are stated at revalued amount less accumulated depreciation and accumulated impairment losses. Independent valuations are performed at least every five years or sooner if considered necessary by the directors. In the intervening years, the directors review the carrying values of the fixed assets and adjustment is made where these are materially different from fair value. Increases in the carrying amount arising on revaluation are credited to the revaluation reserve. Decreases in valuation of fixed assets are first offset against increases from earlier valuations in respect of the same asset and are thereafter charged to the income statement. All other decreases in valuation are charged to the income statement. Any subsequent increases are credited to the income statement up to the amount previously charged.

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NOTES TO THE FINANCIAL STATEMENTS****2 PRINCIPAL ACCOUNTING POLICIES (CONT D)****(j) Fixed assets (cont d)**

- (ii) Depreciation of fixed assets is calculated on the straight-line method to write off the cost or revalued amount of each asset to their residual value over their estimated useful lives. The annual depreciation charges are calculated as follows:-

|                                  |   |
|----------------------------------|---|
| Aircraft                         | - over 20 years to residual value of 5% of cost or revalued amount                                    |
| Flight equipment                 |   |
| - Engines                        | - over 20 years to nil residual value   |
| - Other flight equipment         | - over the expected useful lives to residual value of 5% of cost or revalued amount                   |
| Buildings                        | - over the expected useful lives of 15 to 35 years to residual value of 3% of cost or revalued amount |
| Other fixed assets and equipment | - over 5 to 20 years to residual value of 3% of cost or revalued amount                               |

- (iii) Gains and losses on disposals are determined by comparing proceeds with carrying amount and are included in operating profit. When revalued assets are sold, the amounts included in revaluation reserves are transferred to retained earnings.
- (iv) The carrying amounts of assets are reviewed regularly to assess whether their recoverable amounts have declined below their carrying amounts. The recoverable amount is the greater of the net selling price and value in use. In determining the value in use, expected future cashflows generated by the assets including its residual value on disposals are discounted to their present value. When an impairment has occurred, their carrying amount is reduced immediately to their recoverable amount. The amount of reduction to recoverable amount is charged to the income statement.

**(k) Construction in progress**

Construction in progress represents office buildings, various infrastructure projects under construction and plant and equipment pending installation. This includes the costs of construction and acquisition and interest capitalized. No depreciation is provided on construction in progress until the asset is completed and put into use.



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**CHINA EASTERN AIRLINES CORPORATION LIMITED  
NOTES TO THE FINANCIAL STATEMENTS**

**2 PRINCIPAL ACCOUNTING POLICIES (CONT D)**

**(l) Lease prepayments**

Lease prepayments represent acquisition costs of land use rights less accumulated amortization. Amortization is provided over the lease period of land use rights on a straight-line basis.

Beginning 2002, land use rights are presented as operating leases and stated at historical cost less accumulated amortization. The land use rights, which were revalued as part of the Company's restructuring in 1996 and recorded at valuation as a non-monetary assets in exchange for share capital of the Company, are now stated at historical cost which is nil. Retrospective adjustments have been made in prior year to reflect the change in accounting for land use rights.

**(m) Goodwill and negative goodwill**

Goodwill represents the excess of the cost of an acquisition over the fair value of the Group's share of the net assets of the acquired subsidiary or associate at the date of acquisition. Goodwill is recognized as an asset and amortized by equal annual instalments over its estimated useful economic life up to a maximum of 20 years.

Negative goodwill represents the excess of the fair value of the Group's share of the net assets of the acquired subsidiary or associate over the cost of acquisition. Negative goodwill is presented in the same balance sheet classifications as goodwill. To the extent that negative goodwill relates to expectations of future losses and expenses that are identified in the Group's plan for the acquisition and can be measured reliably, but which do not represent identifiable liabilities, that portion of negative goodwill is recognized in the income statement when the future losses and expenses are recognized. Any remaining negative goodwill, not exceeding the fair values of the non-monetary assets acquired, is recognized in the income statement over the remaining weighted average useful life of those assets up to a maximum of 20 years; negative goodwill in excess of the fair values of those assets is recognized in the income statement immediately.

At each balance sheet date the Group assesses whether there is any indication of impairment. If such indications exist, an analysis is performed to assess whether the carrying amount of goodwill is fully recoverable. A write down is made if the carrying amount exceeds the recoverable amount.

The gain or loss on disposals of an entity includes the carrying amount of goodwill relating to the entity sold.

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**CHINA EASTERN AIRLINES CORPORATION LIMITED  
NOTES TO THE FINANCIAL STATEMENTS**

**2 PRINCIPAL ACCOUNTING POLICIES (CONT D)**

**(n) Advances on aircraft and flight equipment**

Advance contract payments to aircraft manufacturers to secure deliveries of aircraft and flight equipment in future years are capitalized along with attributable interests, and transferred to fixed assets upon delivery of the aircraft.

**(o) Borrowing costs**

Interest attributable to funds used to finance the acquisition of new aircraft and construction of major ground facilities is capitalized as an additional cost of the related asset. Interest is capitalized at the Group's weighted average interest rate on borrowings or, where applicable, the interest rate related to specific borrowings during the period of time that is required to complete and prepare the asset for its intended use.

All other borrowing costs are charged to the income statement in the period in which they are incurred.

**(p) Long-term bank deposits**

Long-term bank deposits placed to secure future lease obligations are stated at cost and are classified as held-to-maturity financial assets.

**(q) Zero coupon bonds**

Zero coupon bonds purchased to secure and to settle future lease obligations are stated at acquisition cost plus discount amortized to date and are classified as held-to-maturity securities. The discount thereon is amortized over the period to maturity under the effective interest method and included as interest income in the income statement.

**(r) Impairment of long lived assets**

Fixed assets and other non-current assets, including goodwill are reviewed for impairment losses whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. An impairment loss is recognized for the amount by which the carrying amount of the asset exceeds its recoverable amount which is the higher of an asset's net selling price and value in use. For the purposes of assessing impairment, assets are grouped at the lowest level for which there are separately identifiable cashflows.

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**CHINA EASTERN AIRLINES CORPORATION LIMITED  
NOTES TO THE FINANCIAL STATEMENTS**

**2 PRINCIPAL ACCOUNTING POLICIES (CONT D)**

**(s) Flight equipment spare parts**

Flight equipment spare parts are carried at weighted average cost less allowance for obsolescence and are expensed when used in operations. Allowance for obsolescence is provided for expendable spare parts at rates which depreciate costs, less an estimated residual value, over the estimated useful lives of the related aircraft.

**(t) Trade receivables**

Trade receivables are carried at original invoice amount less provision made for impairment of these receivables. A provision for impairment of trade receivables is established if there is objective evidence that the Group will not be able to collect all amounts due according to the original terms of receivables. The amount of the provision is the difference between the carrying amount and the recoverable amount, being the present value of expected cashflows, discounted at the market rate of interest for similar borrowers.

**(u) Short-term investments**

Short-term investments are carried at fair value. Realized and unrealized gains or losses arising from the changes in fair value of these investments are recognized in the income statement in the period in which they arise.

**(v) Cash and cash equivalents**

Cash and short-term highly liquid investments, which are readily convertible into cash and have original maturities of three months or less at the date of acquisition, are classified as cash and cash equivalents.

**(w) Frequent flyer programme**

The Group estimates the present value of the incremental cost of providing free travel awards entitled by members under a frequent flyer programme when free travel award levels are achieved based on accumulated mileage. The estimated incremental cost is recognized as an expense in the income statement and accrued as a liability in the balance sheet.

As members redeem awards or their entitlements expire, the incremental cost liability is reduced accordingly to reflect the acquittal of the outstanding obligations.

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**CHINA EASTERN AIRLINES CORPORATION LIMITED  
NOTES TO THE FINANCIAL STATEMENTS**

**2 PRINCIPAL ACCOUNTING POLICIES (CONT D)**

**(x) Provisions**

Provisions are recognized when the Group has a present legal or constructive obligation as a result of past events, it is probable that an outflow of resources will be required to settle the obligation, and a reliable estimate of the amount can be made. Where the Group expects a provision to be reimbursed, for example under an insurance contract, the reimbursement is recognized as a separate asset but only when the reimbursement is virtually certain.

**(y) Leases**

**(i) A Group company is the lessee**

Leases of fixed assets where the Group has substantially all the risks and rewards of ownership are classified as finance leases. Finance leases are capitalized at the inception of the lease at the lower of the fair value of the leased asset or the present value of the minimum lease payments. Each lease payment is allocated between the liability and finance charges so as to achieve a constant rate on the finance balance outstanding. The interest element of the finance cost is charged to the income statement over the lease period so as to produce a constant periodic rate of interest on the remaining balance of the liability for each period.

Leased assets under finance leases are depreciated using the straight-line method over their expected useful lives to residual values.

Leases of assets under which a significant portion of the risks and rewards of ownership are retained by the lessor are classified as operating leases. Lease payments made under operating leases are charged to the income statement on a straight-line basis over the period of the lease.

**(ii) A Group company is the lessor**

When assets are leased out under a finance lease, the present value of the lease payments is recognized as a receivable. The difference between the gross receivable and the present value of the receivable is recognized as unearned finance income. Lease income is recognized over the term of the lease using the net investment method, which reflects a constant periodic rate of return.

Assets leased out under operating leases are included in fixed assets in the balance sheet. They are depreciated over their expected useful lives on a basis consistent with similar fixed assets. Rental income is recognized on a straight-line basis over the lease term.

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**CHINA EASTERN AIRLINES CORPORATION LIMITED  
NOTES TO THE FINANCIAL STATEMENTS**

**2 PRINCIPAL ACCOUNTING POLICIES (CONT D)**

**(z) Derivative financial instruments**

Derivative financial instruments are initially recognized in the balance sheet at cost and subsequently are remeasured at their fair value. The method of recognizing the resulting gain or loss is dependent on the nature of the item being hedged. The Group designates certain derivatives as either (1) a hedge of the fair value of a recognized asset or liability (i.e. fair value hedge), or (2) a hedge of a forecasted transaction or of a firm commitment (i.e. cashflow hedge).

Derivative financial instrument that does not qualify for hedge accounting is accounted for as trading instrument and any unrealized gain or loss, being changes in fair value of the derivative, is recognised in the income statement immediately.

Changes in the fair value of derivatives that are designated and qualify as fair value hedges and that are highly effective, are recorded in the income statement, along with any changes in the fair value of the hedged assets or liabilities that are attributable to the hedged risk.

Derivative financial instrument that qualifies for hedge accounting and is designated as a specific hedge of the variability in cashflows of a highly probable forecast transaction, is accounted for as follows:-

(i) the effective part of any gain or loss on the derivative financial instrument is recognized directly in equity. The cumulative gain or loss on the derivative financial instrument is removed from equity and recognized in the income statement in the same period during which the hedged forecast transaction affects net profit or loss.

(ii) the ineffective part of any gain or loss is recognized in the income statement immediately.

When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting, any cumulative gain or loss existing in equity at that time remains in equity and is recognized in the income statement when the committed or forecasted transaction ultimately occurs. When a committed or forecasted transaction is no longer expected to occur, the cumulative gain or loss that was related in equity is immediately transferred to the income statement.

**(aa) Comparatives**

Where necessary, comparative figures have been reclassified to conform with changes in presentation in the current year.

**Table of Contents****CHINA EASTERN AIRLINES CORPORATION LIMITED  
NOTES TO THE FINANCIAL STATEMENTS****3 REVENUES AND TURNOVER**

The Group is principally engaged in the provision of domestic, Hong Kong and international passenger, cargo and mail airline services. Turnover comprises revenues from airline and related services net of business tax and civil aviation infrastructure levies.

|   | <b>Year Ended December 31,</b> |                   |                   |
|---|--------------------------------|-------------------|-------------------|
|   | <b>2001</b>                    | <b>2002</b>       | <b>2003</b>       |
|   | <b>RMB 000</b>                 | <b>RMB 000</b>    | <b>RMB 000</b>    |
| Gross turnover  | 12,879,786                     | 13,814,709        | 14,575,443        |
| Less: Business tax (note (a))                               | (298,587)                      | (304,558)         | (168,639)         |
| Civil aviation infrastructure levies (note (b))             | (428,391)                      | (431,162)         | (129,646)         |
|   | <hr/>                          | <hr/>             | <hr/>             |
| Turnover  | 12,152,808                     | 13,078,989        | 14,277,158        |
| Rental income from operating subleases of aircraft (note 4) | 125,742                        | 110,469           | 31,209            |
| Interest income (note 6)                                    | 124,419                        | 115,824           | 147,846           |
|   | <hr/>                          | <hr/>             | <hr/>             |
| Total revenues  | <b>12,402,969</b>              | <b>13,305,282</b> | <b>14,456,213</b> |

- (a) Pursuant to various PRC sales tax rules and regulations, the Group is required to pay PRC business tax. Except for traffic revenues derived from inbound international and regional flights which are not subject to PRC business tax, the Group's traffic revenues, commission income and ground service income are subject to PRC business tax levied at rates ranging from 3% to 5%.

From 1 May 2003 to 31 December 2003, PRC business tax for all domestic, international and regional passenger traffic revenues of the Group are waived by the PRC Government, to subsidize for the airlines' losses on revenue due to the outbreak of Severe Acute Respiratory Syndrome ( SARS ).

- (b) The civil aviation infrastructure levies are paid to Civil Aviation Administration of China ( CAAC ), at rates of 5% and 2% respectively for domestic and international or regional traffic revenues.

From 1 May 2003 to 31 December 2003, civil aviation infrastructure levies for all domestic, international and regional traffic revenues of the Group are waived by the PRC Government, to subsidize for the airlines' losses on revenue due to the outbreak of SARS.

**Table of Contents****CHINA EASTERN AIRLINES CORPORATION LIMITED  
NOTES TO THE FINANCIAL STATEMENTS****4 OTHER OPERATING INCOME, NET**

|   | <b>Year Ended December 31,</b> |                |                |
|---|--------------------------------|----------------|----------------|
|   | <b>2001</b>                    | <b>2002</b>    | <b>2003</b>    |
|   | <b>RMB 000</b>                 | <b>RMB 000</b> | <b>RMB 000</b> |
| Gain/(loss) on disposals of aircraft and engines (note (a)) | 1,866                          | 115,904        | (28,767)       |
| Rental income from operating subleases of aircraft          | 125,742                        | 110,469        | 31,209         |
|   | <u>127,608</u>                 | <u>226,373</u> | <u>2,442</u>   |

- (a) The Group disposed of two MD82 engines in the year ended December 31, 2001, two A310 aircraft in the year ended December 31, 2002, and three B737-200 aircraft in the year ended December 31, 2003. All of the above disposals are made to unrelated third parties. The two aircraft disposed in the year ended December 31, 2002 were subleased out to another unrelated third party under operating leases before their disposal.

**5 WAGES, SALARIES AND BENEFITS**

|   | <b>Year Ended December 31,</b> |                  |                  |
|---|--------------------------------|------------------|------------------|
|   | <b>2001</b>                    | <b>2002</b>      | <b>2003</b>      |
|   | <b>RMB 000</b>                 | <b>RMB 000</b>   | <b>RMB 000</b>   |
| Wages, salaries and allowances  | 729,996                        | 897,843          | 989,092          |
| Contribution under defined contribution retirement schemes (note 30(a))                 | 46,471                         | 98,876           | 159,200          |
| Post-retirement benefits (note 30(b)(iii))  | 92,404                         | 39,134           | 40,299           |
| Staff housing allowances (note 31(b))   |                                |                  | 260,463          |
| Curtailed of medical benefit previously included in post-retirement benefit obligations | (95,975)                       |                  |                  |
|   | <u>772,896</u>                 | <u>1,035,853</u> | <u>1,449,054</u> |
| Average number of employees for the year ended  | <u>14,852</u>                  | <u>15,719</u>    | <u>16,435</u>    |

**6 FINANCE COSTS, NET**

|  | <b>Year Ended December 31,</b> |                |                |
|--|--------------------------------|----------------|----------------|
|  | <b>2001</b>                    | <b>2002</b>    | <b>2003</b>    |
|  | <b>RMB 000</b>                 | <b>RMB 000</b> | <b>RMB 000</b> |

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|  |                  |                  |                  |
|--|------------------|------------------|------------------|
| Interest charged on obligations under finance leases   | 646,288          | 509,889          | 490,456          |
| Interest on bank loans   |                  |                  |                  |
| - wholly repayable within five years   | 76,121           | 174,395          | 270,965          |
| - not wholly repayable within five years   | 268,234          | 222,702          | 180,291          |
|  | <u>344,355</u>   | <u>397,097</u>   | <u>451,256</u>   |
| Interest accrued on a long-term payable (note 28)  | 6,693            | 10,802           | 9,610            |
| Interest on loans from an associate  | 1,268            | 1,373            | 6,396            |
| Less: amounts capitalized into fixed assets and advances<br>on aircraft and flight equipment (note 18) | <u>(59,810)</u>  | <u>(71,948)</u>  | <u>(97,414)</u>  |
|  | 938,794          | 847,213          | 860,304          |
| Interest income  | <u>(124,419)</u> | <u>(115,824)</u> | <u>(147,846)</u> |
|  | <u>814,375</u>   | <u>731,389</u>   | <u>712,458</u>   |

The capitalization rates range between 6.00% and 6.21% per annum for the year ended December 31, 2001, 4.00% and 6.50% per annum for the year ended December 31, 2002, and 3 months LIBOR+0.25% and 5.76% per annum for the year ended December 31, 2003.



**Table of Contents****CHINA EASTERN AIRLINES CORPORATION LIMITED  
NOTES TO THE FINANCIAL STATEMENTS****7 TAXATION**

(a) Taxation are (charged)/credited to the consolidated income statements as follows:-

|  | <b>Year Ended December 31,</b> |                 |                  |
|--|--------------------------------|-----------------|------------------|
|  | <b>2001</b>                    | <b>2002</b>     | <b>2003</b>      |
|  | <b>RMB 000</b>                 | <b>RMB 000</b>  | <b>RMB 000</b>   |
| Provision for PRC income tax – current year            | (4,917)                        | (71,061)        | (124,530)        |
| Deferred taxation (note 7(d))                          |                                |                 |                  |
| - current year   | (38,668)                       | 17,570          | (118,797)        |
| - adjustment for change in enacted tax rate (note (i)) | 306,422                        | —               | —                |
|  | <u>267,754</u>                 | <u>17,570</u>   | <u>(118,797)</u> |
| Share of tax attributable to associates (note 16)      | (1,383)                        | (947)           | (4,227)          |
|  | <u>261,454</u>                 | <u>(54,438)</u> | <u>(247,554)</u> |

- (i) Under a preferential tax policy in Pudong, Shanghai, the Company is entitled to a reduced income tax rate of 15% with effect from July 1, 2001.
- (ii) Two major subsidiaries of the Company, namely China Cargo Airlines Co., Ltd. and China Eastern Airlines Jiangsu Co., Ltd. are subject to a reduced income tax rate of 15% and the standard PRC income tax rate of 33% respectively.
- (iii) The difference between the actual taxation credit/(charge) in the consolidated income statements and the amounts which would result from applying the enacted tax rate to profit/(loss) before taxation can be reconciled as follows:-

|   | <b>Year Ended December 31,</b> |                |                |
|---|--------------------------------|----------------|----------------|
|   | <b>2001</b>                    | <b>2002</b>    | <b>2003</b>    |
|   | <b>RMB 000</b>                 | <b>RMB 000</b> | <b>RMB 000</b> |
| Profit/(loss) before taxation   | 313,583                        | 262,894        | (589,831)      |
| Tax calculated at enacted tax rate of 15%                                       | (47,037)                       | (39,434)       | 88,475         |
| Effect attributable to subsidiaries and associates charged at a tax rate of 33% | (14,751)                       | (11,101)       | (4,117)        |
| Adjustments:-   |                                |                |                |
| Effect on deferred taxation brought forward due to the                          | 306,422                        |                |                |

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|   |                   |                   |                   |
|---|-------------------|-------------------|-------------------|
| reduction of enacted income tax rate                              |                   |                   |                   |
| Expenses not deductible for tax purposes                          |                   | (15,799)          | (62,421)          |
| Unrecognized tax losses of the Company                            |                   |                   | (258,515)         |
| Unrecognized tax losses of associates                             |                   | (11,347)          | (14,821)          |
| Utilization of previously unrecognized tax losses of subsidiaries | 20,302            | 36,953            |                   |
| Expired tax losses not deductible for tax purposes                |                   | (15,185)          |                   |
| Others  | (3,482)           | 1,475             | 3,845             |
|   | <u>          </u> | <u>          </u> | <u>          </u> |
| Tax credit/(charge)   | 261,454           | (54,438)          | (247,554)         |
|   | <u>          </u> | <u>          </u> | <u>          </u> |

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**Table of Contents****CHINA EASTERN AIRLINES CORPORATION LIMITED  
NOTES TO THE FINANCIAL STATEMENTS****7 TAXATION (CONT D)**

- (b) The Group operates international flights to certain overseas destinations. There was no material overseas taxation for the years as there exists double tax relief between PRC and the corresponding jurisdictions (including Hong Kong).
- (c) In accordance with the relevant PRC tax regulations, the operating lease rentals and the interest element of finance leases and bank loans paid or payable to foreign enterprises by the Group is subject to Foreign Enterprise Income Tax of PRC. This tax should be withheld by the Group at the time of payment and paid on behalf of the lessors or lenders. Pursuant to the Circular (2000) No. 2551 issued by the State Tax Bureau, lease payments made by aviation companies to foreign enterprises in respect of lease arrangements entered into prior to September 1, 1999 are exempted from the payment of any withholding tax. Withholding tax payable in respect of the leases arrangements entered into on or after September 1, 1999 are charged to the income statement as incurred.
- (d) Movements in net deferred taxation liabilities are as follows:-

|  | <b>December 31,</b> |                |
|--|---------------------|----------------|
|  | <b>2002</b>         | <b>2003</b>    |
|  | <b>RMB 000</b>      | <b>RMB 000</b> |
| At January 1                                       | 234,841             | 232,825        |
| (Credited)/charged to income statement (note 7(a)) | (17,570)            | 118,797        |
| Charged/(credited) to equity                       |                     |                |
| - revaluation reserves                             | 20,535              | (2,518)        |
| - unrecognized losses on cashflow hedges           | (4,981)             | (8,763)        |
|  | <hr/>               | <hr/>          |
| At December 31                                     | 232,825             | 340,341        |
|  | <hr/>               | <hr/>          |

As at December 31, 2002 and 2003, the deferred tax assets and liabilities (prior to offsetting of balances within the same tax jurisdiction) were made up of taxation effects of the followings:-

|   | <b>December 31,</b> |                |                |                |                |                |
|---|---------------------|----------------|----------------|----------------|----------------|----------------|
|   |                     |                |                |                |                |                |
|   | <b>2002</b>         | <b>Total</b>   |                | <b>2003</b>    | <b>Total</b>   |                |
|   | <b>Non-</b>         | <b>current</b> | <b>RMB 000</b> | <b>Non-</b>    | <b>current</b> | <b>Total</b>   |
|   | <b>Current</b>      | <b>current</b> | <b>RMB 000</b> | <b>Current</b> | <b>current</b> | <b>RMB 000</b> |
|   | <b>RMB 000</b>      | <b>RMB 000</b> | <b>RMB 000</b> | <b>RMB 000</b> | <b>RMB 000</b> | <b>RMB 000</b> |
| Deferred tax assets:                                    |                     |                |                |                |                |                |
| Tax losses carried forward                              |                     | 174,472        | 174,472        |                | 312,916        | 312,916        |
| Provision for obsolete flight equipment and spare parts |                     | 32,608         | 32,608         |                | 41,960         | 41,960         |
| Repair cost on flight equipment                         |                     | 203,265        | 203,265        |                | 160,541        | 160,541        |

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|  |               |                  |                  |                |                  |                  |
|--|---------------|------------------|------------------|----------------|------------------|------------------|
| Provision for post-retirement benefits | 2,363         | 82,417           | 84,780           | 2,999          | 86,734           | 89,733           |
| Other accrued expenses                 | 69,891        | 4,981            | 74,872           | 108,518        | 13,744           | 122,262          |
|  | <u>72,254</u> | <u>497,743</u>   | <u>569,997</u>   | <u>111,517</u> | <u>615,895</u>   | <u>727,412</u>   |
| Less: unrecognized assets              |               |                  |                  |                | (258,515)        | (258,515)        |
|  | <u>72,254</u> | <u>497,743</u>   | <u>569,997</u>   | <u>111,517</u> | <u>357,380</u>   | <u>468,897</u>   |
| Deferred tax liabilities:              |               |                  |                  |                |                  |                  |
| Provision for overhaul                 |               | (125,887)        | (125,887)        |                | (103,853)        | (103,853)        |
| Depreciation and amortization          |               | (665,083)        | (665,083)        |                | (705,385)        | (705,385)        |
| Others                                 |               | (11,852)         | (11,852)         |                |                  |                  |
|  |               | <u>(802,822)</u> | <u>(802,822)</u> |                | <u>(809,238)</u> | <u>(809,238)</u> |
| Deferred tax assets/(liabilities), net | <u>72,254</u> | <u>(305,079)</u> | <u>(232,825)</u> | <u>111,517</u> | <u>(451,858)</u> | <u>(340,341)</u> |

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**Table of Contents****CHINA EASTERN AIRLINES CORPORATION LIMITED  
NOTES TO THE FINANCIAL STATEMENTS****7 TAXATION (CONT D)**

Deferred income tax assets and liabilities are offset when there is a legally enforceable right to set off current tax assets against current liabilities and when the deferred income taxes relate to the same authority. The following amounts, determined after appropriate offsetting, are shown in the consolidated balance sheets:

|                          | <b>2002</b>       | <b>2003</b>       |
|--------------------------|-------------------|-------------------|
|                          | <b>RMB 000</b>    | <b>RMB 000</b>    |
| Deferred tax assets      | 569,997           | 399,771           |
| Deferred tax liabilities | (802,822)         | (740,112)         |
|                          | <u>          </u> | <u>          </u> |
|                          | (232,825)         | (340,341)         |
|                          | <u>          </u> | <u>          </u> |

In accordance with PRC tax law, tax losses may be carried forward against future taxable income for a period of five years. As at December 31, 2002 and 2003, the Group had tax losses carried forward approximately RMB1,163 million and RMB2,086 million respectively which will expire between 2006 and 2008, available to set off against the Group's future taxable income. For the year ended December 31, 2003, the Group did not recognize RMB258,515,000 of deferred tax asset arising from the tax losses available as management believe it was more likely than not that such tax losses would not be realized before they expire.

**8 BASIC AND DILUTED EARNINGS PER SHARE**

The calculation of basic earnings/(loss) per share is based on the profit attributable to shareholders of RMB541,713,000, RMB86,369,000 and loss attributable to shareholders of RMB949,816,000 for the years ended December 31, 2001, 2002 and 2003, respectively, and 4,866,950,000 shares in issue during the years ended December 31, 2001, 2002 and 2003. The Company has not issued any potential dilutive instruments that are ordinary share equivalent.

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NOTES TO THE FINANCIAL STATEMENTS****9 DIVIDENDS**

The dividends recognized in the year ended December 31, 2002 represent the final dividend of RMB0.02 per share totaling RMB97,339,000 for the year ended December 31, 2001 proposed by the Board of Directors on April 8, 2002 and approved in the Annual General Meeting on June 18, 2002.

On April 7, 2003, the Board of Directors proposed a final dividend of RMB0.02 per share totaling RMB97,339,000 for the year ended December 31, 2002.

On April 29, 2003, in view of the outbreak of atypical pneumonia resulting in a significant change in the Group's operational environment, the Board of Directors decided to withdraw the final dividend proposal made on April 7, 2003.

The Board of Directors of the Company does not recommend the payment of a dividend for the year ended December 31, 2003.

**10 TRADE RECEIVABLES LESS ALLOWANCE FOR DOUBTFUL ACCOUNTS**

The credit terms given to trade customers are determined on individual basis, with the credit period ranging from half to three months.

As of December 31, 2002 and 2003, the aging analysis of the trade receivables were as follows:-

|                   | <b>December 31,</b> |                  |
|-------------------|---------------------|------------------|
|                   | <b>2002</b>         | <b>2003</b>      |
|                   | <b>RMB 000</b>      | <b>RMB 000</b>   |
| Less than 31 days | 555,787             | 853,303          |
| 31 to 60 days     | 200,702             | 348,159          |
| 61 to 90 days     | 70,333              | 28,094           |
| Over 90 days      | 138,404             | 96,121           |
|                   | <u>965,226</u>      | <u>1,325,677</u> |

**Table of Contents****CHINA EASTERN AIRLINES CORPORATION LIMITED  
NOTES TO THE FINANCIAL STATEMENTS****11 PREPAYMENTS AND OTHER RECEIVABLES**

|  | <b>December 31,</b> |                  |
|--|---------------------|------------------|
|  | <b>2002</b>         | <b>2003</b>      |
|  | <b>RMB 000</b>      | <b>RMB 000</b>   |
| Amounts due from related companies (note 35(a)(i)) | 46,159              | 45,389           |
| Discounts on aircraft acquisitions receivable      | 78,822              | 29,814           |
| Receivables from provision of ground services      | 125,418             | 111,129          |
| Prepaid aircraft operating lease rentals           | 111,908             | 95,959           |
| US treasury zero coupon bonds (note 19)            |                     | 585,736          |
| Receivable on aircraft operating lease rentals     | 8,034               |                  |
| Advance payment for equity interests               | 112,500             |                  |
| Other  | 332,208             | 394,146          |
|  | <u>815,049</u>      | <u>1,262,173</u> |

**12 SHORT-TERM INVESTMENTS**

Short-term investments are valued at market value at December 31 by reference to stock exchange quoted bid prices.

Short-term investments are classified as current assets because they are expected to be realized within twelve months of the balance sheet date.

**13 FIXED ASSETS**

|  | <b>Aircraft and<br/>fight equipment</b> |  |                             |   |                             |
|--|---|--|-----------------------------|---|-----------------------------|
|  | <b>Owned</b>                            | <b>Held under<br/>finance<br/>leases</b> | <b>Buildings</b>            | <b>Other fixed<br/>assets and<br/>equipment</b> | <b>Total</b>                |
|  | <b>RMB 000</b>                          | <b>RMB 000</b>                           | <b>RMB 000</b>              | <b>RMB 000</b>                                  | <b>RMB 000</b>              |
| <b>Valuation</b>   |   |  |                             |   |                             |
| At January 1, 2003   | 14,140,941                              | 11,318,748                               | 1,774,876                   | 2,050,936                                       | 29,285,501                  |
| Reclassification upon completion of<br>finance lease terms | 438,967                                 | (438,967)                                |                             |   |                             |
| Transfer from construction in progress<br>(note 14)        |   |  | 389,612                     | 54,149  | 443,761                     |
| Additions  | 7,728,025                               | 76,645                                   | 63,940                      | 161,727   | 8,030,337                   |
| Disposals  | (144,715)                               |  | (3,908)                     | (228,631)                                       | (377,254)                   |
|  | <u>                    </u>             | <u>                    </u>              | <u>                    </u> | <u>                    </u>                     | <u>                    </u> |

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|  |                   |                   |                  |                  |                   |
|--|-------------------|-------------------|------------------|------------------|-------------------|
| At December 31, 2003                                       | <u>22,163,218</u> | <u>10,956,426</u> | <u>2,224,520</u> | <u>2,038,181</u> | <u>37,382,345</u> |
| <b>Accumulated depreciation</b>                            |                   |                   |                  |                  |                   |
| At January 1, 2003   | 4,614,292         | 3,078,861         | 248,720          | 877,678          | 8,819,551         |
| Reclassification upon completion of<br>finance lease terms | 43,275            | (43,275)          |                  |                  |                   |
| Charge for the year  | 1,035,312         | 577,723           | 86,595           | 274,832          | 1,974,462         |
| Disposals  | <u>(35,286)</u>   | <u></u>           | <u>(364)</u>     | <u>(214,921)</u> | <u>(250,571)</u>  |
| At December 31, 2003                                       | <u>5,657,593</u>  | <u>3,613,309</u>  | <u>334,951</u>   | <u>937,589</u>   | <u>10,543,442</u> |
| <b>Net book value</b>                                      |                   |                   |                  |                  |                   |
| <b>At December 31, 2003</b>                                | <u>16,505,625</u> | <u>7,343,117</u>  | <u>1,889,569</u> | <u>1,100,592</u> | <u>26,838,903</u> |
| Net book value<br>At December 31, 2002                     | <u>9,526,649</u>  | <u>8,239,887</u>  | <u>1,526,156</u> | <u>1,173,258</u> | <u>20,465,950</u> |

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**Table of Contents****CHINA EASTERN AIRLINES CORPORATION LIMITED  
NOTES TO THE FINANCIAL STATEMENTS****13 FIXED ASSETS (CONT D)**

- (a) On December 31, 2002, the Group's fixed assets were revalued by the directors of the Company on a market value or replacement cost basis. The difference between the valuation and the carrying amount of the fixed assets as of December 31, 2002 was recognized. On December 31, 2003, the directors of the Company reviewed the carrying value of the Group's fixed assets as of December 31, 2003 and are of the opinion that the carrying amount is not materially different from the fair value.

Had the Group's fixed assets been stated at cost less accumulated depreciation and impairment losses as of December 31, 2002, the carrying amounts of aircraft and flight equipment, buildings, and other fixed assets and equipment would have been RMB17,495,086,000, RMB1,526,156,000 and RMB1,173,258,000 respectively, and as of December 31, 2003 would have been RMB23,628,586,000, RMB1,889,569,000 and RMB1,100,592,000 respectively.

- (b) Certain aircraft of the Group with an aggregate carrying value of approximately RMB3,272,123,000 and RMB9,735,106,000 as of December 31, 2002 and 2003 were pledged as collateral under certain loan agreements (see note 24).
- (c) Included in the additions of fixed assets of the Group were interest capitalized of RMB33,377,000 and RMB152,591,000 as of December 31, 2002 and 2003 respectively, of which RMB13,362,000 and RMB62,149,000 were capitalized during each of the two years respectively.

**14 CONSTRUCTION IN PROGRESS**

|                                    | <b>December 31,</b> |                   |
|------------------------------------|---------------------|-------------------|
|                                    | <b>2002</b>         | <b>2003</b>       |
|                                    | <b>RMB 000</b>      | <b>RMB 000</b>    |
| At January 1                       | 347,406             | 413,812           |
| Additions                          | 287,179             | 249,737           |
| Transfer to fixed assets (note 13) | (220,773)           | (443,761)         |
|                                    | <u>          </u>   | <u>          </u> |
| At December 31                     | <u>413,812</u>      | <u>219,788</u>    |

**Table of Contents****CHINA EASTERN AIRLINES CORPORATION LIMITED  
NOTES TO THE FINANCIAL STATEMENTS****15 LEASE PREPAYMENTS**

Lease prepayments represent unamortized prepayments for land use rights.

The Group's land use rights are located in the PRC and majority of these land use rights have terms of 50 years from the date of grant. As at December 31, 2002 and 2003, majority of these land use rights had remaining terms ranging from 44 to 50 years and 43 to 49 years respectively.

Certificates of certain land use rights with nil carrying value of the Group are currently registered under the name of CEA Holding. The procedures to change the registration of the land use rights certificates with the relevant municipal land bureaus are currently being addressed by CEA Holding. Until the completion of these transfer procedures, the Group is unable to assign or pledge these land use rights. However, the Group currently has no need to assign and no intention to pledge these land use rights. In addition, the Group is entitled to lawfully and validly occupy and use these lands for its daily operations in spite of the fact that the procedures of changing the registration of these land use rights have not been fully completed. Accordingly, the directors of the Company do not believe the lack of certificates of certain land use rights has any material impact on the financial position of the Group.

**16 INVESTMENTS IN ASSOCIATES**

|                     | <b>December 31,</b> |                |
|---------------------|---------------------|----------------|
|                     | <b>2002</b>         | <b>2003</b>    |
|                     | <b>RMB 000</b>      | <b>RMB 000</b> |
| Share of net assets | 272,098             | 572,818        |
| Goodwill            | 59,472              | 53,266         |
|                     | <u>331,570</u>      | <u>626,084</u> |

Movements in investments in associates are as follows:-

|                                  | <b>2002</b>    | <b>2003</b>    |
|----------------------------------|----------------|----------------|
|                                  | <b>RMB 000</b> | <b>RMB 000</b> |
| At January 1                     | 109,527        | 331,570        |
| Cost of investment               | 254,656        | 327,252        |
| Share of results before taxation | (31,666)       | (28,511)       |
| Share of taxation                | (947)          | (4,227)        |
|                                  | <u>331,570</u> | <u>626,084</u> |

For the years ended December 31, 2002 and 2003, the share of results before taxation includes RMB2,586,000 and RMB6,206,000 amortization charge of goodwill in respect of acquisition of associates.



**Table of Contents****CHINA EASTERN AIRLINES CORPORATION LIMITED  
NOTES TO THE FINANCIAL STATEMENTS****16 INVESTMENTS IN ASSOCIATES (CONT D)**

Particular of the principal associates, all of which are limited companies established and operating in the PRC, are as follows:-;

| <b>Company</b>                                  | <b>Place and date of establishment</b> | <b>Paid-up capital<br/>RMB 000</b> | <b>Attributable equity interest</b> |             | <b>Principal activities</b>   |
|---|--|------------------------------------|-------------------------------------|-------------|---|
|   |  |                                    | <b>2002</b>                         | <b>2003</b> |   |
| China Eastern Airlines Wuhan Co., Ltd.          | PRC<br>August 16, 2002                 | 600,000                            | 40%                                 | 40%         | Provision of air transportation services                            |
| Eastern Air Group Finance Co., Ltd.             | PRC<br>December 6, 1995                | 400,000                            | 25%                                 | 25%         | Provision of financial services to companies comprising CEA Holding |
| Eastern Aviation Advertising Services Co.       | PRC<br>March 4, 1986                   | 10,000                             | 45%                                 | 45%         | Provision of aviation advertising agency services                   |
| China Eastern Air Catering Investment Co., Ltd. | PRC<br>November 17, 2003               | 350,000                            |                                     | 45%         | Provision of air catering services                                  |
| Eastern Aviation Import and Export Co., Ltd.    | PRC<br>June 9, 1993                    | 80,000                             |                                     | 45%         | Provision of aviation equipment, spare parts and tools trading      |
| Shanghai Dongmei Aviation Travel Co., Ltd.      | PRC<br>October 17, 2003                | 31,000                             |                                     | 45%         | Provision of traveling and accommodation agency services            |
| Qingdao Liuting International Airport Co., Ltd. | PRC<br>December 1, 2000                | 450,000                            |                                     | 25%         | Provision of airport operation services                             |

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NOTES TO THE FINANCIAL STATEMENTS****17 GOODWILL AND NEGATIVE GOODWILL**

|  | <b>Goodwill<br/>RMB 000</b> | <b>Negative<br/>Goodwill<br/>RMB 000</b> | <b>Total<br/>RMB 000</b> |
|--|-----------------------------|--|--------------------------|
| <b>Cost</b>                              |                             |  |                          |
| At January 1, 2003 and December 31, 2003 | 113,105                     | (55,245)                                 | 57,860                   |
| <b>Accumulated amortization</b>          |                             |  |                          |
| At January 1, 2003                       | 22,621                      | (5,468)                                  | 17,153                   |
| Charge for the year                      | 5,654                       | (3,452)                                  | 2,202                    |
| At December 31, 2003                     | 28,275                      | (8,920)                                  | 19,355                   |
| <b>Net book value</b>                    |                             |  |                          |
| At December 31, 2003                     | 84,830                      | (46,325)                                 | 38,505                   |
| At December 31, 2002                     | 90,484                      | (49,777)                                 | 40,707                   |

**18 ADVANCES ON AIRCRAFT AND FLIGHT EQUIPMENT**

|                                      | <b>December 31,</b>     |                         |
|--------------------------------------|-------------------------|-------------------------|
|                                      | <b>2002<br/>RMB 000</b> | <b>2003<br/>RMB 000</b> |
| At January 1                         | 1,141,576               | 3,227,720               |
| Additions                            | 2,527,662               | 1,198,242               |
| Interest capitalized during the year | 71,948                  | 97,414                  |
| Transfer to fixed assets             | (513,466)               | (2,283,483)             |
| At December 31                       | 3,227,720               | 2,239,893               |

Included in the balances as of December 31, 2002 and 2003 are interest capitalized of RMB95,701,000 and RMB130,965,000 respectively.

**19 OTHER LONG-TERM RECEIVABLES AND INVESTMENTS**

|  | <b>December 31,</b> |                |
|--|---------------------|----------------|
|  | <b>2002</b>         | <b>2003</b>    |
|  | <b>RMB 000</b>      | <b>RMB 000</b> |
| Long-term bank deposits (note 23)            | 1,463,044           | 1,743,924      |
| US Treasury zero coupon bonds (note (a))     | 542,124             |                |
| Deposits for aircraft under operating leases | 89,273              | 110,812        |
| Prepaid custom duty and valued added tax     | 52,501              | 37,410         |
| Prepayments and other long-term receivables  | 76,826              | 70,216         |
|  | <hr/>               | <hr/>          |
|  | 2,223,768           | 1,962,362      |
|  | <hr/>               | <hr/>          |

- (a) US Treasury zero bonds will mature in February 2004 and are classified as current assets as at 31 December 2003 (see note 11).

**Table of Contents****CHINA EASTERN AIRLINES CORPORATION LIMITED  
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****20 TRADE PAYABLES**

As of December 31, 2002 and 2003, all trade payables were current balances and aged within 30 days.

**21 OTHER PAYABLES AND ACCRUED EXPENSES**

|   | <b>December 31,</b> |                  |
|---|---------------------|------------------|
|   | <b>2002</b>         | <b>2003</b>      |
|   | <b>RMB 000</b>      | <b>RMB 000</b>   |
| Amounts due to related companies (note 35(a)(i))                    | 339,133             | 771,643          |
| Accrued operating expenses  | 1,241,948           | 2,004,906        |
| Payable for land use rights   | 3,093               |                  |
| Current portion of accrued aircraft overhaul expenses (note 22)     | 304,129             | 385,168          |
| Duties and levies payable   | 55,279              | 10,049           |
| Current portion of a long-term payable (note 28)                    | 30,000              | 30,000           |
| Current portion of post-retirement benefits obligation (note 30(b)) | 15,753              | 19,750           |
| Current portion of provision for staff housing allowance (note 31)  | 80,179              | 85,973           |
| Accrued salaries, wages and benefits                                | 125,462             | 138,954          |
| Flight equipment purchase payable                                   | 167,390             | 511,347          |
| Amounts due to minority shareholders                                | 155,486             | 156,308          |
| Other   | 273,181             | 185,891          |
|   | <u>2,791,033</u>    | <u>4,299,989</u> |

**22 ACCRUED AIRCRAFT OVERHAUL EXPENSES**

|                          | <b>2002</b>    | <b>2003</b>    |
|--------------------------|----------------|----------------|
|                          | <b>RMB 000</b> | <b>RMB 000</b> |
| At January 1             | 459,019        | 547,813        |
| Additional provisions    | 124,235        | 123,213        |
| Utilized during the year | (35,441)       | (94,474)       |
|                          | <u>547,813</u> | <u>576,552</u> |
| At December 31           | 547,813        | 576,552        |

|  | <b>December 31,</b> |                |
|--|---------------------|----------------|
|  | <b>2002</b>         | <b>2003</b>    |
|  | <b>RMB 000</b>      | <b>RMB 000</b> |
| Total accrued aircraft overhaul expenses | 547,813             | 576,552        |

|                                 |                  |                  |
|---------------------------------|------------------|------------------|
| Less: current portion (note 21) | <u>(304,129)</u> | <u>(385,168)</u> |
| Long-term portion               | <u>243,684</u>   | <u>191,384</u>   |

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****23 OBLIGATIONS UNDER FINANCE LEASES**

The Group had 19 aircraft and 18 aircraft under finance leases as of December 31, 2002 and 2003 respectively. Under the terms of the leases, the Group has the option to purchase, at or near the end of the lease term, certain aircraft at fair market value and others at either fair market value or a percentage of the respective lessor's defined cost of the aircraft.

The future minimum lease payments, interest and present value of minimum lease payments which are principally denominated in foreign currencies, under these finance leases as of December 31, 2002 and 2003 were as follows:-

|   | <b>December 31,</b>                               |                             |  |   |                             |  |
|---|---|-----------------------------|--|---|-----------------------------|--|
|   | <b>2002</b>                                       |                             | <b>2003</b>  |   |                             |  |
|   | <b>Minimum<br/>lease<br/>payments<br/>RMB 000</b> | <b>Interest<br/>RMB 000</b> | <b>Present<br/>value of<br/>minimum<br/>lease<br/>payments<br/>RMB 000</b> | <b>Minimum<br/>lease<br/>payments<br/>RMB 000</b> | <b>Interest<br/>RMB 000</b> | <b>Present<br/>value of<br/>minimum<br/>lease<br/>payments<br/>RMB 000</b> |
| Within one year                           | 2,733,720   | 486,661                     | 2,247,059  | 2,049,079   | 356,995                     | 1,692,084  |
| In the second year                        | 1,142,846   | 307,758                     | 835,088  | 1,242,950   | 256,355                     | 986,595  |
| In the third to fifth year<br>inclusive   | 4,524,438   | 519,489                     | 4,004,949  | 4,361,682   | 322,316                     | 4,039,366  |
| After the fifth year                      | 1,162,325   | 65,455                      | 1,096,870  | 408,853   | 26,012                      | 382,841  |
| <b>Total</b>                              | <b>9,563,329</b>                                  | <b>1,379,363</b>            | <b>8,183,966</b>   | <b>8,062,564</b>                                  | <b>961,678</b>              | <b>7,100,886</b>   |
| Less: amount repayable<br>within one year | <u>(2,733,720)</u>                                | <u>(486,661)</u>            | <u>(2,247,059)</u>   | <u>(2,049,079)</u>                                | <u>(356,995)</u>            | <u>(1,692,084)</u>   |
| <b>Long-term portion</b>                  | <b><u>6,829,609</u></b>                           | <b><u>892,702</u></b>       | <b><u>5,936,907</u></b>  | <b><u>6,013,485</u></b>                           | <b><u>604,683</u></b>       | <b><u>5,408,802</u></b>  |

As of December 31, 2002 and 2003, the Group had long-term bank deposits and U.S. Treasury zero coupon bonds totaling RMB2,005,168,000 and RMB2,329,660,000 respectively, pledged as securities under certain finance lease arrangements (see note 19). All of these bank deposits and the U.S. Treasury zero coupon bonds will be used to meet future lease obligations as they fall due.

In addition, the Group's finance lease obligations are secured by the related aircraft, the relevant insurance policies and bank guarantees.

**Table of Contents****CHINA EASTERN AIRLINES CORPORATION LIMITED  
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****24 LONG-TERM BANK LOANS**

|   | <b>December 31,</b> |                |
|---|---------------------|----------------|
|   | <b>2002</b>         | <b>2003</b>    |
|   | <b>RMB 000</b>      | <b>RMB 000</b> |
| Bank loans                                |                     |                |
| - secured                                 | 2,589,504           | 6,495,507      |
| - unsecured                               | 3,905,127           | 4,727,416      |
|   | <hr/>               | <hr/>          |
| Total                                     | 6,494,631           | 11,222,923     |
| Less: amount repayable within one year    | (1,261,902)         | (2,250,734)    |
|   | <hr/>               | <hr/>          |
| Long-term portion                         | 5,232,729           | 8,972,189      |
|   | <hr/>               | <hr/>          |
| The bank loans are repayable as follows:- |                     |                |
| Within one year                           | 1,261,902           | 2,250,734      |
| In the second year                        | 1,709,114           | 2,438,574      |
| In the third to fifth year inclusive      | 2,367,721           | 4,163,578      |
| After the fifth year                      | 1,155,894           | 2,370,037      |
|   | <hr/>               | <hr/>          |
| Total                                     | 6,494,631           | 11,222,923     |
|   | <hr/>               | <hr/>          |

The terms of long-term bank loans can be summarized as follows:-

|                                     |   | <b>December 31,</b> |                |
|-------------------------------------|---|---------------------|----------------|
|                                     |   | <b>2002</b>         | <b>2003</b>    |
|                                     |   | <b>RMB 000</b>      | <b>RMB 000</b> |
|                                     | <b>Interest rate and final maturities</b>   |                     |                |
| RMB denominated bank loans:         |   |                     |                |
| Loans for construction projects     | Fixed interest rate of 6.21% per annum as of December 31, 2003; 7 to 10-year loans with final maturities through to 2007            | 800,000             | 637,500        |
| Loans for the purchases of aircraft | Fixed interest rate ranging from 4.12% to 4.94% per annum as of December 31, 2003; 3-year loans with final maturity through to 2006 | 250,000             | 1,306,700      |
|                                     |   | <hr/>               | <hr/>          |

|  |   |                  |                   |
|--|---|------------------|-------------------|
|  |   | 1,050,000        | 1,944,200         |
| U.S. dollar denominated<br>bank loans: |   |                  |                   |
| Loans for the purchases of<br>aircraft | Fixed interest rates ranging from 5.65% to 6.86%<br>per annum and floating interest rates ranging<br>from 3 months LIBOR + 0.25% to 6 months<br>LIBOR + 0.3% as of December 31, 2003; 10 to<br>12-year loans with final maturities through to<br>2008 | 5,444,631        | 9,278,723         |
|  |   | <u>5,444,631</u> | <u>9,278,723</u>  |
| Total long-term bank loans             |   | <u>6,494,631</u> | <u>11,222,923</u> |

**Table of Contents****CHINA EASTERN AIRLINES CORPORATION LIMITED  
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****24 LONG-TERM BANK LOANS (CONT D)**

Bank loans totaling RMB2,589,504,000 and RMB6,495,508,000 as of December 31, 2002 and 2003 respectively, of the Group for the purchases of aircraft were secured by the related aircraft (see note 13(b)).

Bank loans were guaranteed by the following parties:-

|  | <b>December 31,</b> |                |
|--|---------------------|----------------|
|  | <b>2002</b>         | <b>2003</b>    |
|  | <b>RMB 000</b>      | <b>RMB 000</b> |
| RMB denominated bank loans guaranteed by CEA Holding             | 1,050,000           | 1,944,200      |
| U.S. dollar denominated bank loans guaranteed by third parties:- |                     |                |
| Export-Import Bank of the United States                          | 1,488,745           | 1,276,352      |
| China Industrial and Commercial Bank                             | 144,645             | 94,089         |
| China Construction Bank  | 100,399             | 85,879         |
|  | <hr/>               | <hr/>          |
|  | 2,783,789           | 3,400,520      |
|  | <hr/>               | <hr/>          |

**25 SHORT-TERM BANK LOANS**

Short-term bank loans of the Group are repayable within one year with interest charged at the prevailing market rates based on the rates quoted by the People's Bank of China. The interest rates related to such loans were between 2.06% and 5.31% per annum and between 2.06% and 5.04% per annum as of December 31, 2002 and 2003 respectively. During the years ended December 31, 2002 and 2003, the weighted average interest rates on short-term bank loans were 4.39% and 3.34% per annum respectively.

**26 SHARE CAPITAL**

|  | <b>December 31,</b> |                |
|--|---------------------|----------------|
|  | <b>2002</b>         | <b>2003</b>    |
|  | <b>RMB 000</b>      | <b>RMB 000</b> |
| Registered, issued and fully paid of RMB1.00 each A shares |                     |                |
| State-owned shares held by CEA Holding                     | 3,000,000           | 3,000,000      |
| Shares held by public                                      | 300,000             | 300,000        |
|  | <hr/>               | <hr/>          |
|  | 3,300,000           | 3,300,000      |
| Overseas listed foreign H shares                           | 1,566,950           | 1,566,950      |
|  | <hr/>               | <hr/>          |
|  | 4,866,950           | 4,866,950      |

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Pursuant to articles 49 and 50 of the Company's Articles of Association, the A shares held by CEA Holding, employees, the public and H shares are all registered ordinary shares, carrying equal rights.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****27 RESERVES**

(Amounts in thousands)

|   | Share<br>premium | Statutory<br>common<br>reserve<br>fund<br>(note (a)) | Statutory<br>common<br>welfare<br>fund<br>(note (b)) | Discretionary<br>common<br>reserve<br>fund<br>(note (c)) | Revaluation<br>reserve | Capital<br>Reserve | Hedging<br>reserve<br>(note 37) | Retained<br>profits | Total     |
|---|------------------|--|--|--|------------------------|--------------------|---------------------------------|---------------------|-----------|
| In RMB  |                  |  |  |  |                        |                    |                                 |                     |           |
| At January 1,<br>2001   | 1,006,455        | 94,432   | 94,432   | 27,908   |                        | (318,486)          |                                 | 1,098,847           | 2,003,588 |
| Unrealized gain<br>on cashflow<br>hedges                                  |                  |  |  |  |                        |                    | 5,396                           |                     | 5,396     |
| Dividends<br>relating to 2000<br>(note 9)                                 |                  |  |  |  |                        |                    |                                 | (97,339)            | (97,339)  |
| Profit<br>attributable to<br>shareholders                                 |                  |  |  |  |                        |                    |                                 | 541,713             | 541,713   |
| Transfer from<br>retained profits<br>to reserves<br>(note (d))            |                  | 1,681  | 1,681  |  |                        |                    |                                 | (3,362)             |           |
| At<br>December 31,<br>2001  | 1,006,455        | 96,113   | 96,113   | 27,908   |                        | (318,486)          | 5,396                           | 1,539,859           | 2,453,358 |
| Reclassification<br>of revaluation<br>reserve (note<br>(e))               |                  |  |  |  | 401,571                | (401,571)          |                                 |                     |           |
| Revaluation<br>surplus of fixed<br>assets                                 |                  |  |  |  |                        |                    |                                 |                     |           |
| - gross   |                  |  |  |  | 491,772                |                    |                                 |                     | 491,772   |
| - tax   |                  |  |  |  | (73,766)               |                    |                                 |                     | (73,766)  |
| Revaluation<br>surplus after<br>tax shared by<br>minority<br>shareholders |                  |  |  |  | (12,981)               |                    |                                 |                     | (12,981)  |
| Revaluation<br>deficit offset   |                  |  |  |  |                        |                    |                                 |                     |           |

|  |                  |                |                |               |                |                  |                 |                  |                  |
|--|------------------|----------------|----------------|---------------|----------------|------------------|-----------------|------------------|------------------|
| against<br>previous<br>revaluation<br>surplus of fixed<br>assets |                  |                |                |               |                |                  |                 |                  |                  |
| - gross  |                  |                |                | (354,870)     |                |                  |                 |                  | (354,870)        |
| - tax  |                  |                |                | 53,231        |                |                  |                 |                  | 53,231           |
| Unrealized<br>losses on<br>cashflow<br>hedges (note<br>37)       |                  |                |                |               |                |                  |                 |                  |                  |
| - gross  |                  |                |                |               |                | (38,602)         |                 |                  | (38,602)         |
| - tax  |                  |                |                |               |                | 4,981            |                 |                  | 4,981            |
| Dividends<br>relating to 2001<br>(note 9)                        |                  |                |                |               |                |                  | (97,339)        |                  | (97,339)         |
| Profit<br>attributable to<br>shareholders                        |                  |                |                |               |                |                  | 86,369          |                  | 86,369           |
| Transfer from<br>retained profits<br>to reserves<br>(note (d))   |                  | 10,696         | 10,614         | 81            |                |                  |                 | (21,391)         |                  |
|  | <u>1,006,455</u> | <u>106,809</u> | <u>106,727</u> | <u>27,989</u> | <u>504,957</u> | <u>(720,057)</u> | <u>(28,225)</u> | <u>1,507,498</u> | <u>2,512,153</u> |
| At<br>December 31,<br>2002                                       |                  |                |                |               |                |                  |                 |                  |                  |
| Unrealized<br>losses on<br>cashflow<br>hedges (note<br>37)       |                  |                |                |               |                |                  |                 |                  |                  |
| - gross  |                  |                |                |               |                | (58,417)         |                 |                  | (58,417)         |
| - tax  |                  |                |                |               |                | 8,763            |                 |                  | 8,763            |
| Release of<br>reserves upon<br>disposals of<br>aircraft          |                  |                |                |               |                |                  |                 |                  |                  |
| - gross  |                  |                |                |               | (16,787)       |                  | 16,787          |                  |                  |
| - tax  |                  |                |                |               | 2,518          |                  |                 |                  | 2,518            |
| Loss<br>attributable to<br>shareholders                          |                  |                |                |               |                |                  | (949,816)       |                  | (949,816)        |
| Transfer from<br>retained profits<br>to reserves<br>(note (d))   |                  | 36,689         | 35,821         |               |                |                  |                 | (72,510)         |                  |
|  | <u>1,006,455</u> | <u>106,809</u> | <u>106,727</u> | <u>27,989</u> | <u>504,957</u> | <u>(720,057)</u> | <u>(28,225)</u> | <u>1,507,498</u> | <u>2,512,153</u> |

At  
December 31,  
2003

|                  |                |                |               |                |                  |                 |                |                  |
|------------------|----------------|----------------|---------------|----------------|------------------|-----------------|----------------|------------------|
| <u>1,006,455</u> | <u>143,498</u> | <u>142,548</u> | <u>27,989</u> | <u>490,688</u> | <u>(720,057)</u> | <u>(77,879)</u> | <u>501,959</u> | <u>1,515,201</u> |
|------------------|----------------|----------------|---------------|----------------|------------------|-----------------|----------------|------------------|

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**CHINA EASTERN AIRLINES CORPORATION LIMITED  
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

**27 RESERVES (CONT D)**

- (a) Pursuant to PRC regulations and the Company's Articles of Association, the Company is required to transfer 10% of its profit attributable to shareholders, as determined under the PRC Accounting Regulations, to statutory common reserve fund until the fund aggregates to 50% of the Company's registered capital. The transfer to this reserve must be made before distribution of a dividend to shareholders.

Statutory common reserve fund can be used to make good previous years' losses, if any, and to issue new shares to shareholders in proportion to their existing shareholdings or to increase the par value of the shares currently held by them, provided that the balance after such issue is not less than 25% of the registered capital.

- (b) Pursuant to PRC regulations and the Company's Articles of Association, the Company is required to transfer 5% to 10% of its profit for the year, as determined under the PRC Accounting Regulations, to the statutory common welfare fund. This fund can only be used to provide staff welfare facilities and other collective benefits to the Company's employees. This fund is non-distributable other than in liquidation.
- (c) The Company is allowed to transfer 5% of the profit for the year as determined under the PRC Accounting Regulations, to discretionary common welfare fund. The transfer to this reserve is subject to the approval by shareholder's meetings.
- (d) For the year ended December 31, 2001 and 2002, under the PRC Accounting Regulations, the Company recorded profits for the year which had been applied to make good previous years' losses. For the year ended December 31, 2003, under the PRC Accounting Regulations, the Company recorded a loss for the year. Accordingly, no profit appropriation has been made for the years ended December 31, 2001, 2002 and 2003. Transfer from retained profits to reserves for the years ended 2001, 2002 and 2003 represent the profit appropriation to reserves of the Company's subsidiaries.
- (e) Fixed assets of the Group as of June 30, 1996 were revalued as part of the restructuring of the Group, which resulted in a revaluation surplus that formed part of the Company's share capital. The reclassification of the revaluation reserve out of capital reserve has been made in 2002 by reducing capital reserve and increasing revaluation reserve. This change has been done to better present the total amount of revaluation reserve that the Company has since its formation. The revaluation surplus recognized during the restructuring was partially utilized to offset against the revaluation deficit of the same assets arising in 2002 (see note 13(a)). Additional valuation surplus arising in 2002 was credited to the revaluation reserve.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****28 LONG-TERM PAYABLE**

|   | <b>December 31,</b> |                |
|---|---------------------|----------------|
|   | <b>2002</b>         | <b>2003</b>    |
|   | <b>RMB 000</b>      | <b>RMB 000</b> |
| At January 1                              | 191,448             | 172,250        |
| Less: installments paid during the year   | (30,000)            | (30,000)       |
|   | <hr/>               | <hr/>          |
| Interest accrued during the year (note 6) | 161,448             | 142,250        |
|   | 10,802              | 9,610          |
|   | <hr/>               | <hr/>          |
| At December 31                            | 172,250             | 151,860        |
| Less: Current portion (note 21)           | (30,000)            | (30,000)       |
|   | <hr/>               | <hr/>          |
| Long-term portion                         | 142,250             | 121,860        |
|   | <hr/>               | <hr/>          |

**29 MINORITY INTERESTS**

|  | <b>December 31,</b> |                |
|--|---------------------|----------------|
|  | <b>2002</b>         | <b>2003</b>    |
|  | <b>RMB 000</b>      | <b>RMB 000</b> |
| At January 1                             | 257,205             | 404,517        |
| Contributions from minority shareholders | 12,244              | 5,765          |
| Share of profits of subsidiaries         | 122,087             | 112,431        |
| Share of revaluation surplus             | 12,981              |                |
|  | <hr/>               | <hr/>          |
| At December 31                           | 404,517             | 522,713        |
|  | <hr/>               | <hr/>          |

**30 RETIREMENT BENEFIT PLANS AND POST-RETIREMENT BENEFITS****(a) Defined contribution retirement schemes****(i) Pension**

Substantially all of the Group employees are eligible to participate in the Group's retirement schemes. The Group participates in defined contribution retirement schemes organized by the municipal governments of the various provinces in which the Group operates. The Group is required to make annual contributions to the schemes at rates

ranging from 20% to 22.5% of salary costs including certain allowances calculated in the prior year. Employees contribute at rates ranging from 7% to 8% of their basic salaries. The Group has no other material obligation for the payment of retirement benefits beyond the annual contributions under these schemes. For the years ended December 31, 2001, 2002 and 2003, the Group's pension cost charged to the income statement amounted to RMB28,471,000, RMB82,876,000 and RMB121,200,000 respectively.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****30 RETIREMENT BENEFIT PLANS AND POST-RETIREMENT BENEFITS (CONT D)****(a) Defined contribution retirement schemes (cont d)****(ii) Medical insurance**

In 1998, the State Council announced that each municipal government should introduce a medical insurance scheme for employees and retirees of all enterprises, of which the detailed policies and regulations were to be set out by individual municipal government.

In the end of 2000, the Shanghai Municipal Government promulgated the detailed policies and regulations of its medical insurance scheme. In January 2001, the Group joined this scheme under which the Group and its employees contribute approximately 12% and 2% of the employee's basic salaries to the scheme respectively. The Group has no other obligation for the payment of medical expense beyond the annual contributions. For the years ended December 31, 2001, 2002 and 2003, the Group's medical insurance contribution charged to the income statement amounted to approximately RMB18,000,000, RMB16,000,000 and RMB38,000,000, respectively.

**(b) Post-retirement benefits**

In addition to the above retirement schemes, the Group provides retirees with post-retirement benefits including retirement subsidies, transportation subsidies, social function activities subsidies as well as other welfare. The expected cost of providing these post-retirement benefits is actuarially determined and recognized by using the projected unit credit method, which involves a number of assumptions and estimates including the rate of inflation, discount rate, employees' turnover ratio as well as mortality rate.

(i) As of December 31, 2002 and 2003, the post-retirement benefit obligations recognized in the balance sheets of the Group were as follows:-

|   | <b>December 31,</b> |                |
|---|---------------------|----------------|
|   | <b>2002</b>         | <b>2003</b>    |
|   | <b>RMB 000</b>      | <b>RMB 000</b> |
| Present value of unfunded post-retirement benefit obligations | 538,794             | 533,806        |
| Unrecognized actuarial gains                                  | 21,403              | 51,170         |
|   | <u>560,197</u>      | <u>584,976</u> |
| Payments made in the year                                     | (15,520)            | (19,455)       |
|   | <u>544,677</u>      | <u>565,521</u> |
| Post-retirement benefit obligations                           | 544,677             | 565,521        |
| Less: current portion (note 21)                               | (15,753)            | (19,750)       |
|   | <u>528,924</u>      | <u>545,771</u> |
| Post-retirement benefit obligations - long-term portion       | <u>528,924</u>      | <u>545,771</u> |



**Table of Contents****CHINA EASTERN AIRLINES CORPORATION LIMITED  
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****30 RETIREMENT BENEFIT PLANS AND POST-RETIREMENT BENEFITS (CONT D)****(b) Post-retirement benefits (cont d)**

(ii) Changes in post-retirement benefit obligations are as follows: -

|                           | <b>December 31,</b> |                |
|---------------------------|---------------------|----------------|
|                           | <b>2002</b>         | <b>2003</b>    |
|                           | <b>RMB 000</b>      | <b>RMB 000</b> |
| At January 1              | 521,063             | 544,677        |
| Current service cost      | 13,081              | 13,064         |
| Interest on obligation    | 26,053              | 27,235         |
| Payments made in the year | (15,520)            | (19,455)       |
|                           | <hr/>               | <hr/>          |
| At December 31            | 544,677             | 565,521        |
|                           | <hr/>               | <hr/>          |

(iii) The costs of post-retirement benefits were recognized under wages, salaries and benefits in the consolidated income statement for the years as follows:-

|                        | <b>December 31,</b> |                |
|------------------------|---------------------|----------------|
|                        | <b>2002</b>         | <b>2003</b>    |
|                        | <b>RMB 000</b>      | <b>RMB 000</b> |
| Current service cost   | 13,081              | 13,064         |
| Interest on obligation | 26,053              | 27,235         |
|                        | <hr/>               | <hr/>          |
| Total (note 5)         | 39,134              | 40,299         |
|                        | <hr/>               | <hr/>          |

(iv) Principal actuarial assumptions at the balance sheet dates are as follows:-

|   | <b>December 31,</b> |             |
|---|---------------------|-------------|
|   | <b>2002</b>         | <b>2003</b> |
| Discount rate   | 5.00%               | 5.00%       |
| Annual rate of increase of per capita benefit payment | 1.50%               | 1.50%       |
| Employees turnover rate                               | 3.00%               | 3.00%       |

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**CHINA EASTERN AIRLINES CORPORATION LIMITED  
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

**31 STAFF HOUSING BENEFITS**

(a) Staff housing fund

In accordance with the PRC housing reform regulations, the Group is required to make contribution to the State-sponsored housing fund at a range from 1% to 15% (2002: 1% to 15%) of the specified salary amount of its PRC employees. At the same time, the employees are required to make contribution equal to the Group's contribution out of their salaries. The employees are entitled to claim the entire sum of the fund contribution under certain specified withdrawal circumstances. For the years ended December 31, 2001, 2002 and 2003, the Group's contributions to the housing funds amounted to RMB25,305,000, RMB61,179,000 and RMB65,300,000 respectively, which are charged to the income statements.

(b) Staff housing allowances

In 2000, the State Council of the PRC issued circulars stipulating that distribution of staff quarters to employees at discounted prices should be withdrawn and cash allowance should be made to employees thereafter. Eligible staff who joined in enterprises prior to 1998 have not been allocated with any quarters or who have not been allocated with a quarter up to the minimum area are entitled to an one-off cash allowance. However, the specific timetable and procedures of implementation of these policies are to be determined by individual provincial or municipal government based on the particular situation of the province or municipality. Certain provincial governments have already set out the implementation procedures while Shanghai Municipal Government is yet to announce such details. Upon the issuance of the government circulars in 2000, the Company's directors estimated a provision of approximately RMB80,179,000 for staff housing allowance payable to eligible employees who joined in the Group prior to 1998 with reference to staff housing policies already set out by certain provincial governments then. Such provision for staff housing benefits was included in other payables in the Group's consolidated balance sheet as of December 31, 2001 and 2002 (see note 21).

In October 2003, the Board of Directors approved a new staff housing policy (the New Staff Housing Policy) which is extended to cover all existing staff who have not been allocated sufficient housing quarters. The benefit level given to the staff under the New Staff Housing Policy is generally higher as compared to the policies to which the Company's directors made reference in 2000.

Under the New Staff Housing Policy, staff who have not been allocated with any housing quarters or who have not been allocated with a quarter up to the minimum area as set out in the New Staff Housing Policy are entitled to a cash allowance. An eligible staff's entitlement is calculated based on area of quarter entitled and the unit price as set out in the New Staff Housing Policy. The total entitlement is principally vested over a period of 20 years. Upon an employee's resignation, his or her entitlement will cease and any unpaid entitlement related to past services will be paid. Upon the establishment of the New Staff Housing Policy, employees are entitled to a portion of the total entitlement already accrued based on his or her past service period. Such entitlement will be paid over a period of 4 to 5 years. The Group recognized a provision of RMB340,642,000 as related to its present obligation for its employees' staff housing entitlements, RMB85,973,000 of which is to be payable in 2004 and is classified as current portion in other payables in the Group's consolidated balance sheet as of December 31, 2003 (see note 21). The incremental obligation of RMB260,463,000 for staff housing benefits as a result of the New Staff Housing Policy was charged to the consolidated income statement for the year ended December 31, 2003.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****32 NOTES TO THE CONSOLIDATED CASH FLOW STATEMENTS****(a) Analysis of the balances of cash and cash equivalents**

|  | <b>Year Ended December 31,</b> |                  |                  |                  |
|--|--------------------------------|------------------|------------------|------------------|
|  | <b>2001</b>                    | <b>2002</b>      | <b>2003</b>      | <b>2003</b>      |
|  | <b>RMB 000</b>                 | <b>RMB 000</b>   | <b>RMB 000</b>   | <b>US\$ 000</b>  |
|  |                                |                  |                  | <b>(note 2a)</b> |
| Cash and bank balances   | 1,099,630                      | 1,889,647        | 1,477,409        | 178,502          |
| Short-term deposits with an associate                                | 281,362                        | 94,502           | 214,241          | 25,885           |
| Less: short-term deposits with original maturities over three months | (50,012)                       | (39,624)         | (108,870)        | (13,154)         |
|  | <u>1,330,980</u>               | <u>1,944,525</u> | <u>1,582,780</u> | <u>191,233</u>   |

**(b) Supplementary information**

|   | <b>Year Ended December 31,</b> |                |                |                  |
|---|--------------------------------|----------------|----------------|------------------|
|   | <b>2001</b>                    | <b>2002</b>    | <b>2003</b>    | <b>2003</b>      |
|   | <b>RMB 000</b>                 | <b>RMB 000</b> | <b>RMB 000</b> | <b>US\$ 000</b>  |
|   |                                |                |                | <b>(note 2a)</b> |
| Interest received, net of amortization of bond discount   | <u>87,064</u>                  | <u>75,466</u>  | <u>104,243</u> | <u>12,595</u>    |
| Interest paid, net of amount capitalized  | <u>936,751</u>                 | <u>847,213</u> | <u>860,304</u> | <u>103,943</u>   |
| Income tax paid   | <u>9,893</u>                   | <u>33,683</u>  | <u>60,845</u>  | <u>7,351</u>     |
| Investing activities not affecting cash:<br>Discounts on aircraft acquisition used for purchases of flight equipment and spare parts      | <u>8,872</u>                   | <u>125,728</u> | <u>50,220</u>  | <u>6,068</u>     |
| Financing activities not affecting cash:<br>Dividend payable to ultimate holding company set off against loan to ultimate holding company | 60,050                         |                |                |                  |





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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****33 COMMITMENTS AND CONTINGENT LIABILITIES****(a) Capital commitments**

As of December 31, 2002 and 2003, the Group had the following capital commitments:

|                                    | <b>December 31,</b> |                  |
|------------------------------------|---------------------|------------------|
|                                    | <b>2002</b>         | <b>2003</b>      |
|                                    | <b>RMB 000</b>      | <b>RMB 000</b>   |
| Authorized and contracted for:     |                     |                  |
| - Aircraft and related equipment   | 14,543,622          | 7,668,801        |
| - Other                            | 176,810             | 358,415          |
|                                    | <u>14,720,432</u>   | <u>8,027,216</u> |
| Authorized but not contracted for: |                     |                  |
| - Aircraft and related equipment   | 830,000             | 723,000          |
| - Other                            | 2,984,270           | 1,122,526        |
|                                    | <u>3,814,270</u>    | <u>1,845,526</u> |
|                                    | <u>18,534,702</u>   | <u>9,872,742</u> |

The above commitments mainly include amounts for acquisition of twenty A-320 and five A-340 aircraft for delivery between 2003 and 2005 as of December 31, 2002, and ten A-320, two A-340, four A-321 aircraft and two A-340 engines for delivery between 2004 and 2005 as of December 31, 2003.

Contracted expenditures for the above aircraft and related equipment, including deposits prior to delivery, subject to an inflation increase built in the contracts and any discounts available upon delivery of the aircraft, were expected to be paid as follows:-

|      | <b>December 31,</b> |                |
|------|---------------------|----------------|
|      | <b>2002</b>         | <b>2003</b>    |
|      | <b>RMB 000</b>      | <b>RMB 000</b> |
| 2003 | 6,966,689           |                |
| 2004 | 3,781,882           | 5,129,692      |
| 2005 | 3,795,051           | 2,539,109      |

|              |              |
|--------------|--------------|
| _____        | _____        |
| 14,543,622   | 7,668,801    |
| <b>_____</b> | <b>_____</b> |

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****33 COMMITMENTS AND CONTINGENT LIABILITIES (CONT D)****(b) Operating lease commitments**

As of December 31, 2002 and 2003, the Group had commitments under operating leases to pay future minimum lease rentals as follows:

|                                      | <b>December 31,</b>  |   |  |   |
|--------------------------------------|--|---|--|---|
|                                      | <b>2002</b>  |   | <b>2003</b>  |   |
|                                      | <b>Aircraft<br/>and<br/>flight<br/>equipment<br/>RMB 000</b> | <b>Land and<br/>buildings<br/>RMB 000</b> | <b>Aircraft<br/>and<br/>flight<br/>equipment<br/>RMB 000</b> | <b>Land and<br/>buildings<br/>RMB 000</b> |
| Within one year                      | 1,048,361  | 46,366                                    | 1,063,619  | 49,532                                    |
| In the second year                   | 837,456  | 15,272                                    | 1,134,669  | 12,284                                    |
| In the third to fifth year inclusive | 2,144,350  | 19,915                                    | 2,735,477  | 24,413                                    |
| After the fifth year                 | 1,938,362  | 10,436                                    | 1,145,355  | 11,206                                    |
|                                      | <b>5,968,529</b>   | <b>91,989</b>                             | <b>6,079,120</b>   | <b>97,435</b>                             |

**(c) Contingent liabilities**

As of December 31, 2002 and 2003, the Group had provided a guarantee to a bank in respect of bank facilities granted to Nanjing Lu Kou International Airport Company ( Lu Kou Airport ). The guarantee is set to expire in October 20, 2004 with the final maturity of the bank loan. The Group's maximum exposure to the guarantee is RMB150,000,000 and is only payable if Lu Kou Airport defaults in the repayments of its bank loan when they fall due. However, default by Lu Kou Airport is considered remote and therefore no liability was recorded by the Group at the time of the guarantee.

**34 SEGMENT REPORTING****(a) Primary reporting format by business segment**

The Group operates in one business segment which is the common carriage of passengers, cargo and mail over various routes authorized by CAAC.

**Table of Contents****CHINA EASTERN AIRLINES CORPORATION LIMITED  
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****34 SEGMENT REPORTING (CONT D)****(b) Secondary reporting format by geographical segment**

The Group's turnover and operating profit by geographical segments are analyzed as follows:

|                             | <b>Domestic<br/>RMB 000</b> | <b>Hong Kong<br/>RMB 000</b> | <b>Japan<br/>RMB 000</b> | <b>Other countries<br/>(*<br/>RMB 000</b> | <b>Total<br/>RMB 000</b> |
|-----------------------------|-----------------------------|------------------------------|--------------------------|---|--------------------------|
| <b>2001</b>                 |                             |                              |                          |   |                          |
| Traffic revenues            |                             |                              |                          |   |                          |
| Passenger                   | 4,701,198                   | 1,921,148                    | 1,145,183                | 1,819,412                                 | 9,586,941                |
| Cargo and mail              | 286,288                     | 224,584                      | 429,788                  | 1,151,009                                 | 2,091,669                |
|                             | <hr/>                       | <hr/>                        | <hr/>                    | <hr/>                                     | <hr/>                    |
| Other operating revenues    | 4,987,486                   | 2,145,732                    | 1,574,971                | 2,970,421                                 | 11,678,610               |
|                             | 447,636                     |                              | 9,204                    | 17,358                                    | 474,198                  |
|                             | <hr/>                       | <hr/>                        | <hr/>                    | <hr/>                                     | <hr/>                    |
| Turnover                    | <hr/> <b>5,435,122</b>      | <hr/> <b>2,145,732</b>       | <hr/> <b>1,584,175</b>   | <hr/> <b>2,987,779</b>                    | <hr/> <b>12,152,808</b>  |
| Segment results             | <hr/> <b>70,175</b>         | <hr/> <b>484,817</b>         | <hr/> <b>367,602</b>     | <hr/> <b>(53,103)</b>                     | <hr/> <b>869,491</b>     |
| Unallocated income (note 4) |                             |                              |                          |   | <hr/> 127,608            |
| Operating profits           |                             |                              |                          |   | <hr/> <b>997,099</b>     |
| <b>2002</b>                 |                             |                              |                          |   |                          |
| Traffic revenues            |                             |                              |                          |   |                          |
| Passenger                   | 4,669,731                   | 1,911,016                    | 1,279,083                | 2,178,000                                 | 10,037,830               |
| Cargo and mail              | 246,146                     | 257,270                      | 535,915                  | 1,405,336                                 | 2,444,667                |
|                             | <hr/>                       | <hr/>                        | <hr/>                    | <hr/>                                     | <hr/>                    |
| Other operating revenues    | 4,915,877                   | 2,168,286                    | 1,814,998                | 3,583,336                                 | 12,482,497               |
|                             | 563,904                     |                              | 10,957                   | 21,631                                    | 596,492                  |
|                             | <hr/>                       | <hr/>                        | <hr/>                    | <hr/>                                     | <hr/>                    |
| Turnover                    | <hr/> <b>5,479,781</b>      | <hr/> <b>2,168,286</b>       | <hr/> <b>1,825,955</b>   | <hr/> <b>3,604,967</b>                    | <hr/> <b>13,078,989</b>  |
| Segment results             | <hr/> <b>(95,766)</b>       | <hr/> <b>448,359</b>         | <hr/> <b>503,628</b>     | <hr/> <b>152,626</b>                      | <hr/> <b>1,008,847</b>   |

|                             |                  |                  |                  |                  |                   |
|-----------------------------|------------------|------------------|------------------|------------------|-------------------|
|                             |                  |                  |                  |                  |                   |
| Unallocated income (note 4) |                  |                  |                  |                  | 226,373           |
| Unallocated costs           |                  |                  |                  |                  | (171,753)         |
|                             |                  |                  |                  |                  | <u>1,063,467</u>  |
| Operating profits           |                  |                  |                  |                  | <u>1,063,467</u>  |
| <b>2003</b>                 |                  |                  |                  |                  |                   |
| Traffic revenues            |                  |                  |                  |                  |                   |
| Passenger                   | 5,591,640        | 1,627,093        | 977,610          | 2,064,684        | 10,261,027        |
| Cargo and mail              | 279,003          | 390,088          | 588,361          | 1,929,532        | 3,186,984         |
|                             | <u>5,870,643</u> | <u>2,017,181</u> | <u>1,565,971</u> | <u>3,994,216</u> | <u>13,448,011</u> |
| Other operating revenues    | 788,811          | 10,738           | 8,336            | 21,262           | 829,147           |
|                             | <u>6,659,454</u> | <u>2,027,919</u> | <u>1,574,307</u> | <u>4,015,478</u> | <u>14,277,158</u> |
| Turnover                    | <u>6,659,454</u> | <u>2,027,919</u> | <u>1,574,307</u> | <u>4,015,478</u> | <u>14,277,158</u> |
| Segment results             | <u>(518,390)</u> | <u>224,683</u>   | <u>190,042</u>   | <u>322,686</u>   | 219,021           |
|                             |                  |                  |                  |                  |                   |
| Unallocated income (note 4) |                  |                  |                  |                  | <u>2,442</u>      |
| Operating profits           |                  |                  |                  |                  | <u>221,463</u>    |

\* include U.S., Europe and other Asian countries

The major revenue-earning assets of the Group are its aircraft fleet, all of which are registered in the PRC. Since the Group's aircraft fleet is deployed flexibly across its route network, there is no suitable basis of allocating such assets and the related liabilities to geographical segments.

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**CHINA EASTERN AIRLINES CORPORATION LIMITED  
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

**35 RELATED PARTY TRANSACTIONS**

**(a) Balances with related companies**

**(i) Amounts due from/to related companies**

Amounts due from/to related companies arising from trading activities are unsecured, interest free and with no fixed terms of repayment. As of December 31, 2002 and 2003, such balances mainly included the following:-

*CAAC*

Balances with CAAC comprised civil aviation infrastructure levies payable to CAAC.

*China Eastern Airlines Northwest Co., Ltd. ( CEA Northwest Airlines )*

Balances with CEA Northwest Airlines comprised amount of air tickets sold by CEA but uplift by CEA Northwest Airlines.

*China Eastern Airlines Yunnan Co., Ltd. ( CEA Yunnan Airlines )*

Balances with CEA Yunnan Airlines comprised amount of air tickets sold by CEA but uplift by CEA Yunnan Airlines.

*Nanjing Airlines Co., Ltd ( Nanjing Airlines )*

Balances with Nanjing Airlines comprised amount of air tickets sold by CEA but uplift by Nanjing Airlines, and lease rental charges for operating lease of aircraft.

**(ii) Amounts due from/to associates**

*China Eastern Airlines Wuhan Co., Ltd ( CEA Wuhan Airlines )*

Balances with CEA Wuhan Airlines comprised amount of air tickets sold by CEA but uplift by CEA Wuhan Airlines.

*Eastern Aviation Import & Export Co., Ltd. ( EAIEC )*

Balances with EAIEC comprised prepayments and purchases of flight equipment and flight equipment spare parts payable to EAIEC.

*Shanghai Dongmei Aviation Travel Co., Ltd. ( SDATC )*

Balances with SDATC comprised the amount of traveling and accommodation agency services rendered by SDATC.

**(iii) Short-term deposits with an associate**

The Group have short-term deposits of RMB94,502,000 and RMB214,241,000 as of December 31, 2002 and 2003 placed with Eastern Air Group Finance Co., Ltd. ( EAGF ), an associate. The short-term deposits yield interest at an average rate of 0.72% per annum for both years ended December 31, 2002 and 2003.

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NOTES TO THE FINANCIAL STATEMENTS****35 RELATED PARTY TRANSACTIONS (CONT D)****(b) Guarantee by the holding company**

As of December 31, 2002 and 2003, certain long-term bank loans of the Group are guaranteed by CEA Holding (see note 24).

**(c) Related party transactions**

The Group had the following material transactions with its related parties in the normal course of business during the years ended December 31, 2001, 2002 and 2003:

|  |  | <b>Revenue/(Expenses,<br/>payments or purchase consideration)<br/>Year Ended December 31,</b> |                         |                         |
|--|--|---|-------------------------|-------------------------|
|  |  | <b>2001<br/>RMB 000</b>   | <b>2002<br/>RMB 000</b> | <b>2003<br/>RMB 000</b> |
| <b>(i) With CAAC and its affiliates:</b> | <b>Nature of transaction</b>   | <b>Related party</b>  |                         |                         |
|  | Commission income on carriage service provided by other airlines with air tickets sold by the Group at fixed rates ranging from 3% to 9% of value of tickets sold                              | PRC airlines  | 9,915                   | 6,532                   |
|  | Take-off and landing fees charged at predetermined scale of rates published by CAAC  | PRC airports  | (936,594)               | (981,860)               |
|  | Purchase of aircraft fuel at State controlled prices   | Civil Aviation Oil Supply Company   | (1,739,114)             | (1,616,324)             |
|  | Commission expenses on air tickets sold on behalf of the Group at rates ranging from 3% to 9% of value of tickets sold   | CAAC<br>PRC airlines  | (50,229)<br>(1,758)     | (46,207)<br>(1,885)     |
|  | Civil aviation infrastructure levies collected on behalf of CAAC and calculated at the rates of 5% and 2% of the Group's annual gross domestic and international traffic revenues respectively | CAAC  | (370,284)               | (431,162)               |
|  | Aircraft insurance premium paid through CAAC who entered into the  | CAAC  | (82,932)                | (178,625)               |
|  |  |   | 4,117                   | (1,372,896)             |
|  |  |   | (2,128,628)             | (40,204)                |
|  |  |   | (1,080)                 | (129,646)               |
|  |  |   | (157,278)               |                         |

insurance policy on behalf of the Group

|   |   |           |
|---|---|-----------|
| Acquisition of a passenger carriage<br>business | China Civil<br>Aviation<br>Flight College | (214,755) |
|---|---|-----------|

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**Table of Contents****CHINA EASTERN AIRLINES CORPORATION LIMITED  
NOTES TO THE FINANCIAL STATEMENTS****35 RELATED PARTY TRANSACTIONS (CONT D)**

|   |   | <b>Revenue/(Expenses,<br/>payments or purchase consideration)<br/>Year Ended December 31,</b>   |                         |                         |  |
|---|---|---|-------------------------|-------------------------|--|
|   |   | <b>2001<br/>RMB 000</b>   | <b>2002<br/>RMB 000</b> | <b>2003<br/>RMB 000</b> |  |
| <b>(ii) With CEA Holding or companies directly or indirectly held by CEA Holding:</b> | <b>Nature of transaction</b>  | <b>Related party</b>  |                         |                         |  |
|   | Interest income on deposits at rates of 0.99% in 2001, 0.72% in 2002 and 0.72% in 2003  | EAGF  | 2,290                   | 2,738                   | 4,096  |
|   | Interest expenses on loans at rates ranging from 5.30% to 5.58% per annum in 2001, 4.19% to 4.65% per annum in 2002 and 4.54% per annum in 2003                   | EAGF  | (1,268)                 | (1,373)                 | (6,396)  |
|   | Commission income on carriage service provided by other airlines with air tickets sold by the Group at fixed rates ranging from 3% to 9% of value of tickets sold | CEA Northwest Airlines<br>CEA Yunnan Airlines<br>CEA Wuhan Airlines<br>Nanjing Airlines   |                         |                         | 47,457<br>50,442<br>28,964<br>4,210                                |
|   | Commission expenses on air tickets sold on behalf of the Group at rates ranging from 3% to 9% of value of tickets sold  | Shanghai Tourism Company (Hong Kong) Limited<br>CEA Northwest Airlines<br>CEA Yunnan Airlines<br>Certain other subsidiaries of CEA Holding<br>CEA Wuhan Airlines<br>SDATC | (10,105)                | (7,944)                 | (6,046)<br>(17,776)<br>(10,743)<br>(25,466)<br>(8,547)<br>(24,940) |
|   | Purchase of aircraft, flight equipment, flight equipment  | EAIEC   | (1,137,471)             | (3,434,976)             | (3,100,664)  |

spare parts and other fixed  
assets, and repair of aircraft  
inclusive of handling charges of  
0.1% to 2%

|   |   |          |          |          |
|---|---|----------|----------|----------|
| Ticket reservation service charges for utilization of computer reservation system | TravelSky<br>Technology Limited   | (55,800) | (72,925) | (71,884) |
| Repairs and maintenance expenses payable for ground service facilities            | Shanghai Eastern Air<br>Industrial Corporation<br>( SEAIC )                       | (24,362) | (35,055) | (20,112) |
| Repairs and maintenance expenses payable for aircraft and engines                 | Shanghai Eastern<br>Aviation Wheels &<br>Brakes Overhaul<br>Engineering Co., Ltd. |          | (24,146) | (25,361) |

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**Table of Contents****CHINA EASTERN AIRLINES CORPORATION LIMITED  
NOTES TO THE FINANCIAL STATEMENTS****35 RELATED PARTY TRANSACTIONS (CONT D)**

| Nature of transaction   | Related party  | Revenue/(Expenses,<br>payments or purchase<br>consideration) |  |   |
|---|--|--|--|---|
|   |  | Year Ended December 31,                                      |  |   |
|   |  | 2001<br>RMB 000  | 2002<br>RMB 000  | 2003<br>RMB 000                                       |
| <b>(ii) With CEA Holding or companies directly or indirectly held by CEA Holding:</b> |  |  |  |   |
| Lease rental income from operating lease of aircraft                                  | CEA Wuhan Airlines   |  |  | 31,209  |
| Lease rental charges for operating lease of aircraft                                  | CEA Northwest Airlines<br>CEA Yunnan Airlines<br>Nanjing Airlines  |  |  | (69,118)<br>(27,726)<br>(23,348)                      |
| Sourcing of food and beverages  | Eastern Air (Shantou) Economic Development Co., Ltd.<br>Shanghai Eastern Air Catering Co., Ltd.<br>SEAIC<br>Qilu Eastern Air Catering Co., Ltd.<br>Qingdao Air Service Co., Ltd. | (52,821)<br>(101,160)<br>(10,688)<br>(6,426)<br>(10,926)     | (46,666)<br>(117,242)<br>(13,893)<br>(8,824)<br>(12,751) | (36,413)<br>(96,984)<br>(4,941)<br>(5,285)<br>(2,518) |
| Advertising expenses  | Eastern Aviation Advertising Service Co., Ltd. ( EAASC )   | (6,985)  | (4,857)  | (2,676)   |
| Purchase of aviation equipment  | Shanghai Eastern Aviation Equipment Manufacturing Corporation  | (6,434)  | (8,394)  | (3,149)   |
| Inflight hygiene and cleaning service expenses  | Shanghai Eastern General Corporation   | (15,318)   | (1,683)  | (20,561)  |
| Printing expenses   | Shanghai Aviation Printing Co., Ltd.   | (3,799)  | (1,594)  | (10,447)  |
| Rental expenses   |  | (4,461)  | (4,509)  | (5,945)   |

|  |         |         |         |
|--|---------|---------|---------|
| Shanghai Eastern Aviation Equipment<br>Manufacturing Corporation |         |         |         |
| Shanghai Eastern Real Estate Operation Co., Ltd.                 | (5,794) | (3,291) | (6,048) |

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NOTES TO THE FINANCIAL STATEMENTS****35 RELATED PARTY TRANSACTIONS (CONT D)**

|      | Nature of transaction   | Related party | Revenue/(Expenses,<br>payments or purchase consideration)<br>Year Ended December 31, |                 |                 |
|------|---|---------------|--|-----------------|-----------------|
|      |   |               | 2001<br>RMB 000  | 2002<br>RMB 000 | 2003<br>RMB 000 |
| (ii) | <b>With CEA Holding or companies directly or indirectly held by CEA Holding:</b>  |               |  |                 |                 |
|      | Additional investment in an associate, EAASC, 55% interests of which is owned by CEA Holding (see note 16)                                | CEA Holding   |  | (15,762)        |                 |
|      | Investment in an associate, EAIEC, 55% interests of which is owned by CEA Holding (see note 16)   | CEA Holding   |  |                 | (43,820)        |
|      | Investment in an associate, EAGF, a company previously jointly owned by CEA Holding and its subsidiaries (see note 16)                    | CEA Holding   | (106,364)  |                 |                 |
|      | Investment in an associate, China Eastern Air Catering Investment Co., Ltd., 55% interests of which is owned by CEA Holding (see note 16) | CEA Holding   |  |                 | (157,500)       |
|      | Investment in an associate, SDATC, 55% interests of which is owned by CEA Holding (see note 16)   | CEA Holding   |  |                 | (6,828)         |

**36 FINANCIAL RISK MANAGEMENT**

Financial assets of the Group mainly include short-term deposits and bank balances, deposits with and amounts due from related companies, trade receivables, long-term receivables, bank deposits, zero coupon bonds, short-term investments and derivative assets. Financial liabilities of the Group include bank and other loans, obligations under finance leases, amounts due to related companies, trade payables, derivative liabilities and other payables.

**(a) Business risk**

The operations of the air transportation industry are substantially influenced by global political and economic development. Accidents, wars, natural disasters, etc. may have material impact on the Group's operations or the industry as a whole. In addition, the Group conducts its principal operations in the PRC 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 others, the political, economic and legal environment, competition and influence of CAAC in the PRC civil aviation industry.



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**CHINA EASTERN AIRLINES CORPORATION LIMITED  
NOTES TO THE FINANCIAL STATEMENTS**

**36 FINANCIAL RISK MANAGEMENT (CONT D)**

**(b) Price risk**

The Group's results of operations may be significantly affected by the fluctuation of the fuel prices which is a major expense category. While the international fuel prices are determined by worldwide market demand and supply, domestic fuel prices are regulated by CAAC. It is the Group's plan to strengthen the control over the fuel price risk through financial derivatives.

**(c) Interest rate risk**

The Group has significant bank borrowings and is exposed to risk arising from changes in market interest rates. To hedge against the change in market interest rates, the Group entered into certain interest rate swaps during the years ended December 31, 2002 and 2003 (see note 37(a)). The interest rates and terms of repayment of loans made to the Group are disclosed in notes 23, 24 and 25.

**(d) Credit risk**

The Group has no significant concentrations of credit risk. The Group has policies in place to ensure that sales of products and services are made to customers with an appropriate credit history. The Group has policies that limit the amount of credit exposure to any one financial institution.

**(i) Deposits with an associate and cash and bank balances**

Substantially all the Group's cash and bank balances are placed with a number of international and PRC banks and an associate, EAGF. Details of deposits placed with EAGF have been disclosed in note 35(a)(iii).

**(ii) Trade receivables**

These are mainly tickets sales receivable from sales agents and receivables related to uplifts by the Company on behalf of other carriers which are spread among numerous third parties.

**(iii) Other receivables**

These are spread among numerous third parties.

**(iv) Amounts due from or to the related companies**

These balances are disclosed in note 35(a).

**(v) Short-term investments**

Short-term investments as of December 31, 2002 were placed with a PRC financial institution which executed the buying or selling securities on behalf of the Group, the short-term investment have been fully settled during the year end December 31, 2003.

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**CHINA EASTERN AIRLINES CORPORATION LIMITED  
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

**36 FINANCIAL RISK MANAGEMENT (CONT D)**

**(e) Liquidity risk**

The Group's primary cash requirements have been for additions of and upgrades on aircraft and flight equipment and payments on related debts. The Group finances its working capital requirements through a combination of funds generated from operations and short-term bank loans. The Group generally acquires aircraft through either long-term finance leases or operating leases. To take advantage of the low interest rate for long-term loans, recently the Group also purchased certain number of aircraft through long-term loans from banks in the PRC.

The Group generally operates with a working capital deficit. As of December 31, 2002 and 2003, the Group's net current liabilities amounted to RMB7,437 million and RMB9,941 million respectively. For the years ended December 31, 2002 and 2003, the Group recorded net cash inflows from operating activities of RMB2,160 million and RMB3,267 million, respectively, net cash outflows from investing activities and financing activities of RMB1,587 million and RMB3,645 million, respectively and an increase of RMB574 million and a decrease in cash and cash equivalents of RMB378 million respectively.

The directors of Company believe that cash from operations and short-term bank borrowings will be sufficient to meet the Group's operating cashflow. Due to the dynamic nature of the underlying businesses, the Group treasury aims at maintaining flexibility in funding by keeping credit lines available. The directors of the Company believe that the Group has obtained sufficient general credit facilities from PRC banks for financing future capital commitments and for working capital purposes.

**(f) Foreign currency risk**

The Group's finance lease obligation as well as certain bank and other loans are denominated in US dollars, Japanese Yen and Euro, and certain expenses of the Group are denominated in currencies other than RMB. The Group generates foreign currency revenues 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 US dollars had been comparatively stable in the past. However, RMB against Japanese Yen and Euro had experienced a significant level of fluctuation over the past two years which is the major reason for the significant exchange differences recognized by the Group for the years ended December 31, 2002 and 2003.

The Group enters into certain foreign currency forward contracts with PRC banks to hedge against foreign currency risk (see note 37).

**Table of Contents****CHINA EASTERN AIRLINES CORPORATION LIMITED  
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****36 FINANCIAL RISK MANAGEMENT (CONT D)****(g) Fair Value**

The carrying amounts and estimated fair values of significant financial assets and liabilities as of December 31, 2002 and 2003 are set out below:-

|                                  | <b>December 31,</b>                    |                                   |  |                                   |
|----------------------------------|--|-----------------------------------|--|-----------------------------------|
|                                  | <b>2002</b>                            |                                   | <b>2003</b>                            |                                   |
|                                  | <b>Carrying<br/>amount<br/>RMB 000</b> | <b>Fair<br/>value<br/>RMB 000</b> | <b>Carrying<br/>amount<br/>RMB 000</b> | <b>Fair<br/>value<br/>RMB 000</b> |
| Long-term bank loans             | 6,494,631                              | 5,939,491                         | 11,222,923                             | 10,131,805                        |
| Obligations under finance leases | 8,183,966                              | 8,202,528                         | 7,100,886                              | 7,069,346                         |
| Long-term bank deposits          | 1,463,044                              | 1,547,671                         | 1,743,924                              | 1,840,139                         |

The fair values of the long-term banks loans, obligation under finance leases and long-term bank deposits are estimated by applying a discounted cash flow approach using current market interest rates for similar indebtedness/investment.

The fair value of cash and bank balances, trade receivables, other receivables, amounts due from and to related companies, trade payables, other payables and short-term bank loans are not materially different from their carrying amounts because of the short maturities of these instruments.

Investments in subsidiaries and associates represent unquoted equity interests in companies established in the PRC. There is no quoted market price for such interests and accordingly a reasonable estimate of their fair value could not be made without incurring excessive costs.

Fair value estimates are made at specific point in time and are based on relevant market information. This estimate is subjective in nature and involves uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in valuation methods and assumptions could significantly affect the estimates.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****37 DERIVATIVE FINANCIAL INSTRUMENTS**

|   | <b>Assets</b>  | <b>Liabilities</b> |
|---|----------------|--------------------|
|   | <b>RMB 000</b> | <b>RMB 000</b>     |
| <b>At December 31, 2002</b>                   |                |                    |
| Interest rate swaps (note (a))                |                | 37,261             |
| Forward foreign exchange contracts (note (b)) | 9,891          | 5,836              |
|   | <u>9,891</u>   | <u>43,097</u>      |
|   | <b>9,891</b>   | <b>43,097</b>      |
| <b>At December 31, 2003</b>                   |                |                    |
| Interest rate swaps (note (a))                | 2,814          | 40,390             |
| Forward foreign exchange contracts (note (b)) |                | 54,047             |
|   | <u>2,814</u>   | <u>94,437</u>      |
|   | <b>2,814</b>   | <b>94,437</b>      |

**(a) Interest rate swaps**

The Group uses interest rate swaps to reduce risk of changes in market interest rates (see note 36(c)). The interest swaps entered into by the Group fulfill the criteria for hedge accounting and are accounted for as cashflow hedge. As of December 31, 2002 and 2003, the notional amounts of the outstanding interest rate swap agreements were approximately US\$96 million and US\$164 million respectively. For the years ended December 31, 2002 and 2003, net losses of RMB37,261,000 and RMB315,000 respectively arising from changes in the fair value of the interest rate swaps subsequent to initial recognition are recognized directly in the hedging reserve (see note 27).

**(b) Forward foreign exchange contract**

The Group uses currency forward contracts to reduce risks of changes in currency exchange rates in respect of ticket sales and expenses denominated in foreign currencies (see note 36(f)). The Group's currency forward contracts qualify for hedging accounting and are accounted for as cashflow hedges. For the years ended December 31, 2002 and 2003, net losses of RMB1,341,000 and RMB58,102,000 arising from changes in the fair value of these foreign currency forwards subsequent to initial recognition are recognized directly in the hedging reserve (see note 27).

**38 ULTIMATE HOLDING COMPANY**

The directors regard CEA Holding, a company established in the PRC, as being the ultimate holding company.

**39 POST BALANCE SHEET DATE EVENTS**

Subsequent to the balance sheet date, the company contributed US\$2,450,000 to the registered capital of Collins Aviation Maintenance Service Shanghai Limited ( CAMSSL ) pursuant to the joint venture agreement with Rockwell Collins International Inc. ( RCI ) entered into by the parties in September 2002. CAMSSL is a joint venture with will be principally engaged in the provision of repair and maintenance services for avionics and aircraft entertaining facilities in the PRC. The registered capital of the CAMSSL is RMB57,943,000, which is to be contributed by the Company

and RCI at 35% and 65% respectively.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****40 SIGNIFICANT DIFFERENCES BETWEEN IFRS AND U.S. GAAP**

Differences between IFRS and U.S. GAAP which have significant effects on the consolidated profits/(loss) attributable to shareholders and consolidated owners' equity of the Group are summarized as follows:

**Consolidated profit/(loss) attributable to shareholders**

(Amounts in thousands except per share data)

|   |  | <b>Year Ended December 31,</b> |                 |                 |                   |                    |
|---|--|--------------------------------|-----------------|-----------------|-------------------|--------------------|
|   |  | <b>2001</b>                    | <b>2002</b>     | <b>2003</b>     | <b>2003</b>       |                    |
|   |  | <b>RMB</b>                     | <b>RMB</b>      | <b>RMB</b>      | <b>US\$</b>       |                    |
|   |  | <b>Note</b>                    |                 |                 | <b>(note 2a)</b>  |                    |
| As stated under IFRS  |  |                                | 541,713         | 86,369          | (949,816)         | (114,758)          |
| U.S. GAAP adjustments:  |  |                                |                 |                 |                   |                    |
| Reversal of difference in depreciation charges arising from revaluation of fixed assets       |  | (a)                            | 94,140          | 20,370          | 63,895            | 7,720              |
| Reversal of revaluation deficit of fixed assets   |  | (a)                            |                 | 171,753         |                   |                    |
| Gain/(loss) on disposal of aircraft and related assets Others                                 |  | (b)                            | 5,791           | (26,046)        | (10,083)          | (1,218)            |
| Deferred tax effect on U.S. GAAP adjustments  |  | (c)                            | (11,295)        | 23,767          | 6,860             | 829                |
|   |  | (d)                            | (155,877)       | (28,477)        | (9,101)           | (1,100)            |
| As stated under U.S. GAAP   |  |                                | <u>474,472</u>  | <u>247,736</u>  | <u>(898,245)</u>  | <u>(108,527)</u>   |
| Basic and fully diluted earnings/(loss) per share under U.S. GAAP                             |  |                                | <u>RMB0.097</u> | <u>RMB0.051</u> | <u>(RMB0.185)</u> | <u>(US\$0.022)</u> |
| Basic and fully diluted earnings/(loss) per American Depository Share ( ADS ) under U.S. GAAP |  |                                | <u>RMB9.75</u>  | <u>RMB5.09</u>  | <u>(RMB18.46)</u> | <u>(US\$2.23)</u>  |

**Consolidated owners' equity**

(Amounts in thousands)

|  |  | <b>December 31,</b> |             |                  |
|--|--|---------------------|-------------|------------------|
|  |  | <b>2002</b>         | <b>2003</b> | <b>2003</b>      |
|  |  | <b>RMB</b>          | <b>RMB</b>  | <b>US\$</b>      |
|  |  | <b>Note</b>         |             | <b>(note 2a)</b> |
|  |  |                     |             |                  |

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|  |          |                   |                   |                   |
|--|----------|-------------------|-------------------|-------------------|
| As stated under IFRS   |          | 7,379,103         | 6,382,151         | 771,099           |
| U.S. GAAP adjustments:   |          |                   |                   |                   |
| Reversal of net revaluation surplus of fixed assets  | (a)      | (908,873)         | (908,873)         | (109,811)         |
| Reversal of difference in depreciation charges and accumulated depreciation and loss on disposals arising from the revaluation of fixed assets | (a), (b) | 637,423           | 691,235           | 83,516            |
| Others   | (c)      | 29,111            | 35,971            | 4,346             |
| Deferred tax effect on U.S. GAAP adjustments   | (d)      | 20,844            | 9,225             | 1,115             |
|  |          | <u>          </u> | <u>          </u> | <u>          </u> |
| As stated under U.S. GAAP  |          | <u>7,157,608</u>  | <u>6,209,709</u>  | <u>750,264</u>    |

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**CHINA EASTERN AIRLINES CORPORATION LIMITED  
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

**40 SIGNIFICANT DIFFERENCES BETWEEN IFRS AND U.S. GAAP (CONT D)**

**Notes:-**

**(a) Revaluation of fixed assets**

Under IFRS, fixed assets of the Group are initially recorded at cost and are subsequently restated at revalued amounts less accumulated depreciation. Fixed assets of the Group were revalued as of June 30, 1996 as part of the restructuring of the Group for the purpose of listing. In addition, as of December 31, 2002, a revaluation of the Group's aircraft and engines was carried out and difference between the valuation and carrying amount was recognized. Under U.S. GAAP, the revaluation surplus or deficit and the related difference in depreciation are reversed since fixed assets are required to be stated at cost.

**(b) Disposals of aircraft and related assets**

This represents the loss on disposals of aircraft and related assets during the years. Under U.S. GAAP, fixed assets are required to be stated at cost. Accordingly, the accumulated depreciation and the gain or loss on disposals of aircraft is different between IFRS and U.S. GAAP, which is attributable to the surplus or deficit upon valuation associated with the assets disposed of.

**(c) Other U.S. GAAP adjustments**

The application of U.S. GAAP differs in certain other respects from IFRS, mainly relating to sale and leaseback transactions, post retirement benefits and goodwill. Under US GAAP: i) recognition of gain on sale and leaseback transactions is deferred and amortized, ii) transitional obligation for post retirement benefit is amortized over the average remaining service period of active plan participants, and iii) goodwill is reviewed for impairment and is not amortized.

**(d) Deferred tax effect**

These represent the corresponding deferred tax effect as a result of the adjustments stated in (a), (b) and (c) above.

**(e) Segmental disclosures**

The Group adopted Statement of Financial Accounting Standards ( SFAS ) No. 131, Disclosures about Segments of an Enterprise and Related Information . The Group has a route network designed to transport passengers and cargo between destinations in China, Hong Kong, and selected international destinations in Japan, U.S., Australia, South Korea, Thailand, Singapore and a number of European countries. China, Hong Kong, and International constitute the Group's three reportable geographical segments. SFAS No.131 requires that segment financial information be disclosed under the management approach that is consistent with how the Group's management internally desegregates financial information for the purpose of making internal operating decisions. The Group evaluates revenue information of its operating segments based on unaudited management operational information prepared under PRC Accounting Regulations.



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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****40 SIGNIFICANT DIFFERENCES BETWEEN IFRS AND U.S. GAAP (CONT D)**

Notes (cont d):-

**(e) Segmental disclosures (cont d)**

|                         |                 | <b>Unaudited management operational<br/>information under PRC Accounting<br/>Regulations for the year ended<br/>December 31,</b> |                   |                   |
|-------------------------|-----------------|--|-------------------|-------------------|
|                         |                 | <b>2001</b>  | <b>2002</b>       | <b>2003</b>       |
|                         |                 | <b>RMB 000</b>   | <b>RMB 000</b>    | <b>RMB 000</b>    |
|                         | <b>Note</b>     |  |                   |                   |
| <b>Traffic revenues</b> | <b>(i),(ii)</b> |  |                   |                   |
| Domestic                |                 |  |                   |                   |
| Passenger               |                 | 5,513,591  | 5,288,611         | 5,854,542         |
| Cargo                   |                 | 234,658  | 235,470           | 256,661           |
|                         |                 | <hr/>  | <hr/>             | <hr/>             |
| Subtotal                |                 | 5,748,249  | 5,524,081         | 6,111,203         |
|                         |                 | <hr/>  | <hr/>             | <hr/>             |
| Hong Kong               |                 |  |                   |                   |
| Passenger               |                 | 2,024,214  | 1,937,313         | 1,622,538         |
| Cargo                   |                 | 233,149  | 268,944           | 394,246           |
|                         |                 | <hr/>  | <hr/>             | <hr/>             |
| Subtotal                |                 | 2,257,363  | 2,206,257         | 2,016,784         |
|                         |                 | <hr/>  | <hr/>             | <hr/>             |
| International           | <b>(iii)</b>    |  |                   |                   |
| Passenger               |                 | 3,079,730  | 3,526,852         | 3,036,214         |
| Cargo                   |                 | 1,708,194  | 2,014,785         | 2,561,529         |
|                         |                 | <hr/>  | <hr/>             | <hr/>             |
| Subtotal                |                 | 4,787,924  | 5,541,637         | 5,597,743         |
|                         |                 | <hr/>  | <hr/>             | <hr/>             |
| <b>Total</b>            | <b>(iv)</b>     | <b>12,793,536</b>  | <b>13,271,975</b> | <b>13,725,730</b> |
|                         |                 | <hr/>  | <hr/>             | <hr/>             |

- (i) The Group operates in one business segment which is the common carriage of passenger, cargo and mail over various routes. In the PRC management accounts, revenue is split between passenger and cargo for management review purpose. The directors consider it is appropriate to report such information in these financial statements.

- (ii) Traffic revenues by routes are attributed to each geographical segment based on the final destination / origin of each flight route. For international and Hong Kong routes with a domestic segment, revenues for the entire route are attributed to each geographical segment based on the final destination / origin of the route.
- (iii) The Group's international revenues are generated from its international routes to and from countries including Japan, U.S., Australia, South Korea, Thailand, Singapore and selected European countries. Among these countries, the Group generates from Japan routes its largest share of international revenue (note: the Group generated revenues, under IFRS, of RMB1,574,971,000, RMB1,814,998,000 and RMB1,565,971,000 from its Japan routes in 2001, 2002 and 2003 respectively).

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**CHINA EASTERN AIRLINES CORPORATION LIMITED  
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

**40 SIGNIFICANT DIFFERENCES BETWEEN IFRS AND U.S. GAAP (CONT D)**

**Notes (cont d):-**

**(e) Segmental disclosures (cont d)**

- (iv) The traffic revenue figures as stated above are different from the Group's audited PRC statutory accounts and the Group's audited IFRS accounts due to the following reasons:-

The management made use of this operational information before closing of accounts for each accounting period. Accordingly, estimates (which are generally within a discrepancy of 5% on total actual revenues) have been incorporated into this operational information for timely decision making purposes.

Certain discounts granted to sales agents and customers have not been set-off against revenues under management operational information.

- (v) The major revenue-generating assets of the Group are its aircraft fleet, all of which are registered in the PRC. Since the Group's aircraft fleet is deployed flexibly across its route network, there is no suitable basis of allocating such assets and the related liabilities to geographical segments.

**(f) New pronouncements**

*SFAS No. 132 (Revised)*

In December 2003, the Financial Accounting Standards Board ( FASB ) issued SFAS No. 132 (Revised) ( SFAS No. 132R ), Employer's Disclosure about Pensions and Other Postretirement Benefits as amendment of FASB statements No. 87, 88 and 106, and a replacement of FASB Statement No. 132. SFAS No. 132R retains disclosure requirements of the original SFAS No. 132 and requires additional disclosures relating to assets, obligations, cash flows, and net periodic benefit cost. The measurement and recognition guidance under original SFAS 132 has not changed. SFAS No. 132R is effective for fiscal years ending after December 15, 2003, except that certain disclosures are effective of fiscal years ending after June 15, 2004. Management has adopted the disclosure provisions of SFAS No. 132.

*SFAS No. 143*

In June 2001, FASB issued SFAS No. 143 Accounting for Asset Retirement Obligations which addresses accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. SFAS No. 143 is effective for fiscal years beginning after June 15, 2002. The adoption of SFAS No. 143 did not have a material effect on the Group's financial position or results of operations.

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**40 SIGNIFICANT DIFFERENCES BETWEEN IFRS AND U.S. GAAP (CONT D)**

Notes (cont d):-

**(f) New pronouncements (cont d)**

*SFAS No. 149*

In April 2003, the FASB issued SFAS No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities . SFAS No. 149 amends and clarifies accounting for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities under SFAS No. 133. SFAS No. 149 is applied prospectively and is effective for contracts entered into or modified after June 30, 2003, except for SFAS No. 133 implementation issues that have been effective for fiscal quarters that began prior to June 15, 2003, and certain provisions relating to forward purchases or sales of when issued securities or other securities that do not yet exist. The adoption of SFAS No. 149 did not have any significant impact on the Group s results of operations.

*SFAS No. 150*

In June 2003, the FASB issued SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity . SFAS No. 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or as an asset in some circumstances). It is effective for financial instruments entered into or modified after May 31, 2003 and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. It is to be implemented by reporting the cumulative effect of a change in an accounting principle for financial instruments created before the issuance date of SFAS No. 150 and still in existence at the beginning of the interim period of adoption. Restatement is not permitted. The adoption of SFAS No. 150 did not have a material effect on the Group s financial position or results of operations.

*FIN 45*

In November 2002, Financial Interpretation No. ( FIN ) 45, Guarantor s Accounting and Disclosure Requirements for Guarantees, including Indirect Guarantees of Indebtedness of Others (FIN 45 ) was issued. FIN 45 requires that at the time a company issues a guarantee, the company must recognize an initial liability for the fair value, or market value, of the obligations it assumes under that guarantee. This interpretation is applicable on a prospective basis to guarantees issued or modified after December 31, 2002. FIN 45 also contains disclosure provisions surrounding existing guarantees, which are effective for financial statements with periods ending after December 15, 2002. Please refer to Note 33(d) for details.

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**40 SIGNIFICANT DIFFERENCES BETWEEN IFRS AND U.S. GAAP (CONT D)**

Notes (cont d):-

**(f) New pronouncements (cont d)**

*FIN 46*

In January 2003, the FASB issued FIN 46 Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51. FIN 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN 46 is effective for all new variable interest entities created or acquired after January 31, 2003. In December 2003, the FASB issued a revision to FIN No. 46, Consolidation of Variable Interest Entities, and Interpretation of ARB No. 51 (FIN 46R).

Among other changes, the revisions of FIN 46R (a) clarified some requirements of the original FIN 46, (b) eased some implementation problems, and (c) added new scope exceptions. FIN 46R deferred the effective date of the Interpretation for public companies, to the end of the first reporting period ending after March 15, 2004, except that all public companies must at a minimum apply the provisions of the Interpretation to entities that were previously considered special-purpose entities under the FASB literature prior to the issuance of FIN 46R by the end of the first reporting period ending after December 15, 2003. Management does not expect that the adoption of FIN 46R will have a material effect on the Group's financial position or results of operations.

*EITF Issue No. 00-21*

In November 2002, the Emergency Issue Task Force reached a consensus on Issue No. 00-21, Revenue Arrangements with Multiple Deliverables (EITF No. 00-21). This issue addresses how revenue arrangements with multiple deliverables should be divided into separate units of accounting and how the arrangement consideration should be allocated to the identified separate accounting units. EITF No. 00-21 is effective for fiscal periods beginning after June 15, 2003. The Group does not believe that this EITF will have a significant impact on its financial statements.

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**Exhibit Index**

| <b>Exhibits</b> | <b>Description</b>  |
|-----------------|---|
| 1.1             | Articles of Association (English translation).  |
| 2.1             | Specimen Certificate for the H Shares. <sup>(1)</sup>   |
| 2.2             | Form of Deposit Agreement among the Registrant, The Bank of New York, as depositary, and Owners and Beneficial Owners from time to time of American Depositary Receipts. <sup>(2)</sup> |
| 4.1             | Office Space Lease Agreement between the Company and Eastern Air Group Company (together with English translation). <sup>(1)</sup>  |
| 4.8             | Employee Housing Lease Agreement between the Company and Eastern Air Group Company (together with English translation). <sup>(1)</sup>  |
| 8.1             | List of subsidiaries of the Registrant.   |
| 11.1            | Code of Ethics (English translation).   |
| 12.1            | Certification of President pursuant to Rule 13a-14(a).  |
| 12.2            | Certification of CFO pursuant to Rule 13a-14(a).  |
| 13.1            | Certification of President pursuant to Rule 13a-14(b).  |
| 13.2            | Certification of CFO pursuant to Rule 13a-14(b).  |

(1) Incorporated by reference to our Registration Statement on Form F-1 (File No. 333-6260), filed with the Securities and Exchange Commission on January 9, 1997.

(2) Incorporated by reference to our Registration Statement on Form F-6 (File No. 333-6284), filed with the Securities and Exchange Commission with respect to American Depositary Shares representing our H shares.