

CHINA SOUTHERN AIRLINES CO LTD

Form 20-F

June 30, 2004

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*As filed with the Securities and Exchange Commission on June 30, 2004*

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**SECURITIES AND EXCHANGE COMMISSION**

*Washington, D.C. 20549*

**FORM 20-F**

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

*OR*

x *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*

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

*Commission file number: 1-14660*

*(Exact name of Registrant as specified in its charter)*

**CHINA SOUTHERN AIRLINES COMPANY LIMITED**

*(Translation of Registrant's name into English)*

**THE PEOPLE'S REPUBLIC OF CHINA**

*(Jurisdiction of incorporation or organization)*

**BAIYUN INTERNATIONAL AIRPORT**

**GUANGZHOU**

**PEOPLE'S REPUBLIC OF CHINA**

*(Address of principal executive offices)*

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

**Title of each class:**

*Ordinary H Shares of par value RMB1.00 per share  
represented by American Depositary Shares*

**Name of each exchange on which registered:**

*New York Stock Exchange, Inc.*

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*Securities registered or to be registered pursuant to Section 12(g) of the Act: None*

*Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act: None*

*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: 2,200,000,000 ordinary Domestic Shares of par value RMB1.00 per share, 1,174,178,000 ordinary H Shares of par value RMB1.00 per share and 1,000,000,000 ordinary A Shares of par value RMB1.00 per share were issued and outstanding as of December 31, 2003.*

*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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### **FORWARD-LOOKING STATEMENTS**

This Annual Report contains forward-looking statements. These statements appear in a number of different places in this Annual Report. A forward looking statement is usually identified by the use in this Annual Report of certain terminology such as estimates, projects, expects, intends, believes, plans, anticipates, or their negatives or other comparable words. Also look for discussions of strategy that involve risks and uncertainties. Forward-looking statements include statements regarding the outlook for the Company's future operations, forecasts of future costs and expenditures, evaluation of market conditions, the outcome of legal proceedings (if any), the adequacy of reserves, or other business plans. You are cautioned that such forward-looking statements are not guarantees and involve risks, assumptions and uncertainties. The Company's actual results may differ materially from those in the forward-looking statements due to risks facing the Company or due to actual facts differing from the assumptions underlying those forward-looking statements.

Some of these risks and assumptions, in addition to those identified under Item 3, Key Information Risk Factors, include:

- general economic and business conditions, including changes in interest rates;
- prices and other economic conditions;
- natural phenomena;
- actions by government authorities, including changes in government regulation;
- the Company's relationship with CSAHC;
- uncertainties associated with legal proceedings;
- technological development;
- future decisions by management in response to changing conditions;
- the Company's ability to execute prospective business plans; and
- misjudgments in the course of preparing forward-looking statements.

The Company advises you that these cautionary remarks expressly qualify in their entirety all forward-looking statements attributable to the Company, the Group, and persons acting on their behalf.

### **INTRODUCTORY NOTE**

In this Annual Report, unless the context indicates otherwise, the Company means China Southern Airlines Company Limited, a joint stock company incorporated in China on March 25, 1995, the Group means the Company and its consolidated subsidiaries, and CSAHC means China Southern Air Holding Company, the Company's parent company which holds a 50.3% controlling interest in the Company.

References to China or the PRC are to the People's Republic of China, excluding Hong Kong, Macau and Taiwan. References to Renminbi or RMB are to the currency of China, references to U.S. dollars, \$ or US\$ are to the currency of the United States of America (the U.S. or United States), and reference to HK\$ is to the currency of Hong Kong. Reference to the Chinese Government is to the national government of China. References to Hong Kong or Hong Kong SAR are to the Hong Kong Special Administrative Region of the People's Republic of China. References to Macau or Macau SAR are to the Macau Special Administrative Region of the People's Republic of China.

The Company presents its consolidated financial statements in Renminbi. The consolidated financial statements of the Company as of December 31, 2002 and 2003 (the Financial Statements) have been prepared in accordance with International Financial Reporting Standards (IFRS) promulgated by the International Accounting Standards Board. IFRS includes International Accounting Standards (IAS) and related interpretations. IFRS differs in certain significant respects from accounting principles generally accepted in the United States of America (U.S. GAAP). Information relating to the nature and effect of such differences is presented in Note 33 to the Financial Statements.

Solely for the convenience of the readers, this Annual Report contains translations of certain Renminbi amounts into U.S. dollars at the rate of US\$1.00 = RMB8.2767, which is the average of the buying and selling rates as quoted by the People's Bank of China at the close of business on December 31, 2003. No representation is made that the Renminbi amounts or U.S. dollar amounts included in this Annual Report could have been or could be converted into U.S. dollars or Renminbi, as the case may be, at any particular rate or at all. Any discrepancies in the tables

included herein between the amounts listed and the totals are due to rounding.

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**GLOSSARY OF AIRLINE INDUSTRY TERMS**

In this Annual Report, unless the context indicates otherwise, the following terms shall have the respective meanings set forth below.

*Capacity Measurements*

|                                   |                                                                                                                                           |
|-----------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------|
| available seat kilometers or ASKs | the number of seats made available for sale multiplied by the kilometers flown                                                            |
| available ton kilometers or ATKs  | the number of tons of capacity available for the transportation of revenue load (passengers and cargo) multiplied by the kilometers flown |

*Traffic Measurements*

|                                      |                                                                             |
|--------------------------------------|-----------------------------------------------------------------------------|
| revenue passenger kilometers or RPKs | the number of revenue passengers carried multiplied by the kilometers flown |
| cargo ton kilometers                 | the cargo load in tons multiplied by the kilometers flown                   |
| revenue ton kilometers or RTKs       | the load (passenger and cargo) in tons multiplied by the kilometers flown   |

*Yield Measurements*

|                 |                                                                       |
|-----------------|-----------------------------------------------------------------------|
| passenger yield | revenue from passenger operations divided by RPKs                     |
| cargo yield     | revenue from cargo operations divided by cargo ton kilometers         |
| average yield   | revenue from airline operations (passenger and cargo) divided by RTKs |
| ton             | a metric ton, equivalent to 2,204.6 pounds                            |

*Load Factors*

|                       |                                                                                                                                                                         |
|-----------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| passenger load factor | RPKs expressed as a percentage of ASKs                                                                                                                                  |
| overall load factor   | RTKs expressed as a percentage of ATKs                                                                                                                                  |
| breakeven load factor | the load factor required to equate scheduled traffic revenue with operating costs assuming that total operating surplus is attributable to scheduled traffic operations |

*Utilization*

|                  |                                                                  |
|------------------|------------------------------------------------------------------|
| utilization rate | the actual number of flight hours per aircraft per operating day |
|------------------|------------------------------------------------------------------|

*Equipment*

|             |                                                                        |
|-------------|------------------------------------------------------------------------|
| rotables    | aircraft parts that are ordinarily repaired and reused                 |
| expendables | aircraft parts that are ordinarily used up and replaced with new parts |

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Not applicable.

**ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE.**

Not applicable.

**ITEM 3. KEY INFORMATION.****Selected Financial Data**

The following selected data of consolidated statements of operations for each of the years in the five-year period ended December 31, 2003 and consolidated balance sheets for five years ended December 31, 2003 have been derived from the consolidated financial statements of the Company. Such consolidated financial statements have been audited by KPMG, Independent Registered Public Accounting Firm, and prepared in accordance with IFRS. IFRS differs in certain significant respects from U.S. GAAP. See Note 33 to the Financial Statements for the nature and effect of such differences related to the Group between IFRS and U.S. GAAP as of December 31, 2002 and 2003 and for each of the years in the three-year period ended December 31, 2003. The following information should be read in conjunction with, and is qualified in its entirety by, the Financial Statements of the Group.

|                                                      | Year ended December<br>31,          |           |          |          |          |         |
|------------------------------------------------------|-------------------------------------|-----------|----------|----------|----------|---------|
|                                                      | 1999                                | 2000      | 2001     | 2002     | 2003     | 2003    |
|                                                      | RMB                                 | RMB       | RMB      | RMB      | RMB      | US\$    |
|                                                      | (in million, except per share data) |           |          |          |          |         |
| <b>Income Statement Data:</b>                        |                                     |           |          |          |          |         |
| IFRS:                                                |                                     |           |          |          |          |         |
| Operating revenue                                    | 13,299.6                            | 15,178.3  | 16,879.7 | 18,018.6 | 17,470.1 | 2,110.8 |
| Operating expenses                                   | 11,449.7                            | 13,996.2  | 15,479.0 | 15,992.5 | 17,014.4 | 2,055.7 |
| Operating income                                     | 1,849.9                             | 1,182.1   | 1,400.7  | 2,026.1  | 455.7    | 55.1    |
| Equity income of affiliated companies                | 36.1                                | 45.9      | 53.0     | 37.0     | 47.8     | 5.8     |
| Equity loss of jointly controlled entities           |                                     |           | (4.0)    | (3.4)    | (39.5)   | (4.8)   |
| (Loss)/gain on sale of fixed assets                  | (18.7)                              | 372.6     | (55.9)   | 170.7    | (22.2)   | (2.7)   |
| Interest expense                                     | (1,192.2)                           | (1,074.2) | (933.7)  | (959.2)  | (823.7)  | (99.5)  |
| Exchange (loss)/gain, net                            | (426.5)                             | 318.5     | 296.8    | (175.4)  | (164.4)  | (19.9)  |
| Other, net                                           | 119.9                               | 86.3      | 38.4     | 43.3     | 34.7     | 4.2     |
| Income/(loss) before taxation and minority interests | 368.5                               | 931.2     | 795.3    | 1,139.1  | (511.6)  | (61.8)  |
| Taxation (expense)/credit                            | (128.0)                             | (338.9)   | (320.5)  | (398.2)  | 324.2    | 39.2    |

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|                                   |         |        |         |         |         |        |
|-----------------------------------|---------|--------|---------|---------|---------|--------|
| Minority interests                | (158.1) | (90.5) | (134.6) | (165.1) | (170.9) | (20.7) |
| Net income/(loss)                 | 82.4    | 501.8  | 340.2   | 575.8   | (358.3) | (43.3) |
| Basic earnings/(loss) per share   | 0.02    | 0.15   | 0.10    | 0.17    | (0.09)  | (0.01) |
| Basic earnings/(loss) per ADS     | 1.22    | 7.44   | 5.04    | 8.53    | (4.68)  | (0.56) |
| Cash dividends declared per share |         |        |         | 0.02    |         |        |
| U.S. GAAP:                        |         |        |         |         |         |        |
| Net income/(loss)                 | 370.3   | 354.4  | 430.7   | 474.0   | (359.6) | (43.5) |
| Basic earnings/(loss) per share   | 0.11    | 0.11   | 0.13    | 0.14    | (0.09)  | (0.01) |
| Basic earnings/(loss) per ADS     | 5.49    | 5.25   | 6.38    | 7.02    | (4.69)  | (0.57) |
| Cash dividends declared per share |         |        |         | 0.02    |         |        |

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|                                                                          |          |          | December<br>31, |          |          |         |
|--------------------------------------------------------------------------|----------|----------|-----------------|----------|----------|---------|
|                                                                          | 1999     | 2000     | 2001            | 2002     | 2003     | 2003    |
|                                                                          | RMB      | RMB      | RMB             | RMB      | RMB      | US\$    |
|                                                                          |          |          | (in million)    |          |          |         |
| <b>Balance Sheet Data:</b>                                               |          |          |                 |          |          |         |
| IFRS:                                                                    |          |          |                 |          |          |         |
| Cash and cash equivalents                                                | 4,588.4  | 4,197.5  | 2,817.9         | 3,771.0  | 2,080.2  | 251.3   |
| Other current assets                                                     | 1,715.2  | 1,691.9  | 1,560.5         | 1,834.8  | 1,921.3  | 232.1   |
| Fixed assets, net                                                        | 24,211.2 | 23,282.1 | 22,352.2        | 26,920.8 | 28,535.9 | 3,447.7 |
| Total assets                                                             | 32,557.7 | 30,924.0 | 30,653.1        | 37,188.0 | 39,062.1 | 4,719.5 |
| Notes payable, including current installments of long term notes payable | 613.3    | 783.1    | 2,177.5         | 5,240.7  | 7,096.8  | 857.4   |
| Current installments of obligations under capital leases                 | 1,999.7  | 1,776.2  | 1,451.9         | 1,566.7  | 1,297.9  | 156.8   |
| Notes payable, excluding current installments                            | 4,424.2  | 3,788.7  | 3,627.6         | 5,835.4  | 4,521.7  | 546.3   |
| Obligations under capital leases, excluding current installments         | 11,490.9 | 9,416.3  | 7,691.6         | 6,631.8  | 5,543.1  | 669.7   |
| Shareholders' equity                                                     | 8,379.7  | 8,881.4  | 9,221.7         | 9,613.2  | 11,895.7 | 1,437.3 |
| U.S. GAAP:                                                               |          |          |                 |          |          |         |
| Shareholders' equity                                                     | 8,227.4  | 8,527.3  | 8,958.0         | 9,287.3  | 11,568.5 | 1,397.7 |
| Selected Operating Data                                                  |          |          |                 |          |          |         |

The following selected operating data of the Group for the five years ended December 31, 2003 have been derived from consolidated financial statements prepared in accordance with IFRS and other data provided by the Group and have not been audited. In accordance with Order No. 88 of the Civil Aviation Administration of China (the "CAAC"), titled Measures for the Administration of China's Civil Aviation Statistics, new statistical standards have been implemented with effect from January 1, 2001. The Group has not adjusted the operating data for the corresponding period in 1999 according to the new standards. The main differences between the two sets of standards are set forth below:

1. The standard passenger weight has been changed from 75 kg per person to 90 kg per person (luggage weight included). Luggage weight will not be separately calculated;
2. Number of scheduled flights has been changed to number of takeoffs;
3. Any passenger carried on flights which fly international routes will be counted as one domestic passenger and one international passenger; however, any passenger carried on an irregular flight will only be counted once; any cargo carried on flights which fly international routes will be counted as one domestic and one international cargo; however, cargo carried on an irregular flight will only be counted once.

Apart from the data set out in the table below for year 1999, the operating data and the profit analysis and comparison for other years below is calculated and disclosed in accordance with the new statistical standards. See Glossary of Airline Industry Terms at the front of this Annual Report for definitions of certain terms used herein.

|                    | Year ended December 31, |        |        |        |        |
|--------------------|-------------------------|--------|--------|--------|--------|
|                    | 1999                    | 2000   | 2001   | 2002   | 2003   |
| <b>Capacity</b>    |                         |        |        |        |        |
| ASK (million)      |                         |        |        |        |        |
| Domestic           | 24,900                  | 28,345 | 31,393 | 33,753 | 32,590 |
| Hong Kong regional | 1,791                   | 1,744  | 1,690  | 1,746  | 1,347  |
| International      | 5,155                   | 5,742  | 6,981  | 8,746  | 6,930  |
| Total              | 31,846                  | 35,831 | 40,064 | 44,245 | 40,867 |
| ATK (million)      |                         |        |        |        |        |
| Domestic           | 2,865                   | 3,322  | 3,622  | 3,924  | 3,772  |
| Hong Kong regional | 214                     | 198    | 185    | 193    | 150    |
| International      | 683                     | 1,087  | 1,317  | 1,798  | 1,999  |
| Total              | 3,762                   | 4,607  | 5,124  | 5,915  | 5,921  |
|                    | 4                       |        |        |        |        |

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|                                     | Year ended December<br>31, |         |         |         |         |
|-------------------------------------|----------------------------|---------|---------|---------|---------|
|                                     | 1999                       | 2000    | 2001    | 2002    | 2003    |
| Kilometers flown (thousand)         | 182,200                    | 209,431 | 234,051 | 258,379 | 249,068 |
| Hours flown (thousand)              | 287                        | 326     | 365     | 405     | 385     |
| Number of flights                   |                            |         |         |         |         |
| Domestic                            | 126,120                    |         |         |         |         |
| Hong Kong regional                  | 13,460                     |         |         |         |         |
| International                       | 6,600                      |         |         |         |         |
| Total                               | 146,180                    |         |         |         |         |
| Number of landing and take-offs     |                            |         |         |         |         |
| Domestic                            |                            | 165,726 | 183,651 | 194,776 | 191,460 |
| Hong Kong regional                  |                            | 14,255  | 13,712  | 13,891  | 11,400  |
| International                       |                            | 8,861   | 10,698  | 13,990  | 11,330  |
| Total                               |                            | 188,842 | 208,061 | 222,657 | 214,190 |
| <b>Traffic</b>                      |                            |         |         |         |         |
| RPK (million)                       |                            |         |         |         |         |
| Domestic                            | 14,511                     | 16,974  | 19,447  | 22,092  | 21,294  |
| Hong Kong regional                  | 1,106                      | 1,074   | 1,060   | 1,081   | 778     |
| International                       | 3,068                      | 3,605   | 4,550   | 5,767   | 4,315   |
| Total                               | 18,685                     | 21,653  | 25,057  | 28,940  | 26,387  |
| RTK (million)                       |                            |         |         |         |         |
| Domestic                            | 1,518                      | 1,941   | 2,217   | 2,532   | 2,424   |
| Hong Kong regional                  | 106                        | 107     | 105     | 108     | 78      |
| International                       | 379                        | 565     | 712     | 974     | 1,059   |
| Total                               | 2,003                      | 2,613   | 3,034   | 3,614   | 3,561   |
| Passengers carried (thousand)       |                            |         |         |         |         |
| Domestic                            | 12,769                     | 14,450  | 16,499  | 18,535  | 18,259  |
| Hong Kong regional                  | 1,434                      | 1,444   | 1,409   | 1,369   | 1,019   |
| International                       | 909                        | 957     | 1,213   | 1,589   | 1,192   |
| Total                               | 15,112                     | 16,851  | 19,121  | 21,493  | 20,470  |
| Cargo and mail carried (tons)       | 390,750                    | 353,000 | 398,000 | 470,000 | 464,000 |
| <b>Load Factors</b>                 |                            |         |         |         |         |
| Passenger load factor (RPK/ASK) (%) |                            |         |         |         |         |
| Domestic                            | 58.3                       | 59.9    | 61.9    | 65.5    | 65.3    |
| Hong Kong regional                  | 61.8                       | 61.6    | 62.7    | 61.9    | 57.8    |
| International                       | 59.5                       | 62.8    | 65.2    | 65.9    | 62.3    |
| Total                               | 58.7                       | 60.4    | 62.5    | 65.4    | 64.6    |
| Overall load factor (RTK/ATK) (%)   |                            |         |         |         |         |
| Domestic                            | 53.0                       | 58.4    | 61.2    | 64.5    | 64.2    |
| Hong Kong regional                  | 49.5                       | 54.0    | 56.8    | 55.8    | 52.2    |
| International                       | 55.5                       | 52.0    | 54.1    | 54.2    | 53.0    |
| Total                               | 53.2                       | 56.7    | 59.2    | 61.1    | 60.1    |
| Breakeven load factor (%)           | 47.5                       | 54.0    | 55.6    | 55.9    | 61.6    |
| <b>Yield</b>                        |                            |         |         |         |         |
| Yield per RPK (RMB)                 |                            |         |         |         |         |

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|                                               |      |      |      |      |      |
|-----------------------------------------------|------|------|------|------|------|
| Domestic                                      | 0.65 | 0.62 | 0.62 | 0.55 | 0.57 |
| Hong Kong regional                            | 1.00 | 1.06 | 1.06 | 0.98 | 0.96 |
| International                                 | 0.42 | 0.43 | 0.41 | 0.42 | 0.47 |
| Total                                         | 0.63 | 0.61 | 0.60 | 0.54 | 0.57 |
| Yield per cargo and mail ton kilometers (RMB) | 1.63 | 2.13 | 1.76 | 1.73 | 1.62 |
|                                               | 5    |      |      |      |      |

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|                                          | Year ended December 31, |       |       |       |       |
|------------------------------------------|-------------------------|-------|-------|-------|-------|
|                                          | 1999                    | 2000  | 2001  | 2002  | 2003  |
| Yield per RTK (RMB)                      |                         |       |       |       |       |
| Domestic                                 | 6.69                    | 5.90  | 5.83  | 5.21  | 5.40  |
| Hong Kong regional                       | 11.00                   | 11.19 | 11.26 | 10.36 | 10.35 |
| International                            | 3.96                    | 3.63  | 3.31  | 3.25  | 2.90  |
| Total                                    | 6.40                    | 5.63  | 5.43  | 4.84  | 4.76  |
| <b>Fleet</b>                             |                         |       |       |       |       |
| Boeing                                   | 81                      | 89    | 91    | 102   | 108   |
| Airbus                                   | 20                      | 20    | 20    | 20    | 24    |
| Total aircraft in service at period end  | 101                     | 109   | 111   | 122   | 132   |
| Overall utilization rate (hours per day) | 8.1                     | 8.7   | 9.1   | 9.8   | 8.5   |
| <b>Financial</b>                         |                         |       |       |       |       |
| Operating cost per ASK (RMB)             | 0.36                    | 0.39  | 0.39  | 0.36  | 0.42  |
| Operating cost per ATK (RMB)             | 3.04                    | 3.04  | 3.02  | 2.70  | 2.87  |
| Exchange Rate Information                |                         |       |       |       |       |

The following table sets forth certain information concerning exchange rates, based on the noon buying rates in New York City for cable transfers in foreign currencies, as certified for customs purposes by the Federal Reserve Bank of New York (the "Noon Buying Rate"), between Renminbi and U.S. dollars for the five most recent financial years.

| Period               | Period<br>End | Average(1)        | High   | Low    |
|----------------------|---------------|-------------------|--------|--------|
|                      |               | (RMB per<br>US\$) |        |        |
| Annual Exchange Rate |               |                   |        |        |
| 1999                 | 8.2793        | 8.2793            | 8.2917 | 8.2669 |
| 2000                 | 8.2781        | 8.2784            | 8.2799 | 8.2768 |
| 2001                 | 8.2766        | 8.2766            | 8.2910 | 8.2642 |
| 2002                 | 8.2773        | 8.2773            | 8.2897 | 8.2152 |
| 2003                 | 8.2767        | 8.2772            | 8.2800 | 8.2769 |

The following table sets out the range of high and low exchange rates, based on the Noon Buying Rate, between Renminbi and U.S. dollars, for the following periods.

| Period                       | High   | Low    |
|------------------------------|--------|--------|
| <b>Monthly Exchange Rate</b> |        |        |
| December 2003                | 8.2772 | 8.2765 |
| January 2004                 | 8.2772 | 8.2767 |
| February 2004                | 8.2773 | 8.2769 |

|                                 |        |        |
|---------------------------------|--------|--------|
| March 2004                      | 8.2774 | 8.2767 |
| April 2004                      | 8.2772 | 8.2768 |
| May 2004                        | 8.2773 | 8.2768 |
| June 2004 (up to June 25, 2004) | 8.2768 | 8.2767 |

- 
- (1) Determined by averaging the rates on the last business day of each month during the relevant period.  
Dividend Payments

No interim dividend was paid during the year ended December 31, 2003. The Board of Directors of the Company ( Board of Directors ) does not recommend the payment of a final dividend in respect of the year ended December 31, 2003.

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### **Capitalization and Indebtedness**

Not applicable.

### **Reasons for the Offer and Use of Proceeds**

Not applicable.

### **Risk Factors**

Risks relating to the Company

#### *Government ownership and control of the Company*

All Chinese airlines are wholly- or majority-owned either by the Chinese Government or by provincial or municipal governments in China. CSAHC, an entity wholly-owned by the Chinese Government, holds and exercises the rights of ownership of all of the Domestic Shares or 50.3% of the equity of the Company. The interests of the Chinese Government in the Company and in other Chinese airlines may conflict with the interests of the holders of the ADSs, H Shares and A Shares. The public policy considerations of the Chinese Government in regulating the Chinese commercial aviation industry may also conflict with its indirect ownership interest in the Company.

#### *High operating leverage and foreign exchange exposure*

The airline industry is generally characterized by a high degree of operating leverage. In addition, due to high fixed costs, the expenses relating to the operation of any flight do not vary proportionately with the number of passengers carried, while revenues generated from a flight are directly related to the number of passengers carried and the fare structure of such flight. Accordingly, a decrease in revenues could result in a proportionately higher decrease in net income. Moreover, as the Group has substantial obligations denominated in foreign currencies, its results of operations are significantly affected by fluctuations in foreign exchange rates, particularly for the US dollar and the Japanese Yen. The Company incurred a net exchange loss of RMB175 million and RMB164 million for 2002 and 2003, respectively, mainly as a result of yen fluctuations. A majority of these exchange losses were unrealized in nature.

#### *Potential conflicts of interest*

CSAHC will continue to be the controlling shareholder of the Company and CSAHC and certain of its affiliated companies will continue to provide certain important services to the Company, including the import and export of aircraft spare parts and other flight equipment, housing services and financial services. In addition, Mr. Yan Zhi Qing, the Chairman of the Board of Directors, also serves as the President of CSAHC. The interests of CSAHC may conflict with those of the Company. In addition, any disruption of the provision of services by CSAHC's affiliated companies or a default by CSAHC of its obligations owed to the Company could affect the Company's operations and financial condition. In particular, as part of its cash management system, the Company periodically places significant amount of demand deposits to Southern Airlines Group Finance Company Limited ( "SA Finance" ), a PRC authorized financial institution controlled by CSAHC and an affiliated company of the Company. As a result, the Company's deposits with SA Finance are subject to the risks associated with the business of SA Finance over which the Company does not exercise control. As of December 31, 2002 and 2003, the Group had short-term deposits of RMB901 million and RMB366 million, respectively, with SA Finance.

Certain transactions between the Company and CSAHC or its affiliates (as defined in the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited (the "Hong Kong Listing Rules" )) will constitute connected transactions of the Company under the Hong Kong Listing Rules and, unless exemptions are applicable or waivers are granted, will be subject to disclosure requirements and/or independent shareholders' approval in a general meeting.

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### *Risks relating to certain real property*

Although systems for registration and transfer of land use rights and related real property interests in China have been implemented, such systems do not yet comprehensively account for all land and related property interests. The land in Guangzhou on which the Company's headquarters buildings and related aircraft maintenance and other facilities are located and the buildings that the Company uses at its route base in Wuhan, Haikou and Zhengzhou are leased by the Company from CSAHC. However, CSAHC lacks adequate documentation evidencing CSAHC's rights to such land and buildings, and, as a consequence, the lease agreements between CSAHC and the Company for such land have not been registered with the relevant authorities. As a result, such lease agreements may not be enforceable. Lack of adequate documentation for land use rights and ownership of buildings subjects the Company to challenges and claims by third parties with respect to the Company's use of such land and buildings.

The Company has been occupying all of the land and buildings described above without challenge. CSAHC has received written assurance from the CAAC to the effect that CSAHC is entitled to continued use and occupancy of the land in Guangzhou and certain related buildings and facilities. However, such assurance does not constitute formal evidence of CSAHC's right to occupy such lands, buildings and facilities, or the right to transfer, mortgage or lease such real property interests. The Company cannot predict the magnitude of the adverse effect on its operations if its use of any one or more of these parcels of land or buildings were successfully challenged. CSAHC has agreed to indemnify the Company and Guangzhou Aircraft Maintenance Engineering Company Limited (GAMECO), the Company's jointly controlled entity, against any loss or damage caused by any challenge of, or interference with, the use by the Company and GAMECO of any of their respective land and buildings.

### *Risks associated with Hong Kong regional routes*

The Company's Hong Kong regional routes benefit from traffic originating in Taiwan. The Company's Hong Kong regional routes may be materially adversely affected if direct flights between Taiwan and Mainland China were permitted in the future. In such event, Xiamen Airlines Company Limited (Xiamen Airlines), the Company's subsidiary, may apply for route rights for direct flights between Taiwan and mainland China, due partly to the proximity to Taiwan of Fujian province, where Xiamen Airlines is based. However, there can be no assurance that sufficient routes and flights between destinations in Taiwan and mainland China could be obtained by Xiamen Airlines, if at all, or as to the yields on these routes and flights.

### **Risks Relating to the Chinese Commercial Aviation Industry**

#### *Government regulation*

The Company's ability to implement its business strategy will continue to be affected by regulations and policies issued or implemented by the CAAC, which encompasses substantially all aspects of the Chinese commercial aviation industry, including the approval of domestic, Hong Kong regional and international route allocation, air fares, aircraft acquisition, jet fuel prices and standards for aircraft maintenance, airport operations and air traffic control. Such regulations and policies limit the flexibility of the Company to respond to market conditions, competition or changes in the Company's cost structure. The implementation of specific CAAC policies could from time to time adversely affect the Company's operations. The CAAC has confirmed in writing that the Company will be treated equally with other Chinese airlines with respect to certain matters regulated by the CAAC. Nevertheless, there can be no assurance that the CAAC will, in all circumstances, apply its regulations and policies in a manner that results in equal treatment of all airlines that are similarly situated.

#### *Jet fuel supply and costs*

The availability and cost of jet fuel have a significant impact on the Group's results of operations. The Group's jet fuel costs for 2003 accounted for 22.7% of its operating expenses. All of the domestic jet fuel requirements of Chinese airlines (other than at the Shenzhen, Zhuhai and Sanya airports) must be purchased from the exclusive providers, China Aviation Oil Supplies Company (the CAOSC) and Bluesky Oil Supplies Company, companies controlled and supervised by the CAAC. Chinese airlines may also purchase their jet fuel requirements at the Shenzhen, Zhuhai and Sanya airports from joint ventures in which the CAOSC is a partner. Jet fuel obtained from the CAOSC's regional branches is purchased at uniform prices throughout China that are determined and adjusted by the CAOSC from time to time with the approval of the CAAC and the pricing department of the State Planning Commission based on market conditions and other factors. As a result, the costs of transportation and storage of jet fuel in all regions of China are spread among all domestic airlines. Prior to 1994, domestic jet fuel prices were generally below international jet fuel prices. Since then, however, domestic jet fuel price from CAOSC has always been higher than international jet fuel prices, sometimes creating tension in fuel supply. In addition, jet fuel shortages have occurred in China and, on limited occasions before 1993, required the Company to delay or cancel flights. Although such shortages have not materially affected the Company's results of operations since 1993, there can be no assurance that such shortage will not occur in the future. If such shortage occurs in the future and the Company is forced to delay or cancel flights due to fuel shortage, its operational reputation among passengers and results of operations may suffer.



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### *Infrastructure limitations*

The rapid increase in air traffic volume in China in recent years has put pressure on many components of the Chinese commercial aviation industry, including China's air traffic control system, the availability of qualified flight personnel and airport facilities. Airlines, such as the Company, which have route networks that emphasize short- to medium-haul routes are generally more affected by insufficient aviation infrastructure in terms of on-time performance and high operating costs due to fuel inefficiencies resulting from the relatively short segments flown, as well as the relatively high proportion of time on the ground during turnaround. All of these factors may adversely affect the perception of the service provided by an airline and, consequently, the airline's operating results. In recent years, the CAAC has placed increasing emphasis on the safety of Chinese airline operations and has implemented measures aimed at improving the safety record of the industry. The ability of the Company to increase utilization rates and to provide safe and efficient air transportation in the future will depend in part on factors such as the improvement of national air traffic control and navigation systems and ground control operations at Chinese airports, which factors are beyond the control of the Company.

### *Competition*

The CAAC's extensive regulation of the Chinese commercial aviation industry has had the effect of managing competition among Chinese airlines. Nevertheless, competition has become increasingly intense in recent years due to a number of factors, including relaxation of certain regulations by the CAAC, and an increase in the capacity, routes and flights of Chinese airlines. Competition in the Chinese commercial aviation industry has led to widespread price-cutting practices that do not in all respects comply with applicable regulations. Until the interpretation of these CAAC regulations has been finalized and strictly enforced, discounted tickets from competitors will continue to have an adverse effect on the Company's sales.

The Company faces varying degrees of competition on its Hong Kong regional routes from certain Chinese airlines and Dragon Air and on its international routes, primarily from non-Chinese airlines, most of which have significantly longer operating histories, substantially greater financial and technological resources and greater name recognition than the Company. In addition, the public's perception of the safety and service records of Chinese airlines could adversely affect the Company's ability to compete against its Hong Kong regional and international competitors. Many of the Company's international competitors have larger sales networks and participate in reservation systems that are more comprehensive and convenient than those of the Company, or engage in promotional activities, such as International Alliance programs, that may enhance their ability to attract international passengers.

### *Limitation on foreign ownership*

Chinese Government policies limit foreign ownership in Chinese airlines. Under these policies, the percentage ownership of the Company's total outstanding ordinary shares held by investors in Hong Kong and any country outside China ( Foreign Investors ) may not in the aggregate exceed 49%. Currently, 26.8% of the total outstanding ordinary shares of the Company is held by Foreign Investors. As a result of this limitation on foreign ownership, the Company will have no meaningful access to the international equity capital markets unless the restriction on foreign ownership is lifted.

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### *Consolidation and Restructuring*

In 2000, the CAAC announced a restructuring plan with respect to the PRC aviation industry. Pursuant to such restructuring plan, domestic airlines are directed to consolidate, on a voluntary basis, into three major airline groups in China: CSAHC, China National Aviation Holding Company and China Eastern Air Holding Group. The Company announced that it will also participate in such consolidation and restructuring pursuant to the CAAC directives. The Company has taken steps towards the purchase of the airline business of China Northern Airlines Company and Xinjiang Airlines Company, two wholly owned subsidiaries of CSAHC. These proposed acquisitions pursuant to the CAAC restructuring plan may involve uncertainties and risks over a long period of time, including the following:

- failure to achieve the anticipated synergies, cost savings or revenue enhancing opportunities resulting from the restructuring activities;
- diversion of management's attention from existing business concerns and other business opportunities of the Group;
- difficulty in integrating the assets and business of other airlines, including its employees, corporate culture, managerial systems and processes, business information systems and services;
- difficulty in exercising control and supervision over various new operations within the Group;
- failure to retain key personnel; and
- increase in financial pressure due to assumption of recorded/unrecorded liabilities of the acquired businesses.

The inability to manage additional businesses or integrate successfully the acquired businesses without substantial expense, delay or other operational or financial problems, or the occurrence of one or more of the events enumerated above, could materially adversely affect the Group's financial condition and results of operations.

### *Risks relating to the PRC*

#### *Foreign exchange risks*

Renminbi is not a freely convertible currency, and the Company's ability to obtain or retain foreign currencies is subject to regulation in China. Limitations on the availability of foreign exchange could have a material adverse effect on the Company's operations and financial condition, particularly in light of the Company's substantial foreign currency obligations.

The value of Renminbi is subject to changes in Chinese Government policies and depends to a large extent on China's domestic and international economic and political developments, as well as supply and demand in the local market. Since 1994, the official exchange rates for the conversion of Renminbi to US dollars have been stable. There can be no assurance, however, that such rates will not be volatile or that there will be no further devaluation of the Renminbi against the foreign currencies in which the Company's obligations are denominated, principally the US dollar and the Japanese Yen. Based on the Company's foreign currency denominated obligations as of December 31, 2003, a 1% change in the exchange rate between the Renminbi and the US dollar, or between the Renminbi and Japanese Yen, would have resulted in an unrealized gain or loss of RMB152 million (US\$18 million). As the Company is not able to hedge effectively against the devaluation of the Renminbi other than by retaining its foreign exchange-denominated earnings and receipts to the extent permitted by applicable law, any future devaluation in the Renminbi could adversely affect the Company's results of operations and financial condition. The Company's results of operations and financial condition may also be affected by changes in the value of currencies other than the Renminbi in which the Company's earnings and obligations are denominated.

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### *Developing legal system*

The Chinese legal system is based on written statutes and is a system, unlike common law systems, in which decided legal cases have little precedential value. In 1979, China began to promulgate a more comprehensive system of laws. On December 29, 1993, the Chinese National People's Congress promulgated the Company Law, which became effective on July 1, 1994. In August 1994, pursuant to the Company Law, the PRC State Council issued the PRC Special Regulations on Overseas Offering and Listing of Shares by Companies Limited by Shares to regulate joint stock companies that offer and list their shares overseas. These laws, regulations and legal requirements are relatively recent, and, like other laws, regulations and legal requirements applicable in China (including with respect to the commercial aviation industry), their interpretation and enforcement involve significant uncertainties.

### *Taxation of holders of H Shares or ADS by China*

Chinese tax law generally provides for the imposition of a withholding tax on dividends paid by a Chinese company to a non-Chinese shareholder at a rate of 20%. In a notice issued by the State Taxation Bureau of the PRC and a letter issued by the State Taxation Bureau, however, the Chinese tax authorities confirmed that the imposition of this withholding tax on dividends paid by joint stock companies, such as the Company, had been suspended. Accordingly, any future dividends to be paid by the Company to holders of H Shares or ADS who are foreign individuals not resident in China or which are foreign enterprises with no permanent establishment in China will not be subject to a Chinese withholding tax. In the event that the suspension of the withholding tax is lifted, such payments will be subject to withholding tax at the 20% rate unless the holder is entitled to a tax waiver or a lower tax rate under an applicable double-taxation treaty. See Item 10 Additional Information Taxation .

## **ITEM 4. INFORMATION ON THE COMPANY.**

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

The Company is a joint stock company incorporated in China on March 25, 1995, and is 50.3% owned by CSAHC. The registered address of the Company is Guangzhou Economic & Technology Development Zone, People's Republic of China (telephone no: (86)20-8612-4738, website: www.cs-air.com).

During 2001, the Company established a new 50%: 50% joint venture, namely MTU Maintenance Zhuhai Co. Ltd, with MTU Maintenance GmbH, a subsidiary of Daimler-Benz Aerospace Group, to provide repair and maintenance services to aircraft engines. The registered capital is US\$63.1 million.

During 2002, the Company entered into an Interest Transfer and Capital Injection Agreement with China State Post Bureau, Shanghai Municipal Post Office, Post Office of the Inner Mongolian Autonomous Region and China Philately Corporation, pursuant to which the Company injected RMB150 million (equivalent to approximately US\$18.12 million) in cash to acquire 49% interest in China Postal Airlines, Ltd. The China State Post Bureau holds the remaining 51%. In addition, the Company paid RMB136.5 million (equivalent to approximately US\$16.5 million) to acquire 39% interest in Sichuan Airlines Corporation Limited to further expand its market shares in South-western China. The Group also jointly established a new 51%: 49% joint venture, namely Zhuhai Xiang Yi Aviation Technology Company Limited, the first sino-foreign joint venture company engaging in aviation training services in the PRC, with CAE. The registered capital is US\$29.8 million.

On March 13, 2003, the Company obtained an approval certificate from the Ministry of Commerce to change to a permanent limited company with foreign investments and obtained the business license on October 17, 2003 issued by the State Administration of Industry and Commerce of the People's Republic of China.

Pursuant to an extraordinary general meeting of shareholders held on May 21, 2002, a resolution was passed authorizing the Company to issue not more than 1,000,000,000 A shares of par value of RMB1.00 each. The Company issued and listed its 1,000,000,000 A shares with a par value of RMB1.00 each on the Shanghai Stock Exchange in July 2003.

On October 17, 2003, the Company's registered address was moved to Guangzhou Economic & Technology Development Zone. In accordance with the Rules and Regulations for Implementation of Income Tax for Foreign Investment Enterprises and Foreign Enterprises of the PRC and a taxation approval document Guangzhou Municipal State Tax Bureau Suo De Shui Zi Que 020043 , the Company is entitled to enjoy the preferential tax policy implemented in the Guangzhou Economic & Technology Development Zone effective October 1, 2003. As a result, the Company's income tax rate has been changed to 15% from 33% beginning from that date.

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The Group had RMB1,492 million, RMB6,351 million and RMB4,707 capital expenditures in 2001, 2002 and 2003 respectively. Of such capital expenditures in 2003, RMB2,818 million were financed by bank borrowings while the remaining RMB1,889 million were financed by internal resources. The capital expenditures were primarily incurred on the additional investments in aircraft and flight equipment under the Group's fleet expansion plans and Guangzhou new airport, and, to a small extent, additional investments in other facilities and building for operations.

The Chinese Government has approved a new Guangzhou airport project, which commenced construction in 2000, with completion targeted in August 2004. Upon completion, the new airport will replace the Baiyun International Airport as the main hub of the Group's route network. With the approval of the Chinese Government, the Group began construction of its facilities at the new Guangzhou airport in 2000. The Group's total investment will be RMB3,540 million, of which RMB2,620 million will be financed by bank loans. Several major banks in the PRC have committed to finance the project. The balance of RMB920 million will be financed by internal resources. As of December 31, 2003, the Group invested a total of RMB1,445.8 million for this new airport project. The Group believes that the completion of the new airport will substantially enhance the Group's operations in the Southern China region.

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### **Business Overview**

#### **General**

The Group provides commercial airline services throughout China, Hong Kong and Macau regions, Southeast Asia and other parts of the world. The Group is one of the three largest Chinese airlines and, as of year end 2003, ranked first in terms of passengers carried, number of scheduled flights per week, number of hours flown and size of route network and aircraft fleet. During the three years ended December 31, 2003, the Group's RPKs increased at a compound annual rate of 2.6%, from 25,057 million in 2001 to 26,387 million in 2003, while its capacity, measured in terms of ASKs, increased at a compound annual rate of 1.0%, from 40,064 million in 2001 to 40,867 million in 2003. In 2003, the Group carried 20.47 million passengers and had passenger revenue of RMB15,010 million (US\$1,814 million). Net loss for 2003 was RMB358 million (US\$43 million).

The Group conducts a portion of its airline operations through its airline subsidiaries namely Xiamen Airlines, Southern Airlines Group Shantou Airlines Company Limited ( Shantou Airlines ), Guangxi Airlines Company Limited ( Guangxi Airlines ), Zhuhai Airlines Company Limited ( Zhuhai Airlines ) and Guizhou Airlines Company Limited ( Guizhou Airlines ) (collectively, the Airline Subsidiaries ). In 2003, the Airline Subsidiaries carried 7.62 million passengers and had operating revenue of RMB5,368 million (US\$608 million) and accounted for 37.2% and 30.7% of the Group's passengers carried and operating revenue, respectively.

The Group also provides air cargo and mail services. The cargo and mail revenue of the Group increased by 9.5% to RMB1,955 million (US\$236 million) in 2003 as compared with 2002. The Group's airline operations are fully integrated with its airline-related businesses, including aircraft and engine maintenance, flight simulation and air catering operations.

The Group operates the most extensive route network among Chinese airlines with a total of 334 routes as of December 31, 2003, including 274 domestic routes, 18 Hong Kong regional routes (which include Hong Kong routes and Macau routes), and 42 international routes. In 2003, the Group operated an average of 4,118 landing and take-offs per week serving 94 destinations, including major cities in China, such as Beijing, Shanghai, Tianjin, Guangzhou, Shenzhen, Wuhan, Changsha, Zhengzhou, Xiamen, Xian and Chengdu. Most of the cities served by the Group are located in commercial centers or rapidly developing economic regions in China.

The Group's corporate headquarters and principal base of operations are located in Guangzhou, which is the capital of Guangdong Province and the largest city in southern China. Located in the rapidly developing Pearl River Delta region, Guangzhou is also the transportation hub of southern China and one of China's major gateway cities. Guangzhou's significance has increased as the transportation infrastructure of Guangdong Province has developed through the construction and development of expressways, an extensive rail network and the port cities of Yantian, Shekou, Chiwan, Mawan, Huangpu and Zhuhai.

In addition to its main route base in Guangzhou, the Group also maintains twelve regional route bases in Zhengzhou, Wuhan, Changsha, Shenzhen, Zhuhai, Xiamen, Fuzhou, Haikou, Guilin, Beihai, Shantou and Guiyang. All of these regional route bases are located in provincial capitals or major commercial centers in China.

The Group's operations primarily focus on the domestic market. In addition, the Group also operates Hong Kong regional and international flights. As of year end of 2003, the Group had 18 Hong Kong regional routes and 42 international routes. The Group's Hong Kong regional operations include flights between destinations in China and Hong Kong and Macau. The Group's international operations include scheduled services to Tokyo, Osaka, Amsterdam, Sharjah, Los Angeles, Fukuoka, Seoul, Sydney and ten Southeast Asian destinations. The Group operates the most extensive Southeast Asian route network among Chinese airlines.

As of year end 2003, the Group operated a fleet of 132 aircraft, consisting primarily of Boeing 737-300, 737-500, 737-700, 737-800, 747-400, 757-200 and 777-200 aircraft, and Airbus 319-100 and 320-200 aircraft. Significant portions of these aircraft are held under capital and operating leases. The average age of the Group's aircraft was 7.82 years at year end 2003.

**Table of Contents****Restructuring and Initial Public Offering**

As part of China's economic reforms in the 1980's, the PRC State Council directed the CAAC to separate its governmental, administrative and regulatory role from the commercial airline operations that were being conducted by the CAAC and its regional administrators. As a result, CSAHC was established on January 26, 1991 for the purpose of assuming the airline and airline-related commercial operations of the Guangzhou Civil Aviation Administration, one of the six regional bureaus of the CAAC. CSAHC was one of the 55 large-scale enterprises designated by the Chinese Government to play a leading role in their respective industries.

CSAHC was restructured in 1994 and 1995 in anticipation of the initial public offering of the Company. The restructuring was effected through the establishment of the Company and the execution of the Demerger Agreement, dated as of March 25, 1995, as amended (the "Demerger Agreement"), between CSAHC and the Company. Upon the restructuring, the Company assumed substantially all of the airline and airline-related businesses, assets and liabilities of CSAHC, and CSAHC retained its non-airline and non-airline-related businesses, assets and liabilities, and the non-business assets and liabilities. Upon this separation, all interests, rights, duties and obligations of CSAHC, whenever created or accrued, were divided between the Company and CSAHC based on the businesses, assets and liabilities assumed by each of them under the Demerger Agreement. Under the Demerger Agreement, CSAHC agreed not to conduct or participate or hold any interest in, either directly or indirectly, any business, activity or entity in or outside China that competes or is likely to compete with the commercial interests of the Group, although CSAHC may continue to hold and control the affiliates of CSAHC existing on the date of the Demerger Agreement and may continue to operate the businesses of such affiliates.

In July 1997, the Company completed a private placement of 32,200,000 H Shares to certain limited partnership investment funds affiliated with Goldman Sachs & Co. and an initial public offering of 1,141,978,000 H Shares, par value RMB 1.00 per share, and listing of the H Shares on the Stock Exchange of Hong Kong Limited (the "Hong Kong Stock Exchange") and American Depositary Shares ("ADSs", each ADS representing 50 H Shares) on the New York Stock Exchange. Prior to the private placement and the initial public offering, all of the issued and outstanding shares of capital stock of the Company, consisting of 2,200,000,000 Domestic Shares, par value RMB 1.00 per share, were owned by CSAHC, which owns and exercises, on behalf of the Chinese Government and under the supervision of the CAAC, the rights of ownership of the Domestic Shares held by CSAHC. After giving effect to the private placement and the initial public offering, CSAHC continues to own the 2,200,000,000 Domestic Shares, representing approximately 65.2% of the total share capital of the Company, and will be entitled to elect all the directors of the Company and to control the management and policies of the Group. Domestic Shares and H Shares are both ordinary shares of the Company.

Pursuant to an extraordinary general meeting of shareholders held on May 21, 2002, a resolution was passed authorizing the Company to issue not more than 1,000,000,000 A shares of par value of RMB1.00 each. The Company issued and listed its 1,000,000,000 A shares with a par value of RMB1.00 each on the Shanghai Stock Exchange in July 2003. Subsequent to A share issue, the shareholding of CSAHC on the Company was reduced to 50.3% from 65.2%.

**Traffic**

The following table sets forth certain statistical information with respect to the Group's passenger and cargo and mail traffic for the years indicated.

| Passengers Carried |              |                                                    | Cargo and Mail Carried<br>(tons) |                                                    | Total Traffic<br>(ton kilometers) |                                                    |
|--------------------|--------------|----------------------------------------------------|----------------------------------|----------------------------------------------------|-----------------------------------|----------------------------------------------------|
| Year               | Total        | Increase<br>(decrease)<br>over<br>previous<br>year | Total                            | Increase<br>(decrease)<br>over<br>previous<br>year | Total                             | Increase<br>(decrease)<br>over<br>previous<br>year |
|                    | (in million) | (%)                                                | (in<br>thousand)                 | (%)                                                | (in million)                      | (%)                                                |
| 1999               | 15.11        | 0.4                                                | 390.8                            | 12.3                                               | 2,003.0                           | 4.6                                                |
| 2000               | 16.85        | 11.5                                               | 353.0                            | (9.7)                                              | 2,613.0                           | 30.5                                               |
| 2001               | 19.12        | 13.5                                               | 398.0                            | 12.7                                               | 3,034.0                           | 16.1                                               |
| 2002               | 21.49        | 12.4                                               | 470.0                            | 18.1                                               | 3,614.0                           | 19.1                                               |
| 2003               | 20.47        | (4.7)                                              | 464.0                            | (1.3)                                              | 3,561.0                           | (1.5)                                              |



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### **Route Network**

#### *Overview*

The Group operates the most extensive route network among Chinese airlines. As of year end 2003, the Group operated 334 routes consisting of 274 domestic routes, 18 Hong Kong regional routes and 42 international routes. At such date, the Group's route network served 71 destinations within China and 23 destinations outside of China.

The Group continually evaluates its network of domestic, Hong Kong regional and international routes in light of its operating profitability and efficiency. The Group seeks to coordinate flight schedules with the Airline Subsidiaries on shared routes to maximize load factors and utilization rates. The acquisition of domestic, Hong Kong regional and international routes is subject to approval of the CAAC, and the acquisition of Hong Kong regional and international routes is also subject to the existence and the terms of agreements between the Chinese Government and the government of the Hong Kong SAR, the government of Macau Special Administrative Region of the People's Republic of China ( Macau SAR ) and the government of the proposed foreign destination.

In order to expand the Group's international route network, the Group has entered into code-sharing agreements with several international airlines such as Delta Airlines, Asiana Airlines, Japan Air System, Vietnam Airlines, Royal Dutch Airlines and Garuda Indonesian, etc. Under the code sharing agreements, the airlines are permitted to sell tickets on certain international routes for the Group to passengers using their codes. Similarly, the Group is permitted to sell tickets for these airlines using its CZ code. The code sharing agreements help increase the number of the Group's international sales outlets.

#### *Route Bases*

The Group's main route base is in Guangzhou. The Group maintains twelve regional route bases in Zhengzhou, Wuhan, Changsha, Shenzhen, Zhuhai, Xiamen, Fuzhou, Haikou, Guilin, Beihai, Shantou and Guiyang. All of these regional route bases are located in provincial capitals or major commercial centers in China. The Group's network of route bases provides the Group with routes covering all of China, except for Inner Mongolia, Tibet and Ningxia.

The Group believes that its extensive network of route bases enables it to coordinate flights and deploy its aircraft more effectively and to provide more convenient connecting flight schedules and access service and maintenance facilities for its aircraft. The Group believes that the number and location of these route bases may enhance the Group's ability to obtain the CAAC's approval of requests by the Group to open new routes and provide additional flights between these bases and other destinations in China. Under current regulations of the CAAC, airlines are generally expected to operate mainly from their route bases.

The Chinese Government has approved a new Guangzhou airport project, which commenced construction in 2000, with completion targeted in August 2004. Upon completion, the new airport will replace the Baiyun International Airport as the main hub of the Group's route network. With the approval of the Chinese Government, the Group began construction of its facilities at the new Guangzhou airport in 2000. The Group's total investment will be RMB3,540 million, of which RMB2,620 million will be financed by bank loans. Several major banks in the PRC have committed to finance the project. The balance of RMB920 million will be financed by internal resources. As of December 31, 2003, the Group invested a total of RMB1,445.8 million for this new airport project. The Group believes that the completion of the new airport will substantially enhance the Group's operations in the Southern China region.

#### *Domestic Routes*

The Group's domestic route network serves substantially all provinces and autonomous regions in China, including Guangdong, Fujian, Hubei, Hunan, Hainan, Guangxi, Jiangsu, Zhejiang, Henan and Anhui, and serves all four centrally-administered municipalities in China, namely, Beijing, Shanghai, Tianjin, and Chongqing. In 2003, the Group's most profitable domestic routes were the routes between Guangzhou and Beijing, Guangzhou and Shanghai, Shenzhen and Shanghai, Beijing and Guangzhou, Shenzhen and Beijing, Shanghai and Guangzhou, Beijing and Shenzhen, Guangzhou and Zhengzhou, Zhengzhou and Guangzhou and between Guangzhou, Dalian and Harbin.

**Table of Contents***Hong Kong Regional Routes*

The Group offers scheduled service between Hong Kong and Guangzhou, Kunming, Xiamen, Shantou, Beijing, Guilin, Meixian, Haikou, Wuhan, Zhengzhou, Nanning, Changsha and Sanya; between Macau and Fuzhou, Hangzhou and Xiamen. The Group's Hong Kong regional routes also include routes between Hong Kong or Macau and other destinations in China, including Zhang Jia Jie and Wu Yi Shan, which the Group operates on a charter flight basis, as explained below. The Group believes that the routes on which it operates these charter flights are among its highest yielding routes, primarily because the Group faces limited competition on such routes and is consequently less subject to downward pricing pressures. In 2003, the most profitable Hong Kong regional routes were those between Guangzhou and Hong Kong, Hong Kong and Guangzhou, Hong Kong and Wuhan, Wuhan and Hong Kong, Kunming and Hong Kong, Hong Kong and Xiamen, Hong Kong and Zhengzhou, Hong Kong and Kunming, Zhengzhou and Hong Kong, Hong Kong and Changsha.

The Group's charter flights are essentially regularly scheduled flights, but in theory permission to operate these charter flights is subject to monthly review by the CAAC and the Civil Aviation Department of the Hong Kong SAR. The CAAC has informally indicated that it primarily considers market demand and airline capability in granting permission for such flights. The Group has been able to maintain all of its Hong Kong regional routes on which it operates on a charter flight basis and believes that demand on such routes will continue. In 2003, the Group operated a total of 11,395 flights on its Hong Kong regional routes, accounting for approximately 29.8% of all passengers carried by Chinese airlines on routes between Hong Kong or Macau and destinations in China.

*International Routes*

The Group is the principal Chinese airline connecting the rapidly developing Pearl River Delta region of China to Southeast Asia, with 24 routes serving ten Southeast Asian destinations, including Singapore and major cities in Indonesia, Thailand, Malaysia, Philippines, Vietnam and Laos. In 2003, the Group's most profitable Southeast Asian routes were those between Manila, Xiamen and Beijing; Beijing, Xiamen and Manila; Guangzhou and Singapore, and Guangzhou and Bangkok. The Group believes that, among Chinese airlines, it is well-positioned to benefit from the business opportunities arising out of increased air traffic and the growing economic relationships between China and Southeast Asian countries.

In addition to the 24 routes serving ten Southeast Asian destinations, the Group also operates 18 other international routes providing scheduled service to Amsterdam, Sharjah, Osaka, Tokyo, Fukuoka, Seoul, Los Angeles, Sydney and Melbourne.

*Aircraft Fleet*

The Group's fleet plan in recent years has emphasized expansion and modernization through the acquisition of new aircraft and the retirement of less efficient older aircraft. As of year end 2003, the Group operated a fleet of 132 aircraft with an average age of 7.82 years. All aircraft of the Group are Boeing and Airbus aircraft. The Group has the largest fleet among Chinese airline companies. Most of the aircraft operated by the Group are leased pursuant to various types of leasing arrangements.

The following table sets forth certain information regarding the Group's fleet of 132 aircraft as of December 31, 2003.

| Model          | Number<br>of<br>Aircraft | Average Age<br>(years) | Average<br>Passenger<br>Capacity |
|----------------|--------------------------|------------------------|----------------------------------|
| Boeing 777-200 | 4                        | 7.51                   | 380                              |
| Boeing 777-21B | 5                        | 6.27                   | 292                              |
| Boeing 757-200 | 25                       | 11.48                  | 200                              |
| Boeing 747F    | 2                        | 1.42                   | n/a                              |
| Boeing 737-800 | 12                       | 0.78                   | 167                              |
| Boeing 737-700 | 10                       | 3.39                   | 138                              |
| Boeing 737-500 | 18                       | 11.10                  | 132                              |
| Boeing 737-300 | 32                       | 10.16                  | 145                              |
| Airbus 319-100 | 4                        | 0.42                   | 128                              |
| Airbus 320-200 | 20                       | 5.64                   | 158                              |
|                | 132                      |                        |                                  |



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During 2003, the Group continued to expand and modernize its aircraft fleet. In 2003, the Group's major aircraft transactions included:

- (i) The acquisition of seven Boeing 737-800 aircraft financed by a combination of internal funds and long term bank loans;
- (ii) The addition of four Airbus 319-100 aircraft and three Boeing 737-700 aircraft under operating leases;
- (iii) The early retirement of two Boeing 737-200 aircraft;
- (iv) The expiry of two Boeing 747 cargo freighters under short-term wet leases; and
- (v) The extension of four Boeing 737-300 under operating leases for another 2 to 5 years.

In addition, on April 8, 2004, the Company entered into an agreement with Airbus SNC for the acquisition of fifteen Airbus 320-200 aircraft and six Airbus 319-100 aircraft, scheduled for deliveries in 2005 and 2006.

*Aircraft Financing Arrangements*

*Overview*

A significant portion of the Group's aircraft is acquired under long-term capital or operating leases or long-term mortgage loans with remaining terms to maturity ranging from one to nine years. As of December 31, 2003, 29 of the Group's 132 aircraft were operated under

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capital leases, 54 were operated under operating leases, 27 were financed by long-term mortgage loans, while the remaining were acquired either with cash proceeds or acquired by exercising the purchase options upon expiry of the respective capital leases. The Group's planned acquisition of aircraft in the foreseeable future will generally be made pursuant to operating leases or financed by long-term mortgaged loans. The Group's determination as to its acquisition strategy depends on the Group's evaluation at the time of its capacity requirements, anticipated deliveries of aircraft, the Group's capital structure and cash flow, prevailing interest rates and other general market conditions.

The following table sets forth, as of December 31, 2003, the number of Boeing and Airbus aircraft operated by the Group pursuant to capital and operating leases and the remaining terms, expressed in years, of such leases.

| Model                      | Capital<br>Lease | Operating<br>Lease | Average<br>Remaining<br>Lease<br>Term |
|----------------------------|------------------|--------------------|---------------------------------------|
| Boeing 777-200 and 777-21B | 5                | 3                  | 7.66                                  |
| Boeing 757-200             | 1                | 10                 | 4.78                                  |
| Boeing 737-700             |                  | 4                  | 6.13                                  |
| Boeing 737-500             |                  | 18                 | 2.28                                  |
| Boeing 737-300             | 5                | 13                 | 3.24                                  |
| Airbus 320-200             | 18               | 2                  | 4.60                                  |
| Airbus 319-100             |                  | 4                  | 9.57                                  |
|                            | <hr/> 29         | <hr/> 54           |                                       |

*Capital Leases*

As of December 31, 2003, the Group's aggregate future minimum lease payments (including future finance charges) required under its capital leases were RMB7,961 million (US\$962 million). As of year end 2003, a majority of the Group's capital leases had original terms ranging from ten to fifteen years from the date of delivery of the relevant aircraft, and the remaining terms of these leases ranged from one to six years. The Group's capital leases typically cover a significant portion of the relevant aircraft's useful life and transfer the benefits and risks of ownership to the Group. Under its capital leases, the Group generally has an option to purchase the aircraft at or near the end of the lease term. As is customary in the case of capital leases, the Group's obligations are secured by the related aircraft, as well as other collateral.

*Operating Leases*

As of December 31, 2003, the Group's aggregate future minimum lease payments required under its operating leases were RMB8,120 million (US\$981 million). As of year end 2003, the Group's operating leases had original terms generally ranging from eight to ten years from the date of delivery of the relevant aircraft, and the remaining terms of these leases generally ranged from one to nine years. Pursuant to the terms of the operating leases, the Group is obligated to make rental payments based on the lease term, with no termination payment obligations or purchase option, and the lessor bears the economic benefits and risks of ownership. Under its operating leases, the Group has no option to purchase the aircraft and is required to return the aircraft in the agreed condition at the end of the lease term. Although title to the aircraft remains with the lessor, the Group is responsible during the lease term for the maintenance, servicing, insurance, repair and overhaul of the aircraft.

Pursuant to capital or operating leases, the Group is obligated 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 pursuant to such leases. In accordance with relevant PRC tax regulations, a PRC lessee is liable to pay PRC withholding tax in respect of any lease payments regularly made to an overseas lessor. Depending on the circumstances, this tax is generally imposed at a fixed rate ranging from 10% to 20% of the lease payments, or in certain cases, the interest components of such payments. Pursuant to an approval document from the State Taxation Bureau, lease arrangements executed prior to September 1, 1999 are exempt from PRC withholding tax. The PRC withholding tax payable in respect of the operating leases executed after September 1, 1999 of RMB12 million, RMB14 million and RMB8 million during 2001, 2002 and 2003 respectively, have been included as part of the operating lease charges.

*Aircraft Flight Equipment*

The jet engines used in the Group's aircraft fleet are manufactured by General Electric Corporation, Rolls-Royce plc, United Technologies International, Inc., CFM International, Inc. and International Aviation Engines Corporation. As of year end 2003, the Group had 34 spare jet engines for its fleet. The Group determines its requirements for jet engines based on all relevant considerations, including manufacturers

recommendations, the performance history of the jet engines and the planned utilization of its aircraft.

Rotables and certain of the expendables for the Group's aircraft are generally purchased by Southern Airlines (Group) Import & Export Trading Corporation (SAIETC), a subsidiary of CSAHC acting as agent for the Group, in consideration of an agency fee. The Group arranges the ordering of aircraft, jet engines and other flight equipment for the Airline Subsidiaries and keeps an inventory of rotables and expendables for the Airline Subsidiaries.

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### **Aircraft Maintenance**

A major part of the maintenance for the Group's fleet other than overhauls of jet engines is performed by GAMECO, a joint venture established by the Company and Hutchison Whampoa (Hutchison), consistent with the Group's strategy to achieve fully integrated airline operations and to assure continued access to a stable source of high quality maintenance services. The remaining part of the maintenance for the Group's fleet other than overhauls of jet engines is performed by service providers in China and overseas. GAMECO performs all types of maintenance services, ranging from maintenance inspections performed on aircraft before, after and between flights (line maintenance services) to major overhaul performed at specified intervals. GAMECO was the first of three aircraft maintenance facilities in China having been certified as a repair station by both the CAAC and the FAA. In March 1998, GAMECO received an approval certificate from the United Kingdom Civil Aviation Authority for the repair and maintenance of aircraft and aircraft engines.

The Group believes that GAMECO performs major maintenance checks on the Group's aircraft within time periods generally consistent with those of large international airline maintenance centers. GAMECO's repair and maintenance capabilities include overhaul of more than 90% of the Group's aircraft. Although rotables for the Group's aircraft are generally imported through SAIETC, a portion of expendables and other maintenance materials are directly imported by GAMECO. GAMECO also provides line maintenance services to 12 other Chinese airlines and 11 international airlines. GAMECO provides heavy maintenance services to 11 other Chinese airlines and seven international airlines.

Under the Aircraft Maintenance and Engineering Agreement entered into between GAMECO and the Company (the Aircraft Maintenance Agreement), GAMECO charges the Group for expendables on a cost plus basis, and for labor based on a formula that takes into account projected flight hours, costs and other relevant factors. Fees under the Aircraft Maintenance Agreement are payable 50% in Renminbi and 50% in U.S. dollars. Each year, the Company and GAMECO determine the components of the pricing formula. For the year ended December 31, 2003, GAMECO's revenue (excluding Value Added Tax) totaled RMB569 million, approximately 88.2% of which was derived from services provided to the Group.

Overhauls of jet engines are performed by overseas qualified service providers in Germany, Malaysia, Canada and England. Starting from 2003, MTU Maintenance Zhuhai Co., Ltd., (MTU Zhuhai) a jointly controlled entity of the Company and MTU Aero Engines GmbH., also performed overhauls of certain jet engines for the Group. For the year ended December 31, 2003, a total of eleven jet engines were major overhauled by MTU Zhuhai with total repair costs of RMB106 million.

### **Safety**

The Group endeavors to maintain strict compliance with all laws and regulations applicable to flight safety. In addition, the Group has adopted measures to eliminate or minimize factors that may impair flight safety, including specialized training programs and safety manuals. The Air Safety Management Department of the Company implements safety-related training programs on an ongoing basis in all of the Group's operations to raise the safety awareness of all employees. As a result, overall flight safety has gradually improved. There was no serious incidents involving casualty or flight damage throughout the three years ended December 31, 2003. For minor incidents which include various events and conditions prescribed by the CAAC which do not involve serious personal injury or material damage to flight equipment, the Group has kept the number consistently below the standard prescribed by the CAAC. For example, the Company's flight incident ratio was 0.19, 0.42 and 0.13 in 2001, 2002 and 2003, respectively. In comparison, CAAC's published maximum acceptable flight incident ratio was 1.6 in 2001 and 1.5 in 2002 and 1.3 in 2003. This ratio is defined as the occurrence of one incident for every 10,000 hours of flight time.

### **Jet Fuel**

Jet fuel costs typically represent a major component of an airline's operating expenses. The Group's jet fuel costs for 2003 accounted for 22.7% of the Group's operating expenses. Like all Chinese airlines, the Group is generally required by the Chinese Government to purchase its jet fuel requirements from regional branches of CAOSC and Bluesky Oil Supplies Company, except at the Shenzhen, Zhuhai and Sanya airports which are supplied by Sino-foreign joint ventures in which CAOSC is a joint venture partner. CAOSC is a State-owned organization controlled and supervised by the CAAC that controls the importation and distribution of jet fuel throughout China.

Jet fuel obtained from CAOSC's regional branches is purchased at uniform prices throughout China that are determined and adjusted by CAOSC from time to time with the approval of the CAAC and the pricing department of the National Development and Reform Commission ( NDRC ) based on market conditions and other factors. As a result, the costs of transportation and storage of jet fuel in all regions of China are spread among all domestic airlines. Jet fuel costs in China are influenced by costs at State-owned oil refineries and limitations in the transportation infrastructure, as well as by insufficient storage facilities for jet fuel in certain regions of China.

Prior to 1994, domestic jet fuel prices were generally below international jet fuel prices. The Chinese Government had gradually increased domestic jet fuel prices in order to reflect more accurately the costs of supplying jet fuel in China. As a result, domestic jet fuel prices have become higher than those in the international market since the beginning of 1994. With the WTO entry, the jet fuel price in China will probably be trimmed by the market force to be in line with the international market.

CAOSC's maximum fuel price in 2003 was RMB3,500 per ton. The average price paid by the Group in 2003 was RMB3,074 per ton, which represents a 13.2% increase from that of 2002.

To address the problem of high jet fuel prices since 2000, CAAC has announced a policy permitting airlines to impose a fuel surcharge on passengers carried by their domestic and Hong Kong regional flights for the purpose of offsetting the effect of rising jet fuel prices. Such surcharges have been imposed by the Group since November 1, 2000 at the prescribed rates set by the CAAC.

In addition to purchases of jet fuel from CAOSC, the Group is also permitted by the Chinese Government to purchase a portion of its jet fuel requirements for its international flights from foreign fuel suppliers located outside China at prevailing international market prices. Jet fuel purchased from such sources outside China accounted for approximately 10.0% of the Group's total jet fuel consumption in 2003.

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### **Flight Operations**

Flight operations for the Group's flights originating in Guangzhou are managed by the Company's flight operations and marketing divisions, which are responsible for formulating flight plans and schedules consistent with route and flight approvals received from the CAAC. The Company's flight operations center in Guangzhou is responsible for the on-site administration of flights, including the dispatch and coordination of flights, deployment of aircraft, ground services and crew staffing. In addition, each of the Airline Subsidiaries maintains flight operations centers at all servicing airports for on-site administration of their flights. The Company's general dispatch offices are responsible for monitoring conditions on the Group's route network, administering the Group's flight plans, collecting and monitoring navigation data and analyzing and monitoring airport conditions.

To enhance its management of flight operations, the Group's computerized flight operations control system (SOC) began operation in May 1999. The system utilizes advanced computer and telecommunications technology to manage the Group's flights on a centralized, real-time basis. The Group believes that the system will assist it to (i) compile flight schedules more efficiently; (ii) increase the utilization of aircraft; (iii) allow real-time tracking of all of the Group's flights; and (iv) improve coordination of the Group's aircraft maintenance and ground servicing functions.

### **Training of Pilots and Flight Attendants**

The Group believes that its pilot training program which was established in cooperation with the CAAC affiliated Beijing Aeronautics and Aviation University (the BAAU) has significantly improved the quality of the training received by the Group's pilots and has helped maintain the quality of the Group's staff of pilots at a level consistent with the expansion of operations called for by the Group's business strategy.

In the Group's pilot training program, trainees have two years of theoretical training at the BAAU. After successful completion of academic and physical examinations, students receive flight training for a period of approximately 20 months at China Southern West Australian Flying College Pty Ltd. (the Australian Pilot College), a company that is 65% owned by the Company and 35% owned by CSAHC. Each student at the Australian Pilot College is required to fly at least 230 hours before being awarded a flight certificate. Graduates of the BAAU and the Australian Pilot College are hired by the Group as trainee pilots after passing a CAAC-administered examination to obtain a pilot license. The total training period for the Group's trainee pilots is approximately five years. About 110 trainee pilots graduated from the Australian Pilot College each year.

Prior to January 2003, as part of the pilot training program, the Group also operated a flight simulator training center in Zhuhai, Guangdong Province (the Zhuhai Training Center), which was equipped with simulators for all models of aircraft currently operated by the Group. Trainee pilots received their initial training in the operation of a specific aircraft at the Zhuhai Training Center, which also provided training to pilots from other Chinese airlines. Such flight simulation training has been shifted to Zhuhai Xiang Yi Aviation Technology Company Limited (Zhuhai Xiang Yi), a jointly controlled entity between the Company and CAE International Holdings Limited, since January 2003. Zhuhai Xiang Yi currently leases the flight simulation facilities of Zhuhai Training Center from the Group and provides flight simulation training services to the Group.

The Group's pilots are required to be licensed by the CAAC, which requires an annual recertification examination. The Group's pilots attend courses in simulator training twice annually and in simulator emergency procedures annually. The Group also conducts regular advanced training courses for captains and captain candidates. Pilots advance in rank based on number of hours flown, types of aircraft flown and their performance history.



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The Group conducts theoretical and practical training programs for its flight attendants at its Flight Attendants Training Center in Guangzhou (the Guangzhou Training Center). The Guangzhou Training Center is equipped with computerized training equipment, as well as simulator cabins for all models of aircraft currently operated by the Group. At the Guangzhou Training Center, flight attendants of the Group receive comprehensive training in areas such as in-flight service, emergency evacuation and water rescue.

### **Ground Services**

The Group makes arrangements with airport authorities, other airlines or ground services companies for substantially all ground facilities, including jet-ways, waiting areas, ticket counters and support services buildings, at each airport that it serves. The Group pays landing, parking and other fees to such airports, including Baiyun International Airport in Guangzhou. At domestic airports, such fees are generally determined by the CAAC.

At Baiyun International Airport in Guangzhou, the Group operates its own passenger check-in, cargo, mail and baggage handling, aircraft maintenance and cleaning services. The Group also provides such services to other airlines that operate in Baiyun International Airport.

Ground services at the airports in Shenzhen, Changsha, Wuhan, Zhengzhou, Haikou, Zhuhai, Xiamen, Fuzhou, Guilin, Shantou, Guiyang and Beihai are primarily operated directly by the Group. Ground services at other airports in China are provided to the Group by local airport authorities or local airlines pursuant to various service agreements. Ground services and other services at airports outside China are provided to the Group by foreign services providers pursuant to various service agreements with such parties. All such agreements of the Group are short-term and otherwise on terms that are customary in the industry.

### **Air Catering**

The Company owns a 51% equity interest in Guangzhou Nanland Air Catering Company Limited (Nanland). Nanland provides in-flight meals, snacks, drinks and related services for all of the Group's flights originating in Guangzhou and substantially all other flights departing from Baiyun International Airport. The Group contracts with various air catering suppliers with respect to in-flight catering services for flights originating from other airports, generally on an annual basis and otherwise on terms that are customary in the industry.

### **Cargo and Mail**

The Group also provides air cargo and mail services. Previously, a significant portion of these services is combined with passenger flights services. Currently, the Group has two Boeing 747-400 freighters servicing three international cargo routes, Shenzhen to Chicago and Belgium and Shanghai to Amsterdam. Route Shanghai to Amsterdam was newly opened in October 2003. In October 2003, the Group took delivery of its first Boeing 737-300 QC (Quick Change) cargo aircraft. The QC aircraft is designed to provide maximum utilization of aircraft by allowing passenger use during the day and cargo operations at night.

Currently, the Group conducts its cargo business primarily through its cargo division in Shenzhen. To further tap into the growing cargo market, the Group has commenced the construction of a cargo centre in the Guangzhou new airport in 2003, at a cost of Rmb190 million.

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### **Sales, Reservations and Marketing**

#### *Passenger Ticket Sales and Reservations*

The Group's ticket sales and reservations are conducted by or through independent sales agents and the Group's own network of exclusive sales offices as well as the CAAC's sales offices and CSAHC's affiliates. The Group has sales offices in Guangzhou and its other route bases. In addition, the Group maintains regional sales offices in other cities in China, including Beijing and Shanghai. The Group maintains international sales offices in Bangkok, Manila, Hanoi, Ho Chi Minh City, Singapore, Kuala Lumpur, Penang, Jakarta and Phnom Penh in Southeast Asia, as well as in Osaka, Fukuoka, Tokyo, Seoul, Amsterdam, Los Angeles, Sydney, Melbourne and Sharjah.

In Hong Kong, ticket sales and reservations services are provided to the Group by China National Aviation Corporation and Nanlung Travel Agency Limited (a subsidiary of CSAHC) for a commission of 3%–9% of the ticket price. The Group also has agency agreements with airlines in the Asia-Pacific region, Europe, the United States and Africa for the processing of ticket sales and reservations on a reciprocal basis. In 2003, approximately 30% of all ticket sales for the Group's scheduled flights were made by the Group's and CAAC's network of sales offices and CSAHC's affiliates. The Group also sells tickets and accepts reservations through an extensive network of non-exclusive independent sales agents, substantially all of whom operate in cities throughout China, with the remainder operating principally in Hong Kong and other Southeast Asian destinations served by the Group. Under the agency agreements with these sales agents, the Group pays commissions based on the value of tickets sold. The Group pays independent sales agents in China a commission of 3% of the ticket price, and pays independent sales agents outside China a commission ranging from 5% to 9% of the ticket price. Sales agents are typically permitted to withhold their commission from the proceeds of ticket sales that are remitted to the Group. In 2003, independent sales agents accounted for approximately 70% of the Group's ticket sales for its scheduled flights.

Substantially all of the Group's sales offices and agents in China are linked electronically to the CAAC's computerized ticketing and reservations system, which is in turn linked to all domestic airlines for flights throughout China. The Group has also entered into membership agreements with several international reservation systems, including ABACUS in Southeast Asia, SABRE and GALILEO in the United States, AMADEUS in Europe and INFINI in Japan. These systems facilitate reservations and sales of tickets for the Group's international flights.

#### *Cargo*

The Group's cargo and mail services are promoted through its own cargo divisions and independent cargo agents both within and outside China that track available space among all airlines. In particular, the Group employs a number of cargo agents in the Pearl River delta region. The Group generally pays such agents a commission of 4% and 5% of the relevant cargo freight rate for domestic and international services, respectively.

#### *Promotional and Marketing Activities*

The Group engages in regular promotional and marketing activities in an effort to increase its market share. The Group's promotional and marketing activities for domestic routes emphasize safety, passenger comfort and the frequency of the Group's flights. The Group's promotional and marketing activities for international and Hong Kong regional passengers emphasize the Group's quality of service, extensive route network in China and greater frequency of flights relative to other Chinese airlines. In addition, the Group also promotes and markets its Hong Kong regional and international routes on the basis of price.

The Group has been seeking to increase its name recognition by offering new services to passengers. For example, the Group was the first Chinese airline to provide off-airport check-in services. The Group also offers transfer and

baggage thru-handling services to passengers connecting to other airlines, including passengers connecting in Hong Kong for flights to Taiwan.

To enhance relationships with its passengers, the Group has launched two frequent flyer programs, namely the China Southern Airlines Sky Pearl Club, and the Egret Mileage Plus. By the end of 2003, the Group had approximately 3,041,200 members under these programs.

#### Regulation

The Chinese commercial aviation industry is subject to a high degree of regulation and oversight by the CAAC. Regulations and policies issued or implemented by the CAAC encompass substantially all aspects of airline operations, including the approval of domestic, Hong Kong regional and international route allocation, published airfares, aircraft acquisition, jet fuel prices and standards for aircraft maintenance, airport operations and air traffic control. The Civil Aviation Law, which became effective in March 1996, provides a framework for regulation of many of these aspects of commercial aviation activities. Although China's airlines operate under the supervision and regulation of the CAAC, they are accorded an increasingly significant degree of operational autonomy, including with respect to the application for domestic, Hong Kong regional and international routes, the allocation of aircraft among routes, the purchase of flight equipment, the pricing of air fares within a certain range, the training and supervision of personnel and their day-to-day operations.

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As an airline providing services on international routes, the Group is also subject to a variety of bilateral civil air transport agreements that provide for the exchange of air traffic rights between China and various other countries. In addition, China is a contracting state, as well as a permanent member, of the International Civil Aviation Organization (the ICAO), an agency of the United Nations established in 1947 to assist in the planning and development of international air transport, and is a party to many other international aviation conventions. The ICAO establishes technical standards for the international aviation industry. The Group believes that it, in all material respects, complies with all such technical standards.

### *Route Rights*

*Domestic Routes.* The right of any Chinese airline to carry passengers or cargo on any domestic route must be obtained from the CAAC. Non-Chinese airlines are not permitted to provide domestic air service between destinations in China. The CAAC's policy is to assign a domestic route to the Chinese airline that is best suited to serve the route based, in part, on the location of the airline's main or regional base at the point of origin. Under current regulations, airlines are generally expected to operate mainly from their route bases, and flights within a particular region are expected to be served by airlines based in that region. The Group believes that these regulatory parameters benefit airlines, such as the Group, that have a large number of regional route bases. The CAAC also considers other factors that may make a particular airline suitable to operate a domestic route, including the applicant's general operating authority, compliance with pricing regulations and regulations applicable to safety and service quality, market demand, the ability of the applicant in terms of its existing route, and airport facilities and related support services.

The CAAC considers market conditions for a domestic route in determining whether the route should be allocated to one or more airlines. The CAAC requires the passenger load factor on a particular route to reach 75% before additional flights may be added on that route. Airlines serving the route are given priority for such additional flights, and only if such airlines cannot operate more flights will the CAAC permit another airline to commence service.

*Hong Kong Regional Routes.* Hong Kong regional routes and landing rights are derived from agreements between the Chinese Government and the government of the Hong Kong SAR, and between the Chinese Government and the Portuguese government before December 20, 1999 and the government of Macau SAR on and after December 20, 1999. Such rights are allocated by the CAAC among the seven Chinese airlines permitted to fly to Hong Kong or Macau.

The Group understands that the criteria for determining whether a Hong Kong regional route will be allocated to a particular airline, include market demand, the ability of the airline to service the route and the appropriateness of the airline's aircraft for such route. A number of Hong Kong regional routes are operated by Chinese airlines on a charter flight basis. Permission to operate these flights is in theory subject to monthly review by the CAAC and the Hong Kong Civil Aviation Department. The CAAC has informally indicated that it primarily considers market demand and airline capability in granting permission for such flights.

*International Routes.* International route rights, as well as the corresponding landing rights, are derived from air services agreements negotiated between the Chinese Government, 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 service between certain destinations within each of such countries. Upon entering into an air services agreement, the CAAC determines the airline to be awarded such routes based on various criteria, including the availability of appropriate aircraft, flight and management personnel, safety record, the overall size of the airline, financial condition and sufficiency of assets to bear civil liabilities in international air services. These route rights may be terminated by the CAAC under special circumstances.

The criteria for determining whether an international route will be allocated to a second airline generally include (i) the terms of the relevant bilateral civil aviation agreement; (ii) consistency with overall national plans and the national interest and the enhancement of reasonable competition; and (iii) whether the international airports to be used are sufficient for the aircraft flown and employ security measures consistent with international standards.

In addition, if the relevant bilateral civil aviation agreement permits more than one Chinese airline to operate a particular international route, the CAAC will only permit a second airline to operate on such route if the number of passengers carried annually exceeds 100,000 and if there is a minimum average load factor of 68% for routes with at least five weekly flights by Chinese airlines, or 80% for routes with four or fewer weekly flights by Chinese airlines.

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### *Air Fare Pricing Policy*

Published air fares of Chinese airlines for domestic routes are established by the CAAC and the pricing department of the NDRC. The CAAC determines and adjusts from time to time the published fare for each domestic route based on several factors, including average airline operating costs, market conditions, national transportation requirements and the ability of consumers to pay increased fares. Airlines may offer discounts within a range specified by the CAAC under certain circumstances.

Published air fares of Chinese airlines for the Hong Kong regional routes are determined by the CAAC and the relevant civil aviation authorities in Hong Kong or Macau, subject to consultation between the relevant Chinese airlines and Hong Kong or Macau airlines. Airlines may offer discounts on flights on their Hong Kong regional routes.

Published air fares of Chinese airlines for international routes are determined through consultation between the relevant Chinese airlines and foreign airlines in accordance with the civil aviation agreements between the Chinese Government and the relevant foreign government, taking into account the international air fare standards established through the International Air Transport Association. All air fares for international routes must be approved by the CAAC. Discounting of published international air fares is permitted.

### *Acquisition of Aircraft and Flight Equipment*

The CAAC requires all Chinese airlines to acquire their aircraft through China Aviation Supplies Import and Export Corporation ( CASC ), an entity controlled by the CAAC. If a Chinese airline plans to acquire an aircraft, the airline must first seek approval from the CAAC and NDRC. The airline must, as a condition of approval, provide specific acquisition plans, which are subject to modification by the CAAC and NDRC. If the CAAC and NDRC approve an aircraft acquisition, the airline negotiates the terms of the acquisition with the manufacturer together with CASC because CASC possesses the license required to import or export aircraft, and CASC receives a commission in respect thereof. Most Chinese airlines are also required to acquire their aircraft engines, spare parts and other flight equipment through CASC. The Company and a few other Chinese airlines are permitted to import jet engines and other flight equipment for their own use without the participation of CASC. In the case of the Company, SAIETC acts as its importer agent and is paid an agency fee for its services.

### *Jet Fuel Supply and Pricing*

CAOSC and Bluesky Oil Supplies Company, companies controlled and supervised by the CAAC, are the only jet fuel supply companies in China, with the exception of the joint venture jet fuel supply companies that supply the Shenzhen, Zhuhai and Sanya airports, in each of which CAOSC is a partner. Airlines are generally not permitted to buy jet fuel from other suppliers in their domestic operations, since the direct import of jet fuel for domestic purposes is prohibited. As a result, all Chinese airlines purchase their domestic jet fuel supply requirements (other than in respect of their Shenzhen, Zhuhai or Sanya operations) from the seven regional branches of CAOSC. Jet fuel obtained from such regional branches is purchased at uniform prices throughout China that are determined and adjusted by CAOSC from time to time with the approval of the CAAC and the pricing department of the NDRC based on market conditions and other factors.

### *Safety*

The CAAC has made the improvement of air traffic safety in China a high priority and is responsible for the establishment of operational safety, maintenance and training standards for all Chinese airlines. The Chinese airlines are required to provide monthly flight safety reports to the CAAC, including reports of flight or other incidents or

accidents and other safety related problems involving such airline's aircraft occurring during the relevant reporting period. The CAAC periodically conducts safety inspections on individual airlines.

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The CAAC oversees the standards of all Chinese airline pilots through its operation of the CAAC Aviation College. The CAAC Aviation College is a monitoring unit located in Tianjin which implements a uniform pilot certification process applicable to all Chinese airline pilots and is responsible for the issuance, renewal, suspension and cancellation of pilot licenses. Every pilot is required to pass CAAC-administered examinations before obtaining a pilot license and is subject to an annual recertification examination.

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 aircraft operated by Chinese airlines must have a valid certificate of airworthiness, which is issued annually by the CAAC. In addition, maintenance permits are issued to a Chinese airline only after its maintenance capabilities have been examined and assessed by the CAAC. Such maintenance permits are renewed annually. All aircraft operated by Chinese airlines may be maintained and repaired only by 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 supervises the implementation of security standards and regulations for the Chinese commercial aviation industry. Such standards and regulations are based on Chinese laws, as well as standards developed by international commercial aviation organizations. Each airline and airport in China is required to submit to the CAAC an aviation security handbook describing specific security procedures established by such airline or airport for the day-to-day operations of commercial aviation and procedures for staff training on security. Such security procedures must be based on relevant CAAC regulations and international commercial aviation treaties. Chinese airports and airlines that operate international routes must also adopt security measures in accordance with the requirements of the relevant international agreements.

### *Noise and Environmental Regulation*

All airlines in China must comply with the noise and environmental regulations of the PRC State Environmental Protection Agency. Applicable regulations of the CAAC permit Chinese airports to refuse take-off and landing rights to any aircraft that does not comply with noise regulations.

### *Chinese Airport Policy*

The CAAC supervises and regulates all civilian airports in China. The local government of the PRC manages the administration of most civilian airports in China, including Baiyun International Airport as of 2004, with limited exceptions. Airports in China are also subject to regulation and ongoing review by the CAAC, which determines take-off and landing charges, as well as charges for the use of airports and airport services.

### *Competition*

The CAAC's extensive regulation of the Chinese commercial aviation industry has had the effect of managing competition among Chinese airlines. Nevertheless, competition has become increasingly intense in recent years due to a number of factors, including relaxation of certain regulations by the CAAC, an increase in the number of Chinese airlines and an increase in the capacity, routes and flights of Chinese airlines.

In the Chinese aviation industry, the three dominant airlines are the Group, Air China and China Eastern Airlines (China Eastern). In 2003, these three airlines together controlled approximately 56% of the commercial aviation market in China as measured by passengers carried.

Most major Chinese airlines have in recent years significantly expanded their fleets, while at the same time, passenger traffic has not increased proportionately. This has resulted in a reduction in the passenger load factors for most Chinese airlines. As a result, Chinese airlines are required to be more competitive with respect to, for example, quality of service, including ticketing and reservations, in-flight services, flight scheduling and timeliness.

The Group expects that competition in China's commercial aviation industry will continue to be intense. The Group will also face increasing competition from alternative means of transport, such as highway and rail, as China's transportation infrastructure improves.

Relative to other Chinese airlines, however, the Group believes that it possesses certain competitive advantages. The Group has the most extensive route network and the largest number of regional route bases among Chinese airlines, which the Group believes places it in a favorable position in the route allocation process. The Group also has the largest aircraft fleet of any Chinese airline, which, together with the Group's planned aircraft acquisitions, will permit the Group to expand its operations and to improve the deployment of the aircraft in its fleet. The Group also believes that its dominant presence in the populous and economically developed southern and central regions of China provides it with a competitive advantage in attracting new customers and that its fully integrated flight training, aircraft and engine maintenance, and air catering operations enable it to achieve and maintain high quality service to its customers.

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The following table sets forth the Group's market share of passengers carried, cargo and mail carried and total traffic of Chinese airlines for the years indicated.

| Year | Passengers Carried |               | Cargo and Mail Carried (tons) |               | Total Traffic (ton kilometers) |               |
|------|--------------------|---------------|-------------------------------|---------------|--------------------------------|---------------|
|      | Industry Total     | Group's Share | Industry Total                | Group's Share | Industry Total                 | Group's Share |
|      | (in million)       | (% of total)  | (in thousand)                 | (% of total)  | (in billion)                   | (% of total)  |
| 1997 | 56.3               | 27.1          | 1,247                         | 25.0          | 8.7                            | 20.7          |
| 1998 | 57.5               | 26.2          | 1,401                         | 24.9          | 9.3                            | 20.4          |
| 1999 | 60.9               | 24.8          | 1,704                         | 22.9          | 10.6                           | 18.9          |
| 2000 | 67.2               | 24.9          | 1,967                         | 22.5          | 12.3                           | 20.0          |
| 2001 | 75.2               | 25.4          | 1,709                         | 23.3          | 14.1                           | 21.5          |
| 2002 | 85.9               | 25.0          | 2,021                         | 23.3          | 16.5                           | 21.9          |
| 2003 | 87.6               | 23.4          | 2,190                         | 21.2          | 17.1                           | 20.8          |

*Domestic Routes*

The Group competes against its domestic competitors primarily on the basis of flight schedule, route network, quality of service, safety, type and age of aircraft and, to a lesser extent and until recently, price. The Group competes against nine other Chinese airlines in its various domestic route markets. Of these competitors, the largest are two airlines owned or controlled by the Chinese Government, and the remaining six airlines are operated by or under the control of various Chinese provincial or municipal governments.

The following table sets forth the Group's market share of the passengers carried, cargo and mail carried on departing flights and total departing flights at the ten busiest airports in China, based on passenger volume, in 2003.

| Airport           | Passengers Carried (% of total) | Cargo and Mail Carried (% of total) | Departing Flights (% of total) |
|-------------------|---------------------------------|-------------------------------------|--------------------------------|
| Beijing           | 12.1                            | 11.0                                | 10.8                           |
| Shanghai Hongqiao | 15.4                            | 8.3                                 | 15.9                           |
| Guangzhou         | 51.0                            | 40.7                                | 50.3                           |
| Shenzhen          | 27.9                            | 28.0                                | 24.9                           |
| Kunming           | 15.0                            | 12.3                                | 14.2                           |
| Chengdu           | 11.0                            | 14.5                                | 10.0                           |
| Haikou            | 25.3                            | 33.6                                | 19.5                           |
| Xian              | 8.6                             | 11.3                                | 6.2                            |
| Shanghai Pudong   | 7.8                             | 7.0                                 | 7.9                            |
| Hangzhou          | 26.5                            | 20.7                                | 27.2                           |

The following table sets forth the Group's market share of the passengers carried, cargo and mail carried on departing flights and total departing flights at seven busiest airports in southern and central China (excluding

Guangzhou, Shenzhen and Haikou, which are included in the table above), based on passenger volume, in 2003.

| <b>Airport</b> | <b>Passengers<br/>Carried (% of<br/>total)</b> | <b>Cargo and<br/>Mail Carried (% of<br/>total)</b> | <b>Departing<br/>Flights (% of<br/>total)</b> |
|----------------|------------------------------------------------|----------------------------------------------------|-----------------------------------------------|
| Wuhan Tianhe   | 43.6                                           | 45.1                                               | 38.1                                          |
| Changsha       | 40.4                                           | 42.5                                               | 35.7                                          |
| Zhengzhou      | 68.1                                           | 67.1                                               | 54.1                                          |
|                | 25                                             |                                                    |                                               |

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| <b>Airport</b> | <b>Passengers<br/>Carried (% of<br/>total)</b> | <b>Cargo and<br/>Mail Carried (% of<br/>total)</b> | <b>Departing<br/>Flights (% of<br/>total)</b> |
|----------------|------------------------------------------------|----------------------------------------------------|-----------------------------------------------|
| Guiyang        | 32.6                                           | 44.9                                               | 29.3                                          |
| Shantou        | 77.6                                           | 67.9                                               | 69.4                                          |
| Guilin         | 36.8                                           | 22.9                                               | 35.6                                          |
| Zhuhai         | 60.8                                           | 62.3                                               | 28.8                                          |
| Xiamen         | 61.3                                           | 38.7                                               | 55.8                                          |

*Hong Kong Regional Routes*

The Group dominates the routes operated by Chinese airlines between Hong Kong and Macau and China. In 2003, the Group operated an average of more than 219 charter and other scheduled flights per week between China and Hong Kong or Macau, accounting for approximately 29.8% of the total number of passengers carried by all Chinese airlines on the Hong Kong regional routes. The Group believes that the routes on which it operates charter flights are among its highest yielding routes, primarily because the Group faces limited competition on such routes and is consequently less subject to downward pricing pressures. Dragon Air, which is a Hong Kong-based airline, competes with the Group on many of the Group's Hong Kong regional routes.

Air Macau Group Ltd. (Air Macau), a Macau-based airline, started to operate routes in 1996 between Macau and China, including destinations such as Beijing, Shanghai, Xiamen and Wuhan. Air Macau also operates routes between Macau and Taiwan, including flights which allow passengers to travel between Taiwan and China through Macau. The air fares on some of Air Macau's routes are significantly less than air fares on comparable routes of the Group. Air Macau's routes provide an alternative to and compete with the Group's Hong Kong regional routes for passengers travelling between Taiwan and China.

*International Routes*

The Group competes with Air China, China Eastern and many well-established foreign airlines on its international routes. Most of these international competitors have significantly longer operating histories, substantially greater financial and technological resources and greater name recognition than the Group. In addition, the public's perception of the safety and service records of Chinese airlines may adversely affect the Group's ability to compete against its Hong Kong regional and international competitors. Many of the Group's international competitors have larger sales networks and participate in reservation systems that are more comprehensive and convenient than those of the Group, or engage in promotional activities that may enhance their ability to attract international passengers.

Air China has the most extensive international route network among Chinese airlines. Beijing, the hub of Air China's operations, has been the destination for most international flights to China. The Group competes against, among other airlines, Thai Airways International, Singapore Airlines, Malaysian Airlines System, Air China and China Eastern on flights to Southeast Asian destinations. In the case of its European routes, the Group's competitors include KLM-Royal Dutch Airlines. The Group faces competition on its international route from Air China and China Eastern, each of which operates several routes between destinations in China and the United States, as well as international airlines that fly to Los Angeles from Hong Kong. The Group competes in the international market primarily on the basis of safety, price, timeliness and convenience of scheduling.

*Airline Subsidiaries*

The Airline Subsidiaries are joint ventures established by the Company and local companies in the provinces or special economic zones where the Airline Subsidiaries are based and are engaged in providing airline and related services. The Company owns 60% equity interest in each of the Airline Subsidiaries.

As of December 31, 2003, Xiamen Airlines operated under its own MF code a fleet of 27 aircraft on 81 domestic routes, five international route and four Hong Kong regional routes. In 2003, Xiamen Airlines carried a total of about 4.91 million passengers, or approximately 24.0% of the passengers carried by the Group in that year, and had RMB3,460 million in operating revenue.

As of December 31, 2003, Shantou Airlines operated under the Group's CZ code 5 aircraft on 52 domestic routes and two Hong Kong regional route. In 2003, Shantou Airlines carried a total of about 742,000 passengers, or 3.6% of the passengers carried by the Group in that year. Total operating revenue of Shantou Airlines for the year ended December 31, 2003 was RMB546 million.

As of December 31, 2003, Guangxi Airlines operated under the CZ code 5 aircraft on 34 domestic routes, two international routes and three Hong Kong regional routes. In 2003, Guangxi Airlines carried a total of about 678,000 passengers, or 3.3% of the total number of passengers carried by the Group in that year. Total operating revenue of Guangxi Airlines for the year ended December 31, 2003 was RMB457 million.

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As of December 31, 2003, Zhuhai Airlines operated under the CZ code 4 aircraft on 34 domestic routes. In 2003, Zhuhai Airlines carried a total of about 602,000 passengers, or approximately 2.9% of the total number of passengers carried by the Group in that year. Total operating revenue of Zhuhai Airlines for the year ended December 31, 2003 was RMB436 million.

As of December 31, 2003, Guizhou Airlines operated under the CZ code 6 aircraft on 19 domestic routes. In 2003, Guizhou Airlines carried a total of about 691,000 passengers, or approximately 3.4% of the total number of passengers carried by the Group in 2003. Total operating revenue of Guizhou Airlines was approximately RMB469 million for the year ended December 31, 2003.

### **Insurance**

The CAAC maintains fleet and legal liability insurance on behalf of the Group and all other Chinese airlines with the People's Insurance Company of China (PICC) under the PICC master policy. The Group maintains aviation hull all risks, spares and airline liability insurance, aircraft hull all risks and spare engines deductible insurance, aviation hull war and allied perils policy of the type and in the amount customary in the Chinese aviation industry.

Under Chinese law, civil liability of Chinese airlines for injuries suffered by passengers on domestic flights is limited to RMB70,000 (approximately US\$8,455) per passenger. Under the Convention for the Unification of Certain Rules Relating to International Transportation by Air of 1929 (as amended by the protocol of 1955, the Warsaw Convention), unless a separate agreement has been entered into between China and a specific country, civil liability for injuries suffered by passengers on international flights is limited to US\$20,000 per passenger. The Group believes that it maintains adequate insurance coverage for the maximum civil liability that can be imposed in respect of injuries to passengers under Chinese law, the Warsaw Convention or any separate agreement applicable to the Group.

The CAAC allocates insurance premiums payable in respect of the PICC master policy to each participating airline based on the value of the airline's insured aircraft or, in the case of leased aircraft, based on the amount required by the terms of the lease. Insurance claims made by any participating airline may cause the premiums paid by the Group under the PICC master policy to increase. PICC's practice has been to reinsure a substantial portion of its aircraft insurance business through reinsurance brokers on the London reinsurance market.

### **Intellectual Property**

The Group's businesses and operations, other than the businesses and operations of Xiamen Airlines, are conducted under the names China Southern and China Southern Airlines in both English and Chinese. The Group uses as its logo a stylized rendition of a kapok plant. Xiamen Airlines conducts its businesses and operations under the name of Xiamen Airlines in English and Chinese and uses its own logo depicting a stylized rendition of an egret.

The names China Southern and China Southern Airlines contain Chinese words of common usage and are therefore not eligible for registration as tradenames under current Chinese law. The kapok logo is a trademark registered in China and recorded with the International Air Transport Association (IATA), the rights to which are owned by CSAHC. The Company and CSAHC have entered into a trademark license agreement (the Trademark License Agreement), pursuant to which CSAHC has licensed to the Group the right to use the names China Southern and China Southern Airlines in both English and Chinese and granted the Company a 10-year renewable license from 1997 to use the kapok logo on a world-wide basis. CSAHC has retained the right to use the kapok logo in connection with its non-airline related businesses conducted as of the date of the Trademark License Agreement and to permit its affiliates that do not compete, directly or indirectly, with the Group to use the kapok logo. Xiamen Airlines owns all rights to its egret logo, which is a trademark registered in China, and recorded with the IATA.

The Company owns all rights to three trademarks, being SKY PEARL CLUB, the logo relating to Easy Cargo 5000 and SKY PEARL CARD which are registered in China, and recorded with Trademark Office of the State Administration for Industry and Commerce. Zhuhai Airlines Company Limited owns all rights to the airline logo which is registered with the Trademark Office of the State Administration for Industry and Commerce.

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**Organizational Structure**

The following chart illustrates the corporate structure of the Group as of year end 2003 and the aggregate effective equity interest of the Company in each of its principal subsidiaries, affiliated companies and jointly controlled entities.

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The particulars of the Company's principal subsidiaries as of December 31, 2003 are as follows:

| Name of company                                          | Place and date of establishment/operation | Attributable equity interest to the Company |            |
|----------------------------------------------------------|-------------------------------------------|---------------------------------------------|------------|
|                                                          |                                           | Direct %                                    | Indirect % |
| Guangxi Airlines Company Limited                         | PRC<br>April 28, 1994                     | 60                                          |            |
| Southern Airlines Group Shantou Airlines Company Limited | PRC<br>July 20, 1993                      | 60                                          |            |
| Zhuhai Airlines Company Limited                          | PRC<br>May 8, 1995                        | 60                                          |            |
| Xiamen Airlines Company Limited                          | PRC<br>August 11, 1984                    | 60                                          |            |
| Guizhou Airlines Company Limited                         | PRC<br>November 12, 1991                  | 60                                          |            |
| Guangzhou Nanland Air Catering Company Limited           | PRC<br>November 21, 1989                  | 51                                          |            |
| China Southern West Australian Flying College Pty Ltd.   | Australia<br>January 26, 1971             | 65                                          |            |
| China Southern Airlines (Group)                          | PRC                                       | 100                                         |            |
| Zhuhai Helicopter Company Limited                        | August 31, 1993                           |                                             |            |
| Guangzhou Baiyun International Logistic Company Ltd      | PRC<br>July 23, 2002                      | 61                                          |            |

#### Affiliated Companies and Jointly Controlled Entities

The particulars of the Group's principal affiliated companies and jointly controlled entity as of December 31, 2003 are as follows:

| Name of company                                            | Place and date of establishment/operation | Attributable equity interest to the company |            |
|------------------------------------------------------------|-------------------------------------------|---------------------------------------------|------------|
|                                                            |                                           | Direct %                                    | Indirect % |
| Guangzhou Aircraft Maintenance Engineering Company Limited | PRC<br>October 28, 1989                   | 50                                          |            |

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| Name of company                                     | Place and date of establishment/operation | Attributable equity interest to the company |            |
|-----------------------------------------------------|-------------------------------------------|---------------------------------------------|------------|
|                                                     |                                           | Direct %                                    | Indirect % |
| Southern Airlines Group Finance Company Limited     | PRC<br>June 28, 1995                      | 32                                          | 15.42      |
| Sichuan Airlines Corporation Limited                | PRC<br>August 28, 2002                    | 39                                          |            |
| China Postal Airlines Limited                       | PRC<br>November 25, 1996                  | 49                                          |            |
| MTU Maintenance Zhuhai Co. Ltd.                     | PRC<br>April 6, 2001                      | 50                                          |            |
| Zhuhai Xiang Yi Aviation Technology Company Limited | PRC<br>July 10, 2002                      | 51                                          |            |

Certain of the Company's subsidiaries, affiliated companies and jointly controlled entities are PRC joint ventures which have limited duration pursuant to PRC law.

**Property, Plant and Equipment**

For a discussion of the Group's aircraft, see Item 4, Information on the Company History and development of the Company -Aircraft Fleet.

The Group's headquarters in Guangzhou occupy an area of approximately 149,000 square meters of land and a total gross floor area of approximately 149,000 square meters. The Group leases from CSAHC the land in Guangzhou on which the Group's headquarters and other facilities are located. The Group also leases from CSAHC certain buildings at the Wuhan, Haikou and Zhengzhou airports.

The Company's principal properties are located at its headquarters site and at its route bases. The following table sets forth certain information with respect to the Company's properties at its headquarters in Guangzhou and certain route bases as of the date hereof.

|           | Land               |        | Buildings          |        |
|-----------|--------------------|--------|--------------------|--------|
|           | (in square meters) |        | (in square meters) |        |
|           | Owned              | Leased | Owned              | Leased |
| Guangzhou |                    | 80,909 | 103,957            | 1,755  |
| Shenzhen  | 208,740            |        | 35,174             |        |
| Zhuhai    | 170,062            |        | 18,791             |        |
| Changsha  | 138,949            |        | 47,190             |        |
| Zhengzhou | 290,841            |        | 60,582             |        |
| Haikou    | 5,265              |        | 59,543             | 19,633 |
| Wuhan     |                    | 31,061 | 435                | 26,061 |
| Nanyang   |                    |        | 12,156             |        |

The following table sets forth certain information with respect to the properties of the Airline Subsidiaries as of the date hereof.

|         | Land               |        | Buildings          |        |
|---------|--------------------|--------|--------------------|--------|
|         | (in square meters) |        | (in square meters) |        |
|         | Owned              | Leased | Owned              | Leased |
| Xiamen  | 211,632            |        | 29,292             | 1,564  |
| Shantou | 20,292             |        | 27,810             | 3,127  |

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|        |        |        |       |
|--------|--------|--------|-------|
| Zhuhai | 53,797 | 29,697 | 1,513 |
| Guilin |        | 14,594 | 349   |

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|         | Land               |        | Buildings          |        |
|---------|--------------------|--------|--------------------|--------|
|         | (in square meters) |        | (in square meters) |        |
|         | Owned              | Leased | Owned              | Leased |
| Guizhou | 270,001            |        | 10,466             |        |

As systems for registration and transfer of land use rights and related real property interests in China have been implemented relatively recently, such systems do not yet comprehensively account for all land and related property interests. The land in Guangzhou on which the Group's headquarters and other facilities are located and the buildings that the Group uses at its route base in Wuhan, Haikou and Zhengzhou are leased by the Company from CSAHC. However, CSAHC lacks adequate documentation evidencing CSAHC's rights to such land and buildings, and, as a consequence, the lease agreements between CSAHC and the Company for such land may not be registered with the relevant authorities. Lack of registration may affect the validity of such lease agreements. There are certain other parcels of land and buildings owned or used by the Group that lack adequate documentation. Lack of adequate documentation for land use rights and ownership of buildings may impair the ability of the Group to dispose of or mortgage such land use rights and buildings.

The Group has been occupying all of the land and buildings described above without challenge. CSAHC has received written assurance from the CAAC to the effect that CSAHC is entitled to continued use and occupancy of the land in Guangzhou. The Group understands that the CAAC is basing its conclusion on an agreement among certain governmental authorities relating to such land. CSAHC has agreed to indemnify the Group against any loss or damage caused by any challenge of, or interference with, the use by the Group of any of their respective land and buildings.

**ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS.**

The following discussion and analysis should be read in conjunction with the Financial Statements of the Group contained elsewhere in this Annual Report. The Group maintains its books and accounts in accordance with PRC Accounting Rules and Regulations ( PRC GAAP ) and prepares its financial statements in accordance with both PRC GAAP and IFRS. The Financial Statements contained elsewhere in this Annual Report have been prepared in accordance with IFRS. IFRS differs in certain significant respects from U.S. GAAP. Information relating to the nature and effect of such differences is presented in Note 33 to the Financial Statements.

**Critical Accounting Policies**

The discussion and analysis of the Group's financial condition and results of operations are based upon the consolidated financial statements, which have been prepared in accordance with IFRS. The preparation of such consolidated financial statements requires the Group to make estimates and judgments that affect the reported amount of assets and liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities at the date of the consolidated financial statements. Actual results may differ from these estimates under different assumptions or conditions.

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. The Group believes that its critical accounting policies are limited to those described below. For a detailed discussion on the application of these and other accounting policies, see Note 2 to the Financial Statements.

**Revenue Recognition**

The Group records sales of passenger, cargo and mail tickets as Sales in advance of carriage, a current liability, on the consolidated balance sheet. Passenger, cargo and mail revenues are recognized and the related current liability is

reduced when the transportation is provided. Sales in advance of carriage therefore represents ticket sold for future travel dates and estimated future refunds and exchanges of tickets sold for past travel dates. The Group's balance of sales in advance of carriage as of December 31, 2003 was RMB466 million.

Estimating the amount of tickets that will be refunded, exchanged, or expired involves some level of subjectivity and judgment. According to the relevant rules in the PRC in relation to air transportation, the valid period for tickets sold is up to a year from the date of sale. Sales in advance of carriage, therefore, includes an estimate of the amount of future refunds and exchanges, and expired tickets. These estimates are based on historical experience over many years. The Group and members of the airline industry have consistently applied this accounting method to estimate revenue from expired tickets. Estimated future refunds and exchanges included in sales in advance of carriage account are constantly evaluated based on subsequent refund and exchange activity to validate the accuracy of the Group's estimates with respect to expired tickets.

Events and circumstances outside of historical fare sale activity or historical customer travel patterns, as noted above, can result in actual refunds, exchanges, or expired tickets differing significantly from estimates. The Group evaluates its estimates within a narrow range of acceptable amounts. If actual refunds, exchanges, or expiry experience results in an amount outside of this range, estimates and assumptions are reviewed and adjustments to Sales in advance of carriage and to Passenger revenue are recorded as necessary. The Group's estimation techniques have been consistently applied from year to year; however, as with any estimates, actual refund and exchange activity may vary from estimated amounts. Furthermore, the Group believes it is unlikely that materially different estimates for future refunds, exchanges, and forfeited tickets would be reported based on other reasonable assumptions or conditions suggested by actual historical experience and other data available at the time estimates were made.

Up to date, the Group has not experienced any material fluctuations in estimated refunds and exchanges, and correspondingly, expired tickets, due to many of the factors described above.

#### Fixed assets

The Group have approximately RMB28,536 million fixed assets as of December 31, 2003. In addition to the original cost of these assets, their recorded value is impacted by a number of policy elections, including the estimation of useful lives and residual values and when necessary, impairment charges.

The Group records aircraft at acquisition cost. Depreciable life is determined through economic analysis, reviewing existing fleet plans, recommendations from manufacturers and comparing estimated lives to other airlines that operate similar fleets. Residual values are estimated based on our historical experience with regards to the sale of aircraft and are established in conjunction with the estimated useful lives of the aircraft. Residual values are based on current dollars when the aircraft are acquired and typically reflect asset values that have not reached the end of their physical life. Both depreciable lives and residual values are reviewed periodically to recognize changes in our fleet plan and changes in conditions.

In addition, the Group evaluates fixed assets used in operations for impairment. If circumstances indicate that the net book value of an asset may not be recoverable, this asset may be considered impaired, and an impairment loss may be recognized in accordance with IAS 36 Impairment of Assets. The amount of impairment loss is the difference between the carrying amount of the asset and its recoverable amount. The recoverable amount is the greater of the net selling price and the value in use. In determining the value in use, the Group utilizes certain assumptions, including, but not limited to: (i) estimated fair market value of the assets, and (ii) estimated future cash flows expected to be generated by these assets, which are based on additional assumptions such as asset utilization, length of service the asset will be used in the Group's operations and estimated residual values. The Group will use all readily available information in determining an amount that is a reasonable approximation of recoverable amounts, including estimates based on industry trends and reference to market rates and transactions. Changes to the above estimates may have a material effect on the Group's Financial Statements. As of December 31, 2003, based on the result of evaluation, the

Group considered that no impairment is required.

## Overview

In 2003, the Group encountered the most unprecedented challenges and difficulties. The outbreak of the Severe Acute Respiratory Syndrome ( SARS ) earlier 2003 severely hit the PRC aviation industry. From April to June 2003, the Group's passenger volume and passenger load factor dropped which caused the revenue passenger kilometers ( RPK ) for April, May and June of 2003 to fall by 40%, 83.5% and 61.5% respectively, as compared to same period in 2002. In order to minimize the negative impact of SARS, the Group implemented various measures to adjust its operating capacity, for example by reducing the number of flights and suspending certain routes, in response to the reduced air traffic demand caused by the negative impact of SARS. The SARS was effectively under control in the PRC in July 2003 and the domestic market started to recover in the third quarter of 2003. The Group gradually resumed all its suspended flights since July 2003.

In order to alleviate the financial pressure suffered by the PRC civil aviation industry as a result of the SARS epidemic, the PRC government waived the levies of the CAAC Infrastructure Development Fund, sales tax and related supplementary taxes on passenger revenue payable by the PRC airlines, during the period from May 1, 2003 to December 31, 2003.

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In addition, the political tension in the Middle East, in particular the Iraq war in March 2003, led to a surge in oil prices which in turn caused an increase in the Group's jet fuel cost.

The Group conducts a portion of its airline operations through the Airline Subsidiaries. Operating results for the Airline Subsidiaries are included in each of the years presented in the Financial Statements. The Airline Subsidiaries, which derive substantially all of their operating revenue from passenger traffic, accounted for 26.8% and 30.7% of the Group's total operating revenue, and 34.5% and 37.2% of the Group's total passengers carried, in 2002 and 2003, respectively. Xiamen Airlines is the largest member of the Airline Subsidiaries, with operating revenue of RMB3,278 million and RMB3,460 million in 2002 and 2003, respectively, or 18.2% and 19.8% of the Group's total operating revenue.

The Group's operating revenue is substantially dependent on the passenger and cargo traffic volume carried, which is subject to seasonal and other changes in traffic patterns, the availability of appropriate time slots for the Group's flights and alternative routes, the degree of competition from other airlines and alternate means of transportation, as well as other factors that may influence passenger travel demand and cargo and mail volume. In particular, the Group's airline revenue is generally higher in the second and third quarters than in the first and fourth quarters.

Like most airlines, the Group is subject to a high degree of financial and operating leverage. A significant percentage of the Group's operating expenses is fixed costs that do not vary proportionally based on the Group's yields or the load factors. These fixed costs include depreciation expense, jet fuel costs, landing and navigation fees, financing costs, operating lease payments, aircraft maintenance costs and labor for flight crew, cabin crew and ground personnel. Thus, a minor change in the Group's yields or load factors would have a material effect on the Group's results of operations. In addition, certain of these expenses, primarily financing costs and operating lease payments, labor costs and depreciation do not vary based on the number of flights flown. Thus, the Group's operating results can also be substantially affected by minor changes in aircraft utilization rates. The Group is and will continue to be highly leveraged with substantial obligations denominated in foreign currencies and, accordingly, the results of its operations are significantly affected by fluctuations in foreign exchange rates, particularly for the U.S. dollar and the Japanese yen. The Group recognized a net exchange loss of RMB175 million and RMB164 million in 2002 and 2003, respectively. These amounts represented mainly unrealized exchange differences resulting from the retranslation of the foreign currency borrowings.

A number of other external variables, including political and economic conditions in China, tend to have a major impact on the Group's performance. The Group's financial performance is also significantly affected by factors arising from operating in a regulated industry. As substantially all aspects of the Group's airline operations are regulated by the PRC government, the Group's operating revenues and expenses are directly affected by the PRC government's policies with respect to domestic airfares, jet fuel prices and landing and navigation fees, among others. The nature and extent of airline competition and the ability of Chinese airlines to expand are also affected by CAAC's control over route allocations. Any changes in the PRC government's regulatory policies, or any implementation of such policies could have a significant impact on the Group's future operations and its ability to implement its operating strategy.

## **Certain Financial Information and Operating Data by Geographic Region**

The following table sets forth certain financial information and operating data by geographic region for the years ended December 31, 2002 and 2003:

|                            |                 |
|----------------------------|-----------------|
| <b>Year ended December</b> | <b>2003 vs.</b> |
| <b>31,</b>                 | <b>2002</b>     |

|                               | <b>2002</b> | <b>2003</b> | <b>% Increase/<br/>(Decrease)</b> |
|-------------------------------|-------------|-------------|-----------------------------------|
| <b>Traffic</b>                |             |             |                                   |
| RPK (million)                 |             |             |                                   |
| Domestic                      | 22,092      | 21,294      | (3.6)                             |
| Hong Kong regional            | 1,081       | 778         | (28.0)                            |
| International                 | 5,767       | 4,315       | (25.2)                            |
| Total                         | 28,940      | 26,387      | (8.8)                             |
| RTK (million)                 |             |             |                                   |
| Domestic                      | 2,532       | 2,424       | (4.3)                             |
| Hong Kong regional            | 108         | 78          | (27.8)                            |
| International                 | 974         | 1,059       | 8.7                               |
| Total                         | 3,614       | 3,561       | (1.5)                             |
| RTK (million)                 |             |             |                                   |
| Passenger ton kilometers      | 2,584       | 2,356       | (8.8)                             |
| Cargo and mail ton kilometers | 1,030       | 1,205       | 17.0                              |
| Total                         | 3,614       | 3,561       | (1.5)                             |

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|                                        | <b>Year ended December 31,</b> |             | <b>2003 vs. 2002</b>          |
|----------------------------------------|--------------------------------|-------------|-------------------------------|
|                                        | <b>2002</b>                    | <b>2003</b> | <b>% Increase/ (Decrease)</b> |
| Passengers carried (thousand)          |                                |             |                               |
| Domestic                               | 18,535                         | 18,259      | (1.5)                         |
| Hong Kong regional                     | 1,369                          | 1,019       | (25.6)                        |
| International                          | 1,589                          | 1,192       | (25.0)                        |
| Total                                  | 21,493                         | 20,470      | (4.8)                         |
| Cargo and mail carried (thousand tons) |                                |             |                               |
| Domestic                               | 404                            | 379         | (6.2)                         |
| Hong Kong regional                     | 14                             | 12          | (14.3)                        |
| International                          | 52                             | 73          | 40.4                          |
| Total                                  | 470                            | 464         | (1.3)                         |
| <b>Capacity</b>                        |                                |             |                               |
| ASK (million)                          |                                |             |                               |
| Domestic                               | 33,753                         | 32,590      | (3.4)                         |
| Hong Kong regional                     | 1,746                          | 1,347       | (22.9)                        |
| International                          | 8,746                          | 6,930       | (20.8)                        |
| Total                                  | 44,245                         | 40,867      | (7.6)                         |
| ATK (million)                          |                                |             |                               |
| Domestic                               | 3,924                          | 3,772       | (3.9)                         |
| Hong Kong regional                     | 193                            | 150         | (22.3)                        |
| International                          | 1,798                          | 1,999       | 11.2                          |
| Total                                  | 5,915                          | 5,921       | 0.1                           |
| <b>Load Factors</b>                    |                                |             |                               |
| Passenger load factor (RPK/ASK) (%)    |                                |             |                               |
| Domestic                               | 65.5                           | 65.3        | (0.3)                         |
| Hong Kong regional                     | 61.9                           | 57.8        | (6.6)                         |
| International                          | 65.9                           | 62.3        | (5.5)                         |
| Overall                                | 65.4                           | 64.6        | (1.2)                         |
| Overall load factor (RTK/ATK) (%)      |                                |             |                               |
| Domestic                               | 64.5                           | 64.2        | (0.5)                         |
| Hong Kong regional                     | 55.8                           | 52.2        | (6.5)                         |
| International                          | 54.2                           | 53.0        | (2.2)                         |
| Overall                                | 61.1                           | 60.1        | (1.6)                         |
| <b>Yield</b>                           |                                |             |                               |
| Yield per RPK (RMB)                    |                                |             |                               |
| Domestic                               | 0.55                           | 0.57        | 3.6                           |
| Hong Kong regional                     | 0.98                           | 0.96        | (2.0)                         |
| International                          | 0.42                           | 0.47        | 11.9                          |
| Overall                                | 0.54                           | 0.57        | 5.6                           |
| Yield per RTK (RMB)                    |                                |             |                               |
| Domestic                               | 5.21                           | 5.40        | 3.6                           |
| Hong Kong regional                     | 10.36                          | 10.35       | (0.1)                         |
| International                          | 3.25                           | 2.90        | (10.8)                        |

|                                      |        |        |        |
|--------------------------------------|--------|--------|--------|
| Overall                              | 4.84   | 4.76   | (1.7)  |
| <b>Financial</b>                     |        |        |        |
| Passenger revenue (RMB million)      |        |        |        |
| Domestic                             | 12,234 | 12,242 | 0.1    |
| Hong Kong regional                   | 1,055  | 750    | (28.9) |
| International                        | 2,407  | 2,018  | (16.2) |
| Total                                | 15,696 | 15,010 | (4.4)  |
| Cargo and mail revenue (RMB million) | 1,786  | 1,955  | 9.5    |

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### **Operating Results**

The historical results of operations discussed below may not be indicative of the Group's future operating performance. In addition to the factors discussed under "Overview" above, the Group's future operations will be affected by, among other things, changes in the aviation market, the cost of jet fuel, aircraft acquisition and leasing costs, aircraft maintenance expenses, take-off and landing charges, wages, salaries and benefits and other operating expenses, foreign exchange rates and the rates of income taxes paid.

#### **2003 Compared with 2002**

The Group recorded a net loss of RMB358 million for 2003, as compared to a net income of RMB576 million for 2002. The Group's operating revenue decreased by RMB549 million or 3.0% from RMB18,019 million in 2002 to RMB17,470 million in 2003. Passenger load factor decreased by 0.8 percentage point from 65.4% in 2002 to 64.6% in 2003. Passenger yield (in passenger revenue per RPK) increased by 5.6% from RMB0.54 in 2002 to RMB0.57 in 2003. Average yield (in traffic revenue per RTK) decreased by 1.7% from RMB4.84 in 2002 to RMB4.76 in 2003. Operating expenses increased by RMB1,021 million or 6.4% from RMB15,993 million in 2002 to RMB17,014 million in 2003. As operating revenue decreased while operating expenses increased, operating profit decreased by 77.5% from RMB2,026 million in 2002 to RMB456 million in 2003. The Group's net non-operating expenses increased by 9.1%, from RMB887 million in 2002 to RMB967 million in 2003, mainly due to a decrease in gain on disposal of fixed assets of RMB193 million, partly offset by a decrease in interest expense of RMB135 million. Overall, the Group recorded a net loss of RMB358 million in 2003, as compared to a net profit of RMB576 million in 2002.

#### *Operating Revenue*

Substantially all of the Group's operating revenue is attributable to airline operations. Traffic revenue in 2003 and 2002 accounted for 97.1% and 97.0% respectively of total operating revenue. Passenger revenue and, cargo and mail revenue accounted for 88.5% and 11.5% respectively of total traffic revenue in 2003. The balance of the Group's operating revenue is derived from commission income, income from general aviation operations, fees charged for ground services and for air catering services and net income from lease arrangements.

Operating revenue decreased by 3.0% from RMB18,019 million in 2002 to RMB17,470 million in 2003. This decrease was primarily due to a 4.4% fall in passenger revenue from RMB15,696 million in 2002 to RMB15,010 million in 2003 resulting from lower traffic volume caused by SARS. The total number of passengers carried decreased by 4.8% to 20.5 million passengers in 2003. RPKs decreased by 8.8% from 28,940 million in 2002 to 26,387 million in 2003, primarily as a result of a decrease in passengers carried. However, passenger yield increased by 5.6% from RMB0.54 in 2002 to RMB0.57 in 2003, mainly as the result of the exemption of CAAC Infrastructure Development Fund and sales tax during the period from May 1, 2003 to December 31, 2003.

Domestic passenger revenue, which accounted for 81.6% of the total passenger revenue in 2003, increased slightly by 0.1% from RMB12,234 million in 2002 to RMB12,242 million in 2003. Domestic passenger traffic in RPKs decreased by 3.6%, mainly due to a decrease in passengers carried. Passenger yield, however, increased from RMB0.55 in 2002 to RMB0.57 in 2003, mainly as the result of the aforesaid exemption of CAAC Infrastructure Development Fund and sales tax.

Hong Kong passenger revenue, which accounted for 5.0% of total passenger revenue, decreased by 28.9% from RMB1,055 million in 2002 to RMB750 million in 2003. For Hong Kong flights, passenger traffic in RPKs decreased by 28.0%, while passenger capacity in ASKs decreased by 22.9%, resulting in a 4.1 percentage point decrease in

passenger load factor from 2002. Passenger yield decreased from RMB0.98 in 2002 to RMB0.96 in 2003 mainly due to slack in traffic volume.

International passenger revenue, which accounted for 13.4% of total passenger revenue, decreased by 16.2% from RMB2,407 million in 2002 to RMB2,018 million in 2003. For international flights, passenger traffic in RPKs decreased by 25.2%, while passenger capacity in ASKs decreased by 20.8%, resulting in a 3.6 percentage point fall in passenger load factor from 2002. Passenger yield increased by 11.9% from RMB0.42 in 2002 to RMB0.47 in 2003 mainly as the result of the aforesaid exemption of CAAC Infrastructure Development Fund and sales tax.

Cargo and mail revenue, which accounted for 11.5% of the Group's total traffic revenue and 11.1% of total operating revenue, increased by 9.5% from RMB1,786 million in 2002 to RMB1,955 million in 2003. The increase was primarily due to the full year effect of the opening of two international cargo routes to Los Angeles of the United States of America and Leige of Belgium in late 2002.

Other operating revenue decreased by 6.0% from RMB537 million in 2002 to RMB505 million in 2003. The decrease was primarily due to a decrease in aircraft short-term lease income of RMB46 million.

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Substantially all of the Group's operating expenses result from its airline operations. The vast majority of such expenses relate directly to flight operations, aircraft and traffic servicing, aircraft repair and maintenance and to depreciation and amortisation in respect of aircraft and flight equipment. Expenses associated directly with the Group's flight operations (collectively, flight operations expenses) include fuel costs, operating lease payments, catering expenses, aircraft insurance, flight personnel payroll and welfare and training expenses. Expenses associated directly with repairs and maintenance in respect of the Group's aircraft (collectively, repairs and maintenance expenses) include repairs and maintenance and overhaul charges, the costs of consumables and other maintenance materials and labour costs for maintenance personnel. Expenses associated directly with the Group's aircraft and traffic servicing operations (collectively aircraft and traffic servicing expenses) include landing and navigation fees, rental payments and charges in respect of terminal and other ground facilities and labour costs for ground personnel. The balance of the Group's operating expenses result from promotional and marketing activities (collectively, promotional and marketing expenses) such as sales commissions, fees for use of the CAAC's reservation system, ticket-printing and sales office expenses, advertising and promotional expenses, and from general and administrative expenses, such as administrative salaries and welfare and other personnel benefits and office expenses.

Total operating expenses in 2003 amounted to RMB17,014 million, representing an increase of 6.4% or RMB1,021 million over 2002, primarily due to the combined effect of increases in jet fuel costs, maintenance expenses and aircraft and traffic servicing expenses. Total operating expenses as a percentage of total operating revenue increased from 88.8% in 2002 to 97.4% in 2003.

Flight operations expenses, which accounted for 41.6% of total operating expenses, increased by 5.0% from RMB6,733 million in 2002 to RMB7,070 million in 2003, primarily as a result of increases in jet fuel costs and operating lease payments, partly offset by a decrease in catering expenses. Jet fuel costs, which accounted for 54.7% of flight operations expenses, increased by 9.9% from RMB3,519 million in 2002 to RMB3,867 million in 2003 mainly as a result of increased jet fuel prices. Operating lease payments increased by 8.4% from RMB1,417 million in 2002 to RMB1,536 million in 2003, primarily due to the full year effect of the addition of new operating leases in respect of four Boeing 757-200 aircraft in late 2002 and four Airbus 319-100 aircraft and three Boeing 737-700 aircraft during 2003. Catering expenses decreased by 18.4% from RMB625 million in 2002 to RMB510 million in 2003, primarily reflecting a tighter cost controls exercised by the Group. Aircraft insurance costs decreased by 23.4% from RMB256 million in 2002 to RMB196 million in 2003, primarily because of a reduction in the rate of aircraft insurance premiums prescribed by the PRC insurance company. Labor costs for flight personnel decreased by 6.8% from RMB781 million in 2002 to RMB728 million in 2003, largely due to a decrease in flight hours.

Maintenance expenses which accounted for 15.2% of total operating expenses, increased by 11.0% from RMB2,333 million in 2002 to RMB2,589 million in 2003. The increase was primarily attributable to an 11.3% increase in aircraft maintenance and repair charges from RMB2,135 million in 2002 to RMB2,377 million in 2003, mainly as the result of the effect of fleet expansion in recent years.

Aircraft and traffic servicing expenses, which accounted for 16.3% of total operating expenses, increased by 10.2% from RMB2,511 million in 2002 to RMB2,767 million in 2003. The increase primarily resulted from an 8.9% rise in landing and navigation fees from RMB2,354 million in 2002 to RMB2,563 million in 2003, due to an increase in the charge rate for domestic landing and navigation fees effective September 2002.

Promotional and marketing expenses, which accounted for 8.7% of total operating expenses, decreased by 1.3% from RMB1,500 million in 2002 to RMB1,480 million in 2003. The decrease was due to 9.3% decrease in labor costs from RMB248 million in 2002 to RMB225 million in 2003, as fewer bonuses were given because of reduced sales volume in 2003.

General and administrative expenses, which accounted for 6.2% of the total operating expenses, decreased slightly by 0.7% from RMB1,060 million in 2002 to RMB1,053 million in 2003. This was mainly due to a decrease in scale of operations during SARS period.

Depreciation and amortization, which accounted for 12.0% of total operating expenses, increased by 10.8% from RMB1,840 million in 2002 to RMB2,038 million in 2003. This increase was primarily as a result of the addition of aircraft during 2003.

#### *Operating Income*

Operating income decreased by 77.5% from RMB2,026 million in 2002 to RMB456 million in 2003. This was mainly because operating revenue decreased by RMB549 million or 3.0% from 2002 while operating expenses increased by RMB1,021 million or 6.4% over the same period.

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### *Non-operating Income/(Expenses)*

Interest expense decreased by 14.1% from RMB959 million in 2002 to RMB824 million in 2003, mainly reflecting the combined effect of scheduled debt repayments and the replacement of certain RMB denominated bank loans with US\$ denominated bank loans with lower interest rates.

Interest income decreased by 75.2% from RMB53 million in 2002 to RMB13 million in 2003. This was mainly attributable to a decrease in average cash balances.

The Group recorded a net loss on sale of fixed assets of RMB22 million in 2003, mainly resulting from retirement of two old Boeing 737-200 aircraft.

During 2003, the Group recorded a net exchange loss of RMB164 million predominantly due to its Japanese yen denominated borrowings as a result of the Japanese yen appreciation. Such amount comprised mostly unrealized translation loss.

### *Taxation*

On October 17, 2003, the Company's registered address was moved to Guangzhou Economic & Technology Development Zone. In accordance with the Rules and Regulations for Implementation of Income Tax for Foreign Investment Enterprises and Foreign Enterprises of the PRC and a taxation approval document Guangzhou Municipal State Tax Bureau Suo De Shui Zi Que 020043, the Company is entitled to enjoy the preferential tax policy implemented in the Guangzhou Economic & Technology Development Zone effective from October 1, 2003. As a result, the Company's income tax rate has been changed to 15% from 33% beginning from that date.

The Group recorded an income tax credit of RMB324 million for 2003 compared to an income tax expense of RMB398 million for 2002. As a result of the reduction in income tax rate, the Company's net deferred taxation liability balance brought forward from December 31, 2002 of RMB507 million was reduced by RMB392 million and a net deferred tax credit of RMB392 million was recognized in 2003 for such reduction in income tax rate accordingly.

### *Minority Interests*

Minority interests increased by 3.6% from RMB165 million in 2002 to RMB171 million in 2003, primarily reflecting the net income earned by certain of the Group's airline subsidiaries for the year.

### *2002 Compared with 2001*

The Group recorded a net income of RMB576 million for 2002, as compared to a net income of RMB340 million for 2001. The Group's operating revenue increased by RMB1,139 million or 6.7% from RMB16,880 million in 2001 to RMB18,019 million in 2002. Passenger load factor increased by 2.9 percentage points from 62.5% in 2001 to 65.4% in 2002. Passenger yield (in passenger revenue per RPK) decreased by 10.0% from RMB0.60 in 2001 to RMB0.54 in 2002. Average yield (in traffic revenue per RTK) decreased by 10.9% from RMB5.43 in 2001 to RMB4.84 in 2002. Operating expenses increased by RMB514 million or 3.3% from RMB15,479 million in 2001 to RMB15,993 million in 2002. As operating revenue increased more than operating expenses, operating profit increased by 44.7% from RMB1,401 million in 2001 to RMB2,026 million in 2002. The Group's net non-operating expenses increased by 46.5%, from RMB605 million in 2001 to RMB887 million in 2002, mainly due to an unfavorable movement in exchange differences of RMB472 million, partly offset by a gain on disposal of four Boeing 757-200 aircraft of RMB199 million. Overall, the Group's net income increased by 69.2%, from RMB340 million in 2001 to RMB576 million in 2002.

*Operating Revenue*

Substantially all of the Group's operating revenue is attributable to its airline operations. Traffic revenue in 2002 and 2001 accounted for 97.0% and 97.5% respectively of total operating revenue. Passenger revenue and, cargo and mail revenue accounted for 89.8% and 10.2% respectively of total traffic revenue in 2002. The balance of the Group's operating revenue is derived from commission income, income from general aviation operations, fees charged for ground services rendered to other Chinese airlines that operate flights in and out of airports in Southern China (including the airports in Guangzhou, Shenzhen, Xiamen and Wuhan), air catering services and aircraft lease income.

Operating revenue increased by 6.7% from RMB16,880 million in 2001 to RMB18,019 million in 2002. This increase was primarily due to a 4.3% rise in passenger revenue from RMB15,055 million in 2001 to RMB15,696 million in 2002 due to higher traffic volume. The total number of passengers carried increased by 12.4% to 21.49 million passengers in 2002. RPKs increased by 15.5% from 25,057 million in

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2001 to 28,940 million in 2002, primarily as a result of an increase in passengers carried. However, passenger yield decreased by 10.0% from RMB0.60 in 2001 to RMB0.54 in 2002, mainly as a result of a fall in the average fares resulting from increased competition.

Domestic passenger revenue, which accounted for 78.0% of total passenger revenue in 2002, increased by 1.4% from RMB12,068 million in 2001 to RMB12,234 million in 2002. For the Group's domestic routes, passenger traffic in RPKs increased by 13.6%, while passenger capacity in ASKs increased by 7.5%, resulting in 3.6 percentage points increase in passenger load factor, or an increase of 5.8% from 2001. Passenger yield, however, decreased from RMB0.62 in 2001 to RMB0.55 in 2002 mainly as a result of increased competition among the PRC airlines.

Hong Kong passenger revenue, which accounted for 6.7% of total passenger revenue, decreased by 6.5% from RMB1,128 million in 2001 to RMB1,055 million in 2002. For Hong Kong flights, passenger traffic in RPKs increased by 2.0%, while passenger capacity in ASKs increased by 3.3%, resulting in 0.8 percentage point decrease in passenger load factor, or a decrease of 1.3% from 2001. Passenger yield decreased from RMB1.06 in 2001 to RMB0.98 in 2002 mainly due to slack in traffic volume.

International passenger revenue, which accounted for 15.3% of total passenger revenue, increased by 29.4% from RMB1,860 million in 2001 to RMB2,407 million in 2002. For international flights, passenger traffic in RPKs increased by 26.7%, while passenger capacity in ASKs increased by 25.3%, resulting in a 0.7 percentage point gain in passenger load factor, or an increase of 1.1% from 2001. Passenger yield increased slightly by 2.4% from RMB0.41 in 2001 to RMB0.42 in 2002.

Cargo and mail revenue, which accounted for 10.2% of the Group's total traffic revenue and 9.9% of total operating revenue, increased by 27.0% from RMB1,406 million in 2001 to RMB1,786 million in 2002. The increase was primarily due to the opening of two international cargo routes in 2002.

Other operating revenue increased by 28.4% from RMB418 million in 2001 to RMB537 million in 2002. The increase was primarily due to increase in fees charged for ground services rendered to other Chinese airlines as the traffic volume increased as well as an income from a lease arrangement effected during the year.

### *Operating Expenses*

Substantially all of the Group's operating expenses result from its airline operations. The vast majority of such expenses relate directly to flight operations, aircraft and traffic servicing, aircraft repairs and maintenance and to depreciation and amortization in respect of aircraft and flight equipment. Expenses associated directly with the Group's flight operations (collectively, flight operations expenses) include fuel costs, operating lease payments, catering expenses, aircraft insurance, flight personnel payroll and welfare and training expenses. Expenses associated directly with repairs and maintenance in respect of the Group's aircraft (collectively, maintenance expenses) include repairs and maintenance and overhaul charges, the costs of consumables and other maintenance materials and labor costs for maintenance personnel. Expenses associated directly with the Group's aircraft and traffic servicing operations (collectively aircraft and traffic servicing expenses) include landing and navigation fees, rental payments and charges in respect of terminal and other ground facilities and labor costs for ground personnel. The balance of the Group's operating expenses result from promotional and marketing activities (collectively, promotion and sales expenses) such as sales commissions, fees for use of the CAAC's reservation system, ticket-printing and sales office expenses, advertising and promotional expenses, and from general and administrative expenses, such as administrative salaries and welfare and other personnel benefits and office expenses.

Total operating expenses in 2002 amounted to RMB15,993 million, representing an increase of 3.3% or RMB514 million over 2001, primarily due to the combined effect of the growth in operations and increase in

maintenance expenses. Total operating expenses as a percentage of total operating revenue decreased from 91.7% in 2001 to 88.76% in 2002 as the increase in operating revenue exceeded the increase in operating expenses.

Flight operations expenses, which accounted for 42.1% of total operating expenses, decreased by 2.5% from RMB6,906 million in 2001 to RMB6,733 million in 2002, mainly due to a decrease in operating lease rentals. Fuel costs, which accounted for 52.3% of flight operations expenses decreased by 0.8% from RMB3,549 million in 2001 to RMB3,519 million in 2002 mainly resulting from decreased fuel prices. Operating lease rentals decreased by 25.9% from RMB1,913 million in 2001 to RMB1,417 million in 2002, primarily due to the termination of wet leases of five Boeing 737-300/37K aircraft from Zhongyuan Airlines in January 2002. Catering expenses increased by 12.8% from RMB554 million in 2001 to RMB625 million in 2002, reflecting primarily an increase in number of passengers carried. Aircraft insurance costs increased by 108.1% from RMB123 million in 2001 in the rates of aircraft insurance premiums subsequent to the 911 incident of the United States. Labor costs for flight personnel increased by 18.9% from RMB657 million in 2001 to RMB781 million in 2002, largely due to an increase in flight hours as well as an increase in bonuses for flight personnel.

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Maintenance expenses which accounted for 14.6% of total operating expenses, increased by 15.8% from RMB2,015 million in 2001 to RMB2,333 million in 2002. The increase was primarily attributable to a 15.7% increase in aircraft maintenance and repair charges from RMB1,845 million in 2001 to RMB2,135 million in 2002, mainly as a result of the effect of fleet expansion in recent years and the growth in operations.

Aircraft and traffic servicing expenses, which accounted for 15.7% of total operating expenses, increased by 9.3% from RMB2,298 million in 2001 to RMB2,511 million in 2002. The increase primarily resulted from 9.1% rise in landing and navigation fees from RMB2,157 million in 2001 to RMB2,353 million in 2002, as the number of flights increased.

Promotional and sales expenses, which accounted for 9.4% of total operating expenses, decreased by 2.7% from RMB1,541 million in 2001 to RMB1,500 million in 2002. The decrease was due to 15.9% decrease in sale commissions and bonuses paid to sales agents because of tighter cost controls exercised by the Group.

General and administrative expenses, which accounted for 6.6% of total operating expenses, increased by 18.8% from RMB892 million in 2001 to RMB1,060 million in 2002. This was mainly due to an increase in staff salaries and welfare benefits of 27.8% from RMB439 million in 2001 to RMB561 million in 2002 and increased scale of operations.

Depreciation and amortization, which accounted for 11.5% of total operating expenses, increased by 1.4% from RMB1,815 million in 2001 to RMB1,840 million in 2002. This was primarily as a result of the additions of aircraft during 2002.

### *Operating Income*

Operating income increased by 44.7% from RMB1,401 million in 2001 to RMB2,026 million in 2002, as operating revenue increased by RMB1,139 million or 6.7% from 2001, while operating expenses increased by RMB514 million or 3.3% over the same period.

### *Non-operating Income/(Expenses)*

Interest expense increased by 2.7% from RMB934 million in 2001 to RMB959 million in 2002, mainly reflecting the additional bank loans borrowed to finance the acquisitions of aircraft, partly offset by scheduled debt repayments during the year.

Interest income increased by 5.5% from RMB50 million in 2001 to RMB53 million in 2002. This was mainly due to an increase in cash balances.

The Group recognized a net gain on sale of fixed assets of RMB171 million in 2002, mainly resulting from disposal of four Boeing 757-200 aircraft.

During 2002, the Group recorded a net exchange loss of RMB175 million predominantly due to its Japanese yen denominated borrowings as a result of the Japanese yen appreciation. Such amount comprised mostly unrealized translation loss.

### *Taxation*

The Group is subject to PRC income tax at a rate of 33%.

Taxation expense increased by 24.2% from RMB321 million in 2001 to RMB398 million in 2002, reflecting primarily an increase in profit before taxation. A deferred tax asset of RMB149 million was recognized at December 31, 2002 in respect of the unrelieved PRC tax losses brought forward from prior years. Such tax losses are available for carry-forward to offset against future PRC taxable profits for a maximum period of 5 years.

*Minority Interests*

Minority interests increased by 22.7% from RMB135 million in 2001 to RMB165 million in 2002, primarily as a result of an increase in net profits of the Group's Airline Subsidiaries.

**Liquidity and Capital Resources**

Prior to the initial public offering of the Company, the Group met its working capital and capital expenditure requirements through cash from its operations, the proceeds of certain long-term and short-term bank loans, capital lease financing and rebates available under certain of the Group's aircraft leases. In July 1997, the Company received net proceeds of RMB5,459 million from its initial public offering.

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A majority part of these net proceeds was utilized to finance the Group's working capital and capital expenditure requirements. In July 2003, the Company issued 1,000,000,000 A shares with a par value of RMB1.00 each at issue price of RMB2.70 by way of a public offering to natural persons and institutional investors in the PRC. The proceeds received by the Company, net of the issuance costs of RMB59,233, amounted to RMB2,641 million and have been used for the purchase of Boeing 737-800 aircraft in accordance with the disclosure in the Prospectus for Offering of the A Shares.

As of December 31, 2003, the Group had loan facilities from several PRC commercial banks for providing loan finance up to an approximate amount of RMB9,860 million to the Group. As of December 31, 2003, an approximate amount of RMB4,412 million was utilized. As of December 31, 2002 and 2003, the Group's cash and cash equivalents totaled RMB3,771 million and RMB2,080 million, respectively.

Net cash inflows from operating activities in 2001, 2002 and 2003 were RMB2,224 million, RMB3,698 million and RMB2,129 million, respectively.

Net cash used in investing activities in 2001, 2002 and 2003 was RMB3,036 million, RMB5,895 million and RMB5,434 million, respectively. Cash capital expenditures in 2001, 2002 and 2003 were RMB1,492 million, RMB6,351 million and RMB4,707 million, respectively, reflecting predominantly additional investments in aircraft and flight equipment under the Group's fleet expansion plans and Guangzhou new airport, and, to a small extent, additional investments in other facilities and buildings for operations.

Financing activities resulted in net cash (outflows)/inflows of RMB(568) million, RMB3,150 million and RMB1,614 million in 2001, 2002 and 2003, respectively. The net cash outflows of 2001 were primarily as a result of making scheduled repayments of bank borrowings and capital lease obligations in excess of proceeds from new bank borrowings.

As of December 31, 2003, the Group's aggregate long-term debt and obligations under capital leases totaled RMB12,051 million. Based on such amount, in 2004, 2005, 2006, 2007, 2008 and thereafter, amounts payable under such debt and obligations will be RMB1,986 million, RMB1,716 million, RMB1,601 million, RMB1,660 million, RMB1,872 million and RMB3,216 million. Such borrowings were denominated, to a larger extent, in United States dollars and, to a smaller extent, in Japanese yen, with a significant portion being fixed interest rate borrowings. In the normal course of business, the Group is exposed to fluctuations in foreign currencies. The Group's exposure to foreign currencies was primarily as a result of its foreign currency debts. Depreciation or appreciation of the Renminbi against foreign currencies affects the Group's results significantly because the Group's foreign currency payments generally exceed its foreign currency receipts. The Group is not able to hedge its foreign currency exposure effectively other than by retaining its foreign currency denominated earnings and receipts to the extent permitted by the State Administration of Foreign Exchange, or subject to certain restrictive conditions, entering into forward foreign exchange contracts with authorized PRC banks.

As of December 31, 2003, the Group's short term bank debt was RMB6,409 million with interest rates ranging from 1.48% to 5.31%. The Group's weighted average interest rate on short-term bank notes payable was 1.76% as of December 31, 2003. The primary use of the proceeds of the Group's short-term debt is to finance working capital needs. The Group has generally been able to arrange short-term bank loans with domestic banks in China as necessary and believes it can continue to obtain them based on its well-established relationships with various lenders.

As of December 31, 2003, the Group had obligations under operating leases totaling RMB8,120 million, predominately for aircraft. Of such amount, RMB1,483 million, RMB1,412 million, RMB1,144 million, RMB921 million, RMB771 million and RMB2,389 million respectively was due in 2004, 2005, 2006, 2007, 2008 and thereafter.

As of December 31, 2003, the Group had a working capital deficit of RMB10,792 million, as compared to a working capital deficit of RMB7,016 million as of December 31, 2002. Historically, the Group operated in a negative working capital position, relying on cash inflow from operating activities and short-term bank debt refinancings to meet its short-term liquidity and working capital needs. The increase in the Group's working capital deficit from 2002 to 2003 was mainly because the Group sought increased short term debts to finance its aircraft acquisitions. Upon deliveries of the aircraft, the Group continued to seek renewal of its short-term debts instead of replacing such debts with long-term debts, as the interest rates for short-term debts are lower. The liquidity of the Group in the future will primarily be dependent on its ability to maintain adequate cash inflow from operations to meet its debt obligations as they become due and, on its ability to obtain adequate external financing to meet its committed future capital expenditures. With regard to its short-term debt outstanding as of December 31, 2003, the Group has obtained firm commitments from its principal banker to renew relevant debts as they fall due during 2004. With regard to its future capital commitments and other financing requirements, the Group has already entered into loan financing agreements with several PRC banks to provide loan finance up to an appropriate amount of RMB8,450 million during 2004 and thereafter. As the Group is subject to a high degree of operating leverage, a minor decrease in the Group's yield and/or load factor could result in a significant decrease in its operating revenue and hence its operating cashflows. This could arise in such circumstances as where competition between Chinese airlines increases or

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where PRC aviation demand decreases. Similarly, a minor increase in the jet fuel prices, particularly those in domestic market, could result in a significant increase in the Group's operating expenses and hence a significant decrease in its operating cashflows. This could be caused by fluctuations in supply and demand in international oil market. Currently, the Group's existing debt and lease facilities do not contain any financial covenants. Nevertheless, as the Group is subject to a high degree of financial leverage, an adverse change in the Group's operating cashflows could adversely affect its financial health and hence weaken its ability to obtain additional debt and lease facilities and to renew its short-term debt facilities as they fall due.

As of December 31, 2003, the Group had capital commitments in 2004 and 2005 of approximately RMB6,243 million and RMB7,385 million, respectively. Of such amounts, RMB4,585 million in 2004 and RMB6,030 million in 2005 are related to the acquisition of aircraft and related flight equipment, and RMB1,000 million in 2004 and RMB1,072 million in 2005 are related to the Group's facilities and equipment to be constructed and installed at the Guangzhou new airport. This new airport is expected to commence operations in August 2004 to replace the Guangzhou Baiyun International Airport as the Group's main route base. The remaining amounts of RMB658 million in 2004 and RMB283 million in 2005 are related to the Group's other airport and office facilities and equipment, overhaul and maintenance bases and training facilities.

As of December 31, 2003, the Group undertook to make a capital contribution of approximately RMB446 million to jointly controlled entities.

As of December 31, 2003, the cash and cash equivalents of the Group totaled RMB2,080 million. Of such balance, 22.2% was denominated in foreign currencies.

No interim dividend was paid during the year ended December 31, 2003. The Board of Directors does not recommend the payment of a final dividend in respect of the year ended December 31, 2003.

The Group expects that the Group's cash from operations and short-term and long-term bank borrowings will be sufficient to meet its cash requirements in the foreseeable future.

Table of Contents**Contractual Obligations and Commercial Commitments**

The following table sets forth the Group's obligations and commitments to make future payments under contracts and under contingent commitments as of December 31, 2003.

|                                                                            | As of December 31, 2003 |        |           |           |               |
|----------------------------------------------------------------------------|-------------------------|--------|-----------|-----------|---------------|
|                                                                            | Payment due by period   |        |           |           |               |
|                                                                            | less than               |        |           |           |               |
|                                                                            | Total                   | 1 year | 1-3 years | 4-5 years | After 5 years |
|                                                                            |                         |        |           |           |               |
|                                                                            | (RMB million)           |        |           |           |               |
| Contractual obligations                                                    |                         |        |           |           |               |
| Short-term debt                                                            | 6,409                   | 6,409  |           |           |               |
| Long-term debt                                                             | 5,210                   | 688    | 1,426     | 953       | 2,143         |
| Capital lease obligations                                                  | 6,841                   | 1,298  | 3,551     | 1,725     | 267           |
|                                                                            |                         |        |           |           |               |
| Total contractual obligations                                              | 18,460                  | 8,395  | 4,977     | 2,678     | 2,410         |
|                                                                            |                         |        |           |           |               |
| Other commercial commitments                                               |                         |        |           |           |               |
| Operating lease commitments                                                | 8,120                   | 1,483  | 3,477     | 1,412     | 1,748         |
| Aircraft purchase commitments (Note 1)                                     | 10,615                  | 4,585  | 6,030     |           |               |
| Capital commitments in respect of investments in the Guangzhou new airport | 2,072                   | 1,000  | 1,072     |           |               |
| Other capital commitments                                                  | 941                     | 658    | 283       |           |               |
| Investing commitments                                                      | 446                     | 446    |           |           |               |
|                                                                            |                         |        |           |           |               |
| Total commercial obligations                                               | 22,194                  | 8,172  | 10,862    | 1,412     | 1,748         |

Note 1 Amounts shown are net of previously paid purchase deposits.

**ITEM 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES.****Directors and Senior Management**

The following table sets forth certain information concerning directors ( Directors ), senior management ( Senior Management ) and supervisors ( Supervisors ) of the Company in 2003. There were certain changes in the Company's Directors, Senior Management and Supervisors subsequent to December 31, 2003, details of which are set forth below.

| Name            | Age | Position                                           |
|-----------------|-----|----------------------------------------------------|
| Yan Zhi Qing    | 62  | Chairman of the Board of Directors                 |
| Liu Ming Qi     | 60  | Vice Chairman of the Board of Directors            |
| Wang Chang Shun | 47  | Vice Chairman of the Board of Directors; President |
| Peng An Fa      | 56  | Director                                           |
| Wang Quan Hua   | 50  | Director                                           |
| Zhao Liu An     | 56  | Director                                           |
| Zhou Yong Qian  | 59  | Director                                           |
| Zhou Yong Jin   | 61  | Director                                           |
| Xu Jie Bo       | 39  | Director; Chief Financial Officer; Vice President  |
| Wu Rong Nan     | 62  | Director                                           |
| Simon To        | 53  | Independent Non-Executive Director                 |
| Peter Lok       | 68  | Independent Non-Executive Director                 |
| Wei Ming Hai    | 40  | Independent Non-Executive Director                 |
| Wang Zhi        | 62  | Independent Non-Executive Director                 |
| Sui Guang Jun   | 43  | Independent Non-Executive Director                 |
| Liang Hua Fu    | 62  | Chairman of the Supervisory Committee              |
| Gan Yu Hua      | 76  | Supervisor                                         |
| Li Qi Hong      | 56  | Supervisor                                         |
| Jiang Ping      | 54  | Vice President                                     |
| Li Kun          | 44  | Vice President                                     |

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| <b>Name</b>  | <b>Age</b> | <b>Position</b>   |
|--------------|------------|-------------------|
| Yuan Xin An  | 47         | Vice President    |
| Zheng En Ren | 59         | Vice President    |
| Hao Jian Hua | 54         | Vice President    |
| Su Liang     | 42         | Company Secretary |

On May 13, 2003, Mr. Liu Ming Qi, Mr. Peng An Fa, Mr. Wang Quan Hua, Mr. Zhao Liu An, Mr. Zhou Yong Qian, Mr. Wang Zhi and Mr. Sui Guang Jun respectively were appointed as Directors of the Company at the Shareholders' meeting of the Company.

On May 13, 2003, Mr. Wang Shao Xi and Mr. Zhang Rui Ai tendered their resignations to the Company as Directors of the Company due to retirement. Their resignations were approved at the Shareholders' meeting of the Company.

On July 30, 2003, the Board of Directors resolved to appoint Mr. Hao Jian Hua and Mr. Xu Jie Bo as Vice Presidents of the Company. On the same day, Mr. Yang Guang Hua resigned as Vice President of the Company due to work arrangement.

**Mr. Yan Zhi Qing** is the Chairman of the Board of Directors. He became an employee of the Company in February 1996. Administrative positions which Mr. Yan has held include Director of Flight Operations of the Hunan Provincial Civil Aviation Administration, Director of the Guangxi Provincial Civil Aviation Administration, Director of the Central and Southern China Civil Aviation Administration, Director of the Political Department of the CAAC and Party Secretary and Managing Vice President of the CSAHC Group. Mr. Yan is currently the President and Vice Party Secretary of CSAHC. Mr. Yan graduated from the School of Aviation Administration and Flight Control in 1962. Save as disclosed above, Mr. Yan is not connected with any directors, senior management, substantial shareholders or controlling shareholders of the Company.

**Mr. Liu Ming Qi** is the Vice Chairman of the Board of Directors of the Company and joined the Company since May 2003. Mr. Liu graduated from South China Normal University and obtained a master's degree in economics from Fudan University. Mr. Liu is currently the Party Secretary and the Vice President of CSAHC. Mr. Liu began his career in 1968, and has successively served as the Municipal Secretary and Mayor of Sanya city of Hainan province, the Vice Governor of Hainan province, the Vice Director of Hong Kong and Macao Affairs office of the State Council and the Vice Director of Macao Liaison Office of the Central Government. Save as disclosed above, Mr. Liu is not connected with any directors, senior management, substantial shareholders or controlling shareholders of the Company.

**Mr. Wang Chang Shun** is the Vice Chairman of the Board of Directors and the President of the Company and joined the Company in April 2001. He began his career in civil aviation in February 1976, mainly involved in air traffic control. He has held positions as Director of the Flight Operations Office of the Urumqi Civil Aviation Administration, Director of the Flight Meteorology and Flight Safety Monitoring Division, Deputy General Manager of Xinjiang Airlines and Deputy Director of Urumqi Civil Aviation Administration, Party Secretary and Deputy General Manager of Xinjiang Airlines and Party Secretary of Urumqi Civil Aviation Administration. Mr. Wang is also the Vice President of CSAHC. Mr. Wang graduated from the School of the Chinese Academy of Social Sciences as a post graduate in Business Management and is qualified as a Senior Expert of Political Science. Save as disclosed above, Mr. Wang is not connected with any directors, senior management, substantial shareholders or controlling shareholders of the Company.

**Mr. Peng An Fa** is currently a Director of the Company and the Vice President of CSAHC and became the employee of the Company since March 1995 after the establishment of the Company. Mr. Peng graduated from the pilot department of China Civil Aviation Flying College and the department of Chinese language and literature of South China Normal University. Mr. Peng began his career in civil aviation in 1969, and successively served as the Pilot Director, Vice Party Secretary and Party Secretary of the Sixth Squadron of the Civil Aviation Administration. In July 1994, Mr. Peng held office as the Party Secretary of the Flight Operations Department of China Southern Airlines. In March 1998, Mr. Peng served as the President and Vice Secretary of China Southern Airlines Shenzhen Co. From August 2001 to October 2002, Mr. Peng served as the Vice President of CSAHC. Mr. Peng is concurrently the Vice Chairman of Shenzhen Air Catering Co., Ltd and CATIC (Hong Kong). Save as disclosed above, Mr. Peng is not connected with any directors, senior management, substantial shareholders or controlling shareholders of the Company.

**Mr. Wu Rong Nan** is a Director of the Company. He joined CSAHC in January 1991 and became an employee of the Company upon its establishment in March 1995. Mr. Wu is an air traffic control engineer. He was once employed as the Director of Flight Operations of the Guangzhou Civil Aviation Administration and has been President of Xiamen Airlines since 1986. Mr. Wu is not connected with any directors, senior management or substantial shareholders or controlling shareholders of the Company.

**Mr. Simon To** has been an Independent Non-Executive Director of the Company since June 1999. Mr. To is currently the Managing Director of Hutchison Whampoa (China) Limited, and also serves as director of several companies in Hong Kong and Foreign-invested companies in China. Mr. To has managed investment projects in China since early 1980's and is familiar with the laws and regulations of Hong Kong and China. Mr. To graduated from the Stanford University with a Master degree in Business Administration. Mr. To is not connected with any directors, senior management or substantial shareholders or controlling shareholders of the Company.

**Mr. Peter Lok** has been an Independent Non-Executive Director of the Company since June 2001. He is also a veteran in the civil aviation industry. Mr. Lok joined the Civil Aviation Department of Hong Kong in 1956 and became its Assistant Director in 1982, Deputy Director in 1988, and Director from 1990 to 1996. From 1997 to 2000, Mr. Lok was an advisor and president of Hong Kong Commercial Airlines Center. Mr. Lok has sat on various Committees such as the Evaluation Committees for the Design of Shanghai's Pudong Airport, Committee for China's Zhuhai Aviation and Spaceflight Fair, Evaluation Committees for the IATA Eagle Award. He is also independent director of several listed airline companies. Mr. Lok is not connected with any directors, senior management or substantial shareholders or controlling shareholders of the Company.

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**Mr. Wei Ming Hai** has been an Independent Non-Executive Director of the Company since June 2001. He is a Professor and Dean of the School of Management of Zhongshan University. Professor Wei has worked in Jiangxi Provincial Accounting Association, and he started working in Zhongshan University from 1991. In 1993 he became the chairman of the Accounting Department in the School of Management of Zhongshan University. In 1996 he became the Deputy Dean of the School of Management in Zhongshan University. In January 2000, he became Dean of the School of Management in Zhongshan University. Since 1998, Professor Wei has been a doctorate advisor for Accounting Information and Investment Analysis. Professor Wei is also on the board of directors of China Accountants Association, Vice Chairman of Accountants Association of Guangdong Province, Vice Chairman of Auditors Association of Guangzhou, Executive Member of the Research Institute of Financial Costs for Young and Middle-aged Accountants, member of American Accounting Association. Professor Wei holds a Ph.D degree in economics and has an MBA degree from Tulane University in the United States of America. He has published over ten academic books or textbooks, and over 60 academic papers. Mr. Wei is not connected with any directors, senior management or substantial shareholders or controlling shareholders of the Company.

**Mr. Wang Zhi** has been an Independent Non-Executive Director of the Company since May 2003. Mr. Wang graduated from the Aircraft Design Department of Harbin Institute of Technology. Mr. Wang began his career in 1965, and has successively served as the Director and Senior Engineer of Aeronautics Research Institute of China, the Vice Director and Vice Secretary of the First Research Institute of Civil Aviation, the Vice Director and Director of the Planning Bureau of CAAC and the Director of the Planning Technology System Reform Department and the Planning Technology Department of CAAC. Mr. Wang is also professor in several universities. Mr. Wang is not connected with any directors, senior management or substantial shareholders or controlling shareholders of the Company.

**Mr. Sui Guang Jun** has been an independent Non-Executive Director of the Company since May 2003. Mr. Sui graduated from the Economic Department of Jinan University and obtained a master degree. Mr. Sui obtained a doctor degree in the Management of Organizations of Jinan University. He has successively served as the Vice Director of the Research Institute of Hong Kong and Macao Economies and the Dean of Corporate Administration Department of Jinan University. Mr. Sui is currently the Chief of the Post-doc Committee of Applied Economics and the Dean of Management College in Jinan University. Mr. Sui is not connected with any directors, senior management or substantial shareholders or controlling shareholders of the Company.

### Supervisory Committee

As required by the Company Law and the Articles of Association, the Company has a supervisory committee (the Supervisory Committee ) which is primarily responsible for the supervision of senior management of the Company, including the Board of Directors, executive officers and other senior management personnel, to ensure that they act in the interests of the Company, its shareholders and employees, as well as in compliance with applicable law. The Supervisory Committee consists of three Supervisors. Two of the Supervisors are shareholder representatives appointed by shareholders, and one Supervisor is a representative of the Company's employees. The Supervisors serve terms of three years and may serve consecutive terms.

**Mr. Liang Hua Fu** is the Chairman of the Supervisory Committee of the Company. He became an employee of the Company since its establishment in March 1995. Mr. Liang held numerous positions in the Guangzhou Civil Aviation Administration, including Chief of the Navigation Division, Party Secretary of the Transportation Department, Secretary of the Disciplinary Department and Director of Administration and Supervision. Mr. Liang attended Tianjin Aviation School and Guangzhou Political Science College. Mr. Liang is not connected with any directors, senior management or substantial shareholders or controlling shareholders of the Company.

**Mr. Gan Yu Hua** is a Supervisor of the Company. He became an employee of the Company since its establishment in March 1995. Mr. Gan held various positions in the Chinese commercial aviation industry, including Deputy Director of the Finance Department, Deputy Chief Accountant and Director of the Audit Department of the Guangzhou Civil Aviation Administration. He holds a Senior Accountant Certificate and is a member of the International Auditors Association. Mr. Gan graduated from Shanghai Li Xin Accounting College in 1948. Mr. Gan is not connected with any directors, senior management or substantial shareholders or controlling shareholders of the Company.

**Mr. Li Qi Hong** is a Supervisor of the Company and the Representative of the Labour Union of the Company. He became an employee of the Company since its establishment in March 1995. Mr. Li graduated from the CAAC Aviation College in 1968, and held various administrative positions in the commercial aviation industry in China. Mr. Li is not connected with any directors, senior management or substantial shareholders or controlling shareholders of the Company.

All Directors and Supervisors of the Company have entered into service contracts with the Company for a term of three years commencing on April 16, 2001. The service contracts of Mr. Liu Ming Qi, Mr. Peng An Fa, Mr. Wang Quan Hua, Mr. Zhao Liu An, Mr. Zhou Yong Qian, Mr. Wang Zhi and Mr. Sui Guang Jun entered into on May 13, 2003 will expire at the end of the term of the current session of the Board. Except for such service contracts, none of the Directors or Supervisors of the Company has entered or proposed to enter into any other service contracts with the Company or its subsidiaries. None of the Directors or Supervisors has entered into any service contracts with the Company which is not determinable by the Company within one year without payment of compensation, other than statutory compensation.

#### **Compensation**

RMB0.2 million has been paid to non-executive directors for the year ended December 31, 2003. The aggregate compensation paid by the Company to all directors (excluding non-executive directors), supervisors and senior management for 2003 was RMB1.5 million. For the year ended December 31, 2003, the Company accrued an aggregate of approximately RMB25,000 on behalf of its executive directors, supervisors and senior management pursuant to the SA Pension Scheme and the retirement plans operated by various municipal governments in which the Company participates.

#### **Board Practices**

Directors' service contracts with the Company or any of its subsidiaries provide prorated monthly salary upon termination of employment in accordance with his contract. The Director is entitled to paid leave in accordance with his contract.

Audit Committee

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The audit committee is appointed by the Board of Directors and consists of five independent non-executive Directors. The current members of the audit committee are Mr. Simon To, Mr. Peter Lok, Mr. Wei Ming Hai, Mr. Wang Zhi and Mr. Sui Guang Jun. At least once a year, the committee is required to meet with the external auditors without any executive members of the Board in attendance. The quorum necessary for the transaction of any business is two committee members. The committee will normally meet four times a year. The external auditors or the Chief Financial Officer of the Company may request a meeting of the audit committee.

The audit committee selects and engages, on behalf of the Company, external auditors to audit the Company's annual financial statements and considers questions regarding the audit fees and the resignation or dismissal of the external auditors. The audit committee also reviews and approves the planned scope of the Company's annual audit. In addition, the audit committee reviews the annual and interim financial statements, the preliminary announcement of results and any other announcement regarding the Company's results or other financial information to be made public, before submission to the Board of Directors. Moreover, the committee discusses problems arising from the audit and reviews the external auditors' management letter and management's response. Furthermore, the audit committee reviews the effectiveness of the system of internal financial controls from information provided by the Executive Directorate and management of the Company and ensures adherence to the Company's control policies so that the Company's assets are safeguarded and that the financial records are complete and accurate. The audit committee meets regularly with the Company's senior financial, internal audit and the external auditors to consider the Company's financial reporting, the nature and scope of audit review and the effectiveness of the systems of internal control. The audit committee also reviews any significant transactions that are not in the ordinary course of business.

The Company has an internal audit department which reviews procedures in all major financial and operational activities. This department is led by the head of internal audit who is directly responsible to the Chairman of the Board and submits regular reports to the audit committee.

The Company does not have a Remuneration Committee. The executive compensation program of the Company is administered by the Board of Directors.

## **Employees**

As of December 31, 2003, the Group had 17,569 employees, including 1,943 pilots, 2,984 flight attendants, 2,317 maintenance personnel, 4,146 sales and marketing personnel and 3,873 administrative personnel. All of the Group's pilots, flight attendants, technical personnel, management personnel and sales and marketing personnel are contract employees, and most of the Group's ancillary service workers are temporary employees. Contract employees are hired by the Group pursuant to renewable employment contracts with terms ranging from three to five years. Temporary employees generally are hired by the Group pursuant to at-will employment contracts or employment contracts with a term of one year.

The Company's employees are members of a trade union organized under the auspices of the All-China's Federation of Trade Unions, which is established in accordance with the Trade Union Law of China. A representative of the Company labor union currently serves on the Supervisory Committee of the Company. Each of the Company's subsidiaries has its own trade union. The Group has not experienced any strikes, slowdowns or labor disputes that have interfered with its operations, and the Group believes that its relations with its employees are good.

All employees of the Group receive cash remuneration and certain non-cash benefits. Cash remuneration consists of salaries, bonuses and cash subsidies provided by the Group. Salaries are determined in accordance with the national basic wage standards. The total amount of wages payable by the Group to its employees is subject to a maximum limit based on the profitability of the Group and other factors. Bonuses are based on the profitability of the Group. Cash subsidies are intended as a form of cost-of-living adjustment. In addition to cash compensation, the Group's contract employees receive certain non-cash benefits, including housing, education and health services, and the Group's temporary employees receive limited health services, but not housing or education. CSAHC provides certain services in respect of these benefits to the Group's employees in consideration of certain fees and other charges.

### **Pension Programs**

Historically, the Group participated in an industry-wide pension scheme managed by the CAAC. With effect from January 1, 1998, the pension scheme of the CAAC was replaced by several new retirement schemes operated under the auspices of various municipal governments. Employees of the Group are currently covered by such schemes. Under such schemes, the Group is required to pay quarterly premiums to the relevant municipal governments. The premiums range from 14% to 19% of the total monthly salary, bonuses and other benefits paid by the Group to its employees.

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In addition, the Group was selected as one of the pilot enterprises to establish a supplementary defined contribution retirement scheme for the benefit of employees. In this connection, employees of the Group participate in a supplementary defined contribution retirement scheme whereby the Group is required to make defined contributions at the rate of 4.5% of total salaries. The Group has no obligation for the payment of pension benefits beyond the contributions described above. Contributions to the retirement schemes are charged to consolidated statement of operations as and when incurred.

**Workers Compensation**

There is no workers compensation or other similar compensation scheme under the Chinese labor and employment system. As required by Chinese law, however, the Group, subject to certain conditions and limitations, pays for the medical expenses of any contract employee who suffers a work-related illness, injury or disability and continues to pay the full salary of, and provides all standard cash subsidies to, such employee during the term of such illness, injury or disability. The Group also pays for certain medical expenses of its temporary employees.

At no time during 2003 had any Director, Supervisor or member of the Senior Management or any of their spouses or minor children, been granted or exercised or subscribed for shares or debentures or options of the Company.

**Share Ownership**

Except as disclosed herein, as of the date of this Annual Report, no Director, Senior Management or Supervisor of the Company is a beneficial owner of any shares of the Company's capital stock. As of the date of this Annual Report, no arrangement has been put in place involving issue or grant of options or shares or securities of the Company to any of the Director, Senior Management, Supervisor or employees of the Company.

| <b>Name</b> | <b>The Company/<br/>associated<br/>corporation</b> | <b>Types of<br/>interest</b>      | <b>Type of<br/>shares</b> | <b>Number<br/>of shares<br/>held</b> | <b>% to the<br/>total<br/>issued<br/>share<br/>capital<br/>of the<br/>Company</b> | <b>% to the<br/>total<br/>issued<br/>domestic<br/>shares<br/>of the<br/>Company</b> | <b>% to the<br/>total<br/>issued<br/>H shares<br/>of the<br/>Company</b> | <b>Short<br/>position</b> |
|-------------|----------------------------------------------------|-----------------------------------|---------------------------|--------------------------------------|-----------------------------------------------------------------------------------|-------------------------------------------------------------------------------------|--------------------------------------------------------------------------|---------------------------|
| Simon To    | the<br>Company                                     | Interest<br>of spouse<br>(Note 1) | H<br>Shares               | 100,000                              | 0.002%                                                                            |                                                                                     | 0.009%                                                                   |                           |

Note 1: The spouse of Mr. Simon To is the owner of these 100,000 H Shares of the Company and accordingly, Mr. Simon To, is taken to be interested in these 100,000 H Shares by virtue of the SFO.

**ITEM 7. MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS.****Major Shareholders****Share Capital Structure**

As of December 31, 2003, the total share capital of the Company was 4,374,178,000 shares, of which approximately 50.3% (2,200,000,000 domestic shares) is held by CSAHC, approximately 26.84% (1,174,178,000 H shares) is held by Hong Kong and overseas shareholders and approximately 22.86% (1,000,000,000 A shares) is held by domestic shareholders.

**Substantial Shareholders**

As of December 31, 2003, the following shareholders had an interest of 5% or more in the Company's shares:

| <b>Name</b>            | <b>Number of Shares</b>       | <b>Approximate Percentage<br/>of the Total Number of<br/>Shares</b> |
|------------------------|-------------------------------|---------------------------------------------------------------------|
| CSAHC                  | 2,200,000,000 domestic shares | 50.30%                                                              |
| HKSCC Nominees Limited | 1,149,955,998 H shares        | 26.29%                                                              |

The table below sets forth, as of December 31, 2003, the following entities hold 5% or more of the total number of H shares issued by the Company.

| <b>Name</b>            | <b>Number of H Shares</b> | <b>Approximate<br/>Percentage of<br/>the Total Number of<br/>H Shares</b> |
|------------------------|---------------------------|---------------------------------------------------------------------------|
| HKSCC Nominees Limited | 1,149,955,998             | 97.94%                                                                    |

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Domestic shares and H shares have identical voting rights.

## **Related Party Transactions**

The Company enters into transactions from time to time with CSAHC and its affiliates. For a description of such transactions, see Note 25 to the Financial Statements. In particular, the following arrangements, which the Company believes are material to its operations, have been made between the Company and CSAHC and its affiliates. The Company believes that these arrangements are effected in the prevailing market rates and are commercially reasonable and on terms no less favorable than terms available from third parties.

### **Arrangements with CSAHC**

#### *Trademark License Agreement*

The Company and CSAHC have entered into the Trademark License Agreement dated May 22, 1997, pursuant to which CSAHC has acknowledged that the Group has the right to use the name China Southern and China Southern Airlines in both Chinese and English, and has granted to the Company a 10-year renewable license to use the kapok logo on a world-wide basis in connection with its airline-related businesses. CSAHC has retained the right to use the kapok logo in connection with its non-airline related businesses conducted as of the date of the Trademark License Agreement and to permit its affiliates that do not compete, directly or indirectly, with the Group to use the kapok logo. Unless CSAHC gives written notice of termination three months before the expiration of the 10-year term of the agreement, the agreement will be automatically extended for another 10-year term.

#### *Leases*

The Company as lessee and CSAHC as lessor have entered into the following lease agreements:

The Company and CSAHC have entered into a land lease agreement dated May 22, 1997, in respect of the land used by the Company within Baiyun International Airport. The total rental payment is RMB2.7 million per year. The term of the lease is five years commencing April 1, 1997, and is renewable by the Company thereafter.

The Company and CSAHC have separately entered into four lease agreements dated May 22, 1997, in respect of office premises located at the east wing of the Guangzhou Railway Station on Guangzhou Huanshi Dong Road, office premises at Haikou Airport, office premises in Haikou City, and office premises at Tianhe Airport in Wuhan, Hubei Province. The aggregate rental payment under the four leases is RMB12.6 million per year. The original term of each lease is one year and is renewable annually by the Company thereafter.

The Company and CSAHC have entered into an indemnification agreement dated May 22, 1997, in which CSAHC has agreed to indemnify the Company against any loss or damage caused by or arising from any challenge of, or interference with, the Company's right to use certain land and buildings.

#### *Comprehensive Services and Employee Benefits*

The Company and CSAHC have entered into a comprehensive services agreement dated May 22, 1997, pursuant to which CSAHC agrees to provide adequate quarters to eligible employees of the Group as and when required. In return, the Group agrees to pay a fixed annual fee of RMB85 million to CSAHC for a ten-year period effective January 1, 1995.

Arrangements with CSAHC's Affiliates

*Southern Airlines (Group) Import and Export Trading Company (SAIETC), a wholly-owned subsidiary of CSAHC*

The Company and SAIETC have entered into an agreement dated May 22, 1997, for the import and export of aircraft, flight equipment, special vehicles for airline use, communication and navigation facilities, and training facilities for a term extending from May 22, 1997 to May 22, 2000 which was subsequently extended to May 22, 2006 by mutual agreement between the parties. The parties have mutually agreed that the agreement can be extended automatically.

For the year ended December 31, 2003, the amount incurred by the Group for the import and export of the above equipment was RMB1,155 million, inclusive of agency commission of 1.5% above the contract prices paid to SAIETC.

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*Southern Airlines Advertising Company ( SAAC ), which is 90% owned by the Group and 10% owned by CSAHC*

In August 2002, the Group entered into a takeover agreement with CSAHC. As a result, the Group owns 90% and CSAHC owns 10% of SAAC.

The Company and SAAC have entered into an agreement dated May 22, 1997, for the provision of advertising services for a term extending from May 22, 1997 to May 22, 2000. The agreement has been extended to May 22, 2006.

For the year ended December 31, 2003, the amount incurred by the Group to SAAC for advertising services was RMB1.3 million.

*Southern Airlines Group Finance Company Limited ( SA Finance ), which is 42% owned by CSAHC, 32% owned by the Company, 26% owned by five subsidiaries of the Company*

The Company has entered into a financial agreement dated May 22, 1997, with SA Finance for the provision of financial services such as deposit and loan facilities, credit facilities, financial guarantees and credit references for a term extending from May 22, 1997 to May 22, 2000. As agreed by the parties, the agreement has been extended for six years to May 22, 2006.

Under such agreement, (a) all funds that the Company deposits with SA Finance will be deposited by SA Finance with the Commercial and Industrial Bank of China, Bank of Communications, Bank of Agriculture, China Construction Bank, or other banks of similar creditworthiness; and (b) SA Finance will not at any time have outstanding loans in excess of the amount representing the aggregate of (i) deposits received from entities other than the Company, (ii) SA Finance's shareholders' equity and (iii) capital reserves.

As of December 31, 2003, the Group had short-term deposits placed with SA Finance amounting to RMB365.9 million, which earned interest at the rate of 1.98% - 3.00% per annum.

*Shenzhen Air Catering Company Limited, which is 33% owned by CSAHC, and 67% owned by two independent third parties*

The Company and Shenzhen Air Catering Company Limited have entered into an agreement dated May 23, 1997 for the sale and purchase of in-flight meals for flights originating or stopping at the airport in Shenzhen. Pursuant to such agreement, Shenzhen Air Catering Company Limited would supply in-flight meals to the Group from time to time during the term from May 23, 1997 to May 23, 1998. The parties have agreed that the agreement can be extended automatically.

For the year ended December 31, 2003, the amount paid by the Group to Shenzhen Air Catering Company Limited for the provision of in-flight meals was approximately RMB28.2 million.

*GAMECO, which is 50% owned by the Company and 50% owned by an independent third party*

The Company and GAMECO have entered into an Aircraft Maintenance and Engineering Agreement for the provision of aircraft repair and maintenance services. On May 17, 1996, the Company and GAMECO entered into an agreement regarding the fee arrangement for the provision of such repair and maintenance services (the "Fee Agreement"). Pursuant to the Fee Agreement and subsequent agreements, GAMECO charged the Company for expendables at cost plus 15%, and labor costs at US\$30.0 per hour during 2003.

For the year ended December 31, 2003, the amount incurred by the Company for such repair and maintenance services was RMB587.3 million.

*The China Southern West Australian Flying College Pty Ltd (the Australian Pilot College), which is 65% owned by the Company and 35% owned by CSAHC.*

CSAHC and the Australian Pilot College entered into an agreement dated October 7, 1993, for the provision of pilot training in Australia to the cadet pilots of CSAHC (the Training Agreement). The Training Agreement will remain in force unless terminated by either party upon 90 days prior written notice to the other party. Pursuant to the Demerger Agreement, the Company has assumed all the interests, rights and obligations of CSAHC under the Training Agreement.

For the year ended December 31, 2003, the amount paid by the Group to the Australian Pilot College for training services was RMB82.4 million.

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*Southern Airlines (Group) Economic Development Company ( SAGEDC ), which is 61% owned by CSAHC and 39% owned by an independent third party.*

The Company and SAGEDC have entered into an agreement dated May 22, 1997, for the provision of drinks, snacks, liquor, souvenirs and other products for a term extending from May 22, 1997, to May 22, 2007.

For the year ended December 31, 2003, the amount paid by the Group to Southern Airlines (Group) Economic Development Company for the provision of drinks, snacks, liquor, souvenirs and other products was RMB42.8 million.

*Ticket sales arrangements*

The Company has entered into ticket agency agreements for the sale of the Group's air tickets with several subsidiaries of CSAHC (the Agents). The Agents charge a commission, at a rate prescribed by the CAAC and the International Air Transport Association, for each air ticket sold in the amount of 3% of the ticket price for domestic tickets and 5% - 12% of the ticket price for Hong Kong regional/international tickets, respectively. In addition to the Agents, the Company has other air ticket sales agents in China who charge commission at the same rates. The Agents also act as air ticket sales agents for other Chinese airlines and charge the same rates of commission to such other airlines as those charged to the Company.

For the year ended December 31, 2003, the aggregate amount of ticket sales of the Group conducted through the Agents was RMB143.0 million.

**Interests of Experts and Counsel**

Not applicable.

**ITEM 8. FINANCIAL INFORMATION.**

**Consolidated Statements and Other Financial Information**

See Item 18. Financial Statements for financial statements filed as part of this Annual Report.

**Table of Contents****Significant Changes**

No significant changes have occurred since the date of the financial statements provided in Item 18 below.

**Legal Proceedings**

The Company is currently involved in a civil litigation (Hong Kong High Court Action No. 515 of 2001) ( Litigation ). According to the writ of summons for the Litigation, New Link Consultants Limited, the plaintiff, claimed against the Company (as one of the defendants to the Litigation) on the basis of certain evidence proving that United Aero-Supplies System of China, Limited ( UASSC ) entered into an agreement with the defendants for exclusive purchase of aviation equipment consigned to UASSC for sale and, that as the defendants failed to perform the agreement, UASSC has the right to compensation. Since UASSC is in the course of its winding up proceedings, all the rights and benefits of UASSC in connection with the claim have been transferred to the plaintiff. The Company, as one of the defendants to the Litigation, has been claimed for unspecified damages for breach of the agreement. Given that the Litigation is still at its preliminary stage, it is pre-matured to predict the result of the court judgment. Based on the opinion given by its instructing solicitors, the Company's directors consider that the Company has a reasonable chance of success in its defense to the claim. At present, the Company has filed an objection in respect of the jurisdiction of the court, and has requested the court to transfer the case to the PRC for trial. Accordingly, the Directors of the Company consider that a provision for such claim and/or the associated legal costs is not required.

Other than the above legal proceeding, the Company is not party to any material legal proceedings.

**Dividend Information**

No interim dividend was paid during the year ended December 31, 2003. The Board of Directors does not recommend the payment of a final dividend in respect of the year ended December 31, 2003.

**ITEM 9. THE OFFER AND LISTING.**

The principal trading market for the Company's H Shares is the Hong Kong Stock Exchange, and the Company's trading code is 1055 . The ADSs, each representing 50 H Shares, are evidenced by ADRs issued by The Bank of New York as the Depositary for the ADRs, and are listed on the New York Stock Exchange under the symbol ZNH. As of May 31, 2004, approximately 104,740,000 of the Company's H Shares in the form of 2,094,800 ADSs were held in the U.S. by approximately 42 record holders in the U.S., including the Depositary Trust Company.

In July 2003, the Company issued and listed 1,000,000,000 A shares on the Shanghai Stock Exchange with trading code of 600029 . The 2,200,000,000 Domestic Shares held by CSAHC are not listed on any stock exchange and are essentially not transferrable by CSAHC.

Set forth below for the periods indicated are the high and low sales prices of H Shares on the Hong Kong Stock Exchange, ADSs on the New York Stock Exchange and A Shares on the Shanghai Stock Exchange.

|                             | The Stock Exchange of Hong Kong<br>Price per H Share (HK\$) |      | The New York Stock Exchange<br>Price per ADS (US\$) |      | The Shanghai Stock Exchange<br>Price per A Share (RMB) |     |
|-----------------------------|-------------------------------------------------------------|------|-----------------------------------------------------|------|--------------------------------------------------------|-----|
|                             | High                                                        | Low  | High                                                | Low  | High                                                   | Low |
| <i>Annual Market Prices</i> |                                                             |      |                                                     |      |                                                        |     |
| <i>Fiscal Year ended</i>    |                                                             |      |                                                     |      |                                                        |     |
| <i>December 31, 1998</i>    | 2.40                                                        | 0.50 | 14.75                                               | 3.06 | N/A                                                    | N/A |

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|                                                |      |      |       |       |      |      |
|------------------------------------------------|------|------|-------|-------|------|------|
| <i>Fiscal Year ended<br/>December 31, 1999</i> | 2.25 | 0.61 | 13.94 | 3.88  | N/A  | N/A  |
| <i>Fiscal Year ended<br/>December 31, 2000</i> | 2.93 | 1.02 | 18.38 | 6.06  | N/A  | N/A  |
| <i>Fiscal Year ended<br/>December 31, 2001</i> | 2.95 | 1.35 | 18.10 | 8.00  | N/A  | N/A  |
| <i>Fiscal Year ended<br/>December 31, 2002</i> | 3.60 | 1.50 | 22.25 | 10.35 | N/A  | N/A  |
| <i>Fiscal Year ended<br/>December 31, 2003</i> | 3.50 | 1.46 | 22.78 | 9.53  | 5.34 | 3.75 |
| <i>Quarterly Market Prices</i>                 |      |      |       |       |      |      |
| <i>Fiscal Year ended<br/>December 31, 2000</i> |      |      |       |       |      |      |
| <i>First Quarter</i>                           | 1.86 | 1.02 | 11.19 | 6.88  | N/A  | N/A  |
| <i>Second Quarter</i>                          | 2.05 | 1.06 | 12.44 | 6.06  | N/A  | N/A  |
| <i>Third Quarter</i>                           | 2.93 | 1.63 | 18.38 | 10.19 | N/A  | N/A  |
| <i>Fourth Quarter</i>                          | 2.40 | 1.46 | 15.06 | 9.56  | N/A  | N/A  |
| <i>Fiscal Year ended<br/>December 31, 2001</i> |      |      |       |       |      |      |
| <i>First Quarter</i>                           | 2.70 | 1.83 | 17.38 | 12.22 | N/A  | N/A  |
| <i>Second Quarter</i>                          | 2.95 | 1.89 | 18.10 | 12.00 | N/A  | N/A  |
| <i>Third Quarter</i>                           | 2.53 | 1.35 | 16.50 | 8.00  | N/A  | N/A  |
| <i>Fourth Quarter</i>                          | 2.42 | 1.66 | 15.25 | 9.8   | N/A  | N/A  |
| <i>Fiscal Year ended<br/>December 31, 2002</i> |      |      |       |       |      |      |

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|                                            | The Stock Exchange of Hong Kong<br>Price per H Share<br>(HK\$) |      | The New York Stock Exchange<br>Price per ADS<br>(US\$) |       | The Shanghai Stock Exchange<br>Price per A Share<br>(RMB) |      |
|--------------------------------------------|----------------------------------------------------------------|------|--------------------------------------------------------|-------|-----------------------------------------------------------|------|
|                                            | High                                                           | Low  | High                                                   | Low   | High                                                      | Low  |
| <i>First Quarter</i>                       | 2.83                                                           | 2.22 | 17.63                                                  | 14.80 | NA                                                        | NA   |
| <i>Second Quarter</i>                      | 3.42                                                           | 2.33 | 21.74                                                  | 14.95 | NA                                                        | NA   |
| <i>Third Quarter</i>                       | 3.60                                                           | 1.89 | 22.25                                                  | 12.00 | NA                                                        | NA   |
| <i>Fourth Quarter</i>                      | 2.42                                                           | 1.50 | 15.00                                                  | 10.35 | NA                                                        | NA   |
| <i>Fiscal Year ended December 31, 2003</i> |                                                                |      |                                                        |       |                                                           |      |
| <i>First Quarter</i>                       | 2.62                                                           | 1.71 | 16.50                                                  | 11.75 | N/A                                                       | N/A  |
| <i>Second Quarter</i>                      | 2.40                                                           | 1.46 | 14.85                                                  | 9.53  | N/A                                                       | N/A  |
| <i>Third Quarter</i>                       | 2.88                                                           | 2.03 | 18.59                                                  | 13.25 | 4.15                                                      | 3.75 |
| <i>Fourth Quarter</i>                      | 3.50                                                           | 2.50 | 22.78                                                  | 16.76 | 5.34                                                      | 3.86 |
| <i>Monthly Market Prices</i>               |                                                                |      |                                                        |       |                                                           |      |
| <i>December 2003</i>                       | 3.50                                                           | 2.92 | 22.78                                                  | 19.00 | 5.34                                                      | 4.46 |
| <i>January 2004</i>                        | 3.95                                                           | 3.35 | 25.18                                                  | 21.94 | 6.30                                                      | 4.95 |
| <i>February 2004</i>                       | 4.68                                                           | 3.20 | 29.73                                                  | 20.91 | 6.73                                                      | 5.70 |
| <i>March 2004</i>                          | 4.47                                                           | 3.30 | 28.60                                                  | 21.00 | 6.57                                                      | 5.77 |
| <i>April 2004</i>                          | 3.90                                                           | 3.20 | 24.89                                                  | 21.07 | 6.24                                                      | 5.49 |
| <i>May 2004</i>                            | 3.53                                                           | 2.47 | 22.62                                                  | 15.95 | 6.10                                                      | 4.82 |

**Offer and Listing details**

Not applicable.

**Plan of Distribution**

Not applicable.

**Markets**

Not applicable.

**Selling Shareholders**

Not applicable.

**Dilution**

Not applicable.

**Expenses of the Issue**

Not applicable.

**ITEM 10. ADDITIONAL INFORMATION.**

**Share Capital**

Not applicable.

**Memorandum and Articles of Association**

The Company is registered with and has obtained a business license from the State Administration Bureau of Industry and Commerce of the People's Republic of China on March 25, 1995. The Company's business license number is 1000001001760.

On March 13, 2003, the Company obtained an approval certificate from the Ministry of Commerce to change to a permanent limited company with foreign investments and obtained the business license (Qi Gu Guo Zi Di No. 000995) on October 17, 2003 issued by the State Administration of Industry and Commerce of the People's Republic of China.

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### **Director**

Pursuant to Article 13 of the Articles of Association, the business purposes of the Company are: (i) to absorb domestic and foreign capital; (ii) to assist in developing the aviation industry of China; (iii) to promote the development of the national economy of China; (iv) to utilize corporate incentive mechanisms of privatization; (v) to draw on the advanced management expertise of other domestic and foreign companies; (vi) to continuously improve the management of the Company; (vii) to enhance the market competitiveness of the Company; (viii) to generate economic and social benefits for the Company; and (ix) to generate steady income for the Company's shareholders. Pursuant to Article 14 of the Articles of Association, the scope of business of the Company shall be consistent with and subject to the scope of business approved by the relevant supervisory department of the State. The scope of business of the Company includes: (i) provision of scheduled and non-scheduled domestic, regional and international air transportation services for passengers, cargo, mail and luggage; (ii) undertaking general aviation services; (iii) provision of aircraft repair and maintenance services; (iv) acting as agent for other domestic and international airlines; (v) provision of air catering services and (vi) engaging in other airline or airline-related business, including advertising for such services.

Pursuant to Article 154 of the Articles of Association, where a director of the Company is in any way, directly or indirectly, materially interested in a contract, transaction or arrangement or proposed contract, transaction or arrangement with the Company, (other than his contract of service with the Company), he shall declare the nature and extent of his interests to the board of directors at the earliest opportunity, whether or not the contract, transaction or arrangement or proposal therefor is otherwise subject to the approval of the board of directors.

Pursuant to Article 108 of the Articles of Association, where a director is interested in any resolution proposed at a board meeting, such director shall not be present and shall not have a right to vote. Such director shall not be counted in the quorum of the relevant meeting.

Pursuant to Article 162 of the Articles of Association, the Company shall, with the prior approval of shareholders in general meeting, enter into a contract in writing with a director wherein his emoluments are stipulated. The aforesaid emoluments include, emoluments in respect of his service as director, supervisor or senior administrative officer of the Company or any subsidiary of the Company; emoluments in respect of the provision of other services in connection with the management of the affairs of the Company and any of its subsidiaries; and payment by way of compensation for loss of office, or as consideration for or in connection with his retirement from office.

Pursuant to Article 102(6) of the Articles of Association, the board of directors has the power to formulate proposals for increases or reductions in the Company's registered capital and the issue of debentures of the Company; such resolutions must be passed by more than two-thirds of all the directors.

There is no mandatory retirement age for the directors of the Company. The directors of the Company are not required to hold shares of the Company.

### **Ordinary Shares**

Pursuant to Article 19 of the Articles of Association, subject to the approval of the securities authority of the State Council, the Company may issue and offer shares to domestic investors or foreign investors for subscription. Foreign investors are those investors of foreign countries and regions of Hong Kong, Macau and Taiwan who subscribe for shares issued by the Company. Domestic investors are those investors within the territory of the PRC (excluding investors of the regions referred to in the preceding sentence) who subscribe for shares issued by the Company.

Pursuant to Article 20 of the Articles of Association, Shares issued by the Company to domestic investors for subscription in Renminbi shall be referred to as Domestic-Invested Shares. Shares issued by the Company to foreign investors for subscription in foreign currencies shall be referred to as Foreign-Invested Shares. Foreign-Invested Shares which are listed overseas are called Overseas-Listed Foreign-Invested Shares. The foreign currencies mean the legal currencies (apart from Renminbi) of other countries or districts which are recognized by the foreign exchange control authority of the State and can be used to pay the Company for the share price.

Pursuant to Article 21 of the Articles of Association, Domestic-Invested Shares issued by the Company shall be called A Shares. Overseas-Listed Foreign-Invested Shares issued by the Company and listed in Hong Kong shall be called H Shares. H Shares are shares which have been admitted for listing on The Stock Exchange of Hong Kong Limited, the par value of which is denominated in Renminbi and which are subscribed for and traded in Hong Kong dollars. H Shares can also be listed on a stock exchange in the United States of America in the form of American depositary receipts.

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The Company has issued a total of 4,374,178,000 ordinary shares, of which (a) 2,200,000,000 domestic shares are held by CSAHC, (b) 1,174,178,000 H shares are held by Hong Kong and overseas shareholders and (c) 1,000,000,000 A shares are held by the PRC shareholders.

Pursuant to Article 54 of the Articles of Association, the ordinary shareholders of the Company shall enjoy the following rights:

- (1) the right to attend or appoint a proxy to attend shareholders' general meetings and to vote thereat;
- (2) the right to dividends and other distributions in proportion to the number of shares held;
- (3) the right of supervisory management over the Company's business operations, and the right to present proposals or enquiries;
- (4) the right to transfer, donate or pledge his shares in accordance with laws, administrative regulations and provisions of these articles of association;
- (5) the right of knowledge and decision making power with respect to important matters of the Company in accordance with laws, administrative regulations and these articles of association;
- (6) the right to obtain relevant information in accordance with the provisions of these articles of association, including:
  - (i) the right to obtain a copy of these articles of association, subject to payment of the cost of such copy;
  - (ii) the right to inspect and copy, subject to payment of a reasonable charge:
    - (a) all parts of the register of shareholders;
    - (b) personal particulars of each of the Company's directors, supervisors, president and other senior administrative officers, including:
      - (aa) present name and alias and any former name or alias;
      - (bb) principal address (residence);
      - (cc) nationality;
      - (dd) primary and all other part-time occupations and duties;
      - (ee) identification documents and their relevant numbers;
    - (c) state of the Company's share capital;
    - (d) reports showing the aggregate par value, quantity, highest and lowest price paid in respect of each class of shares repurchased by the Company since the end of last accounting year and the aggregate amount paid by the Company for this purpose;
    - (e) minutes of shareholders' general meetings;
    - (f) interim and annual reports of the Company.
- (7) in the event of the termination or liquidation of the Company, to participate in the distribution of surplus assets of the Company in accordance with the number of shares held;
- (8) other rights conferred by laws, administrative regulations and these articles of association.

Pursuant to Article 55 of the Articles of Association, the ordinary shareholders of the Company shall assume the following obligations:

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- (1) to abide by these articles of association;
- (2) to pay subscription monies according to the number of shares subscribed and the method of subscription;
- (3) no right to return shares to the Company unless laws and regulations provide otherwise;
- (4) other obligations imposed by laws, administrative regulations and these articles of association.

Shareholders are not liable to make any further contribution to the share capital other than as agreed by the subscriber of the relevant shares on subscription.

Action necessary to change rights of shareholders

Pursuant to Article 92 of the Articles of Association, those shareholders who hold different classes of shares are shareholders of different classes.

The holders of the Domestic-Invested shares and holders of Overseas-Listed Foreign-Invested Shares shall be deemed to be shareholders of different classes.

Pursuant to Article 93 of the Articles of Association, rights conferred on any class of shareholders in the capacity of shareholders ( class rights ) may not be varied or abrogated unless approved by a special resolution of shareholders in general meeting and by holders of shares of that class at a separate meeting conducted in accordance with Articles 95 to 99.

Pursuant to Article 95 of the Articles of Association, shareholders of the affected class, whether or not otherwise having the right to vote at shareholders' general meetings, shall nevertheless have the right to vote at class meetings in respect of matters concerning sub-paragraphs (2) to (8), (11) and (12) of Article 94, but interested shareholder(s) shall not be entitled to vote at class meetings. Interested shareholder(s) is:

- (1) in the case of a repurchase of shares by offers to all shareholders or public dealing on a stock exchange under Article 31, a controlling shareholder within the meaning of Article 57;
- (2) in the case of a repurchase of share by an off-market contract under Article 31, a holder of the shares to which the proposed contract relates;
- (3) in the case of a restructuring of the Company, a shareholder within a class who bears less than a proportionate obligation imposed on that class under the proposed restructuring or who has an interest in the proposed restructuring different from the interest of shareholders of that class.

Pursuant to Article 96 of the Articles of Association, resolutions of a class of shareholders shall be passed by votes representing more than two-thirds of the voting rights of shareholders of that class represented at the relevant meeting who, according to Article 95, are entitled to vote at class meetings.

Pursuant to Article 97 of the Articles of Association, written notice of a class meeting shall be given forty-five (45) days before the date of the class meeting to notify all of the shareholders in the share register of the class of the matters to be considered, the date and the place of the class meeting. A shareholder who intends to attend the class meeting shall deliver his written reply concerning attendance at the class meeting to the Company twenty (20) days before the date of the class meeting.

If the number of shares carrying voting rights at the meeting represented by the shareholders who intend to attend the class meeting reaches more than one half of the voting shares at the class meeting, the Company may hold the class meeting; if not, the Company shall within five (5) days notify the shareholders again by public notice of the matters to be considered, the date and the place for the class meeting. The Company may then hold the class meeting after such publication of notice.

Pursuant to Article 98 of the Articles of Association, notice of class meetings need only be served on shareholders entitled to vote thereat.

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Meeting of any class of shareholders shall be conducted in a manner as similar as possible to that of general meetings of shareholders. The provisions of these articles of association relating to the manner to conduct any shareholders' general meeting shall apply to any meeting of a class of shareholders.

Pursuant to Article 99 of the Articles of Association, the special procedures for voting at any meeting of a class of shareholders shall not apply to the following circumstances:

- (1) where the Company issues, upon the approval by special resolution of its shareholders in general meeting, either separately or concurrently once every twelve months, not more than 20 per cent of each of its existing issued Domestic-Invested Shares and Overseas-Listed Foreign-Invested Shares;
- (2) where the Company's plan to issue Domestic-Invested Shares and Overseas-Listed Foreign-Invested Shares at the time of its establishment is carried out within fifteen (15) months from the date of approval of the Securities Committee of the State Council.

### Meetings of shareholders

Shareholders' general meetings is the organ of authority of the Company and shall exercise its functions and powers, among other things, to decide on the Company's operational policies and investment plans, to elect and replace directors and decide on matters relating to the remuneration of directors, to examine and approve reports of the board of directors, etc.

There are two types of shareholders' general meetings: annual general meetings and extraordinary general meetings. Shareholders' general meetings shall be convened by the board of directors. Annual general meetings are held once every year and within six (6) months from the end of the preceding financial year.

Under any of the following circumstances, the board of directors shall convene an extraordinary general meeting within two (2) months:

- (1) when the number of directors is less than the number of directors required by the Company Law or two thirds of the number of directors specified in the Articles of Association;
- (2) when the unrecovered losses of the Company amount to one third of the total amount of its share capital;
- (3) when shareholder(s) holding 10 per cent or more of the Company's issued and outstanding shares carrying voting rights request(s) in writing the convening of an extraordinary general meeting;
- (4) when deemed necessary by the board of directors or as requested by the supervisory committee.

When the Company convenes a shareholders' general meeting, written notice of the meeting shall be given forty five (45) days before the date of the meeting to notify all of the shareholders in the share register of the matters to be considered and the date and the place of the meeting. A shareholder who intends to attend the meeting shall deliver his written reply concerning the attendance of the meeting to the Company twenty (20) days before the date of the meeting.

The Company shall, based on the written replies received twenty (20) days before the date of the shareholders' general meeting from the shareholders, calculate the number of voting shares represented by the shareholders who intend to attend the meeting. If the number of voting shares represented by the shareholders who intend to attend the meeting reaches one half or more of the Company's total voting shares, the Company may hold the meeting; if not, then the Company shall within five (5) days notify the shareholders again by public notice of the matters to be considered, the place and date for, the meeting. The Company may then hold the meeting after such publication of notice.

### Limitation on right to own securities

The PRC Special Regulations on Overseas Offering and the Listing of Shares by Companies Limited by Share (the "Special Regulations") and the Mandatory Provisions for Articles of Association of Companies to be Listed Overseas (the "Mandatory Provisions") provide for different classes of shares to be subscribed for and traded by local and overseas investors respectively. Shares which can be traded by overseas investors must be in registered form and while denominated in Renminbi, they are traded in foreign currency with dividends payable in foreign currency. Local investors are prohibited from dealing in such shares.

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### **Merger, acquisition or corporate restructuring**

Pursuant to Article 193 of the Articles of Association, in the event of the merger or division of the Company, a plan shall be presented by the Company's board of directors and shall be approved in shareholders' general meeting and the relevant examining and approving formalities shall be processed as required by law. A shareholder who objects to the plan of merger or division shall have the right to demand the Company or the shareholders who consent to the plan of merger or division to acquire that dissenting shareholder's shareholding at a fair price. The contents of the resolution of merger or division of the Company shall be made into special documents for shareholders' inspection. Such special documents shall be sent by mail to holders of Overseas-Listed Foreign-Invested Shares.

The Articles of Association do not contain any provisions governing the ownership threshold above which shareholder ownership must be disclosed.

### **Material Contracts**

The Company has not entered into any material contracts, other than in the ordinary course of business, during the preceding two years.

### **Exchange Controls**

Under current Chinese foreign exchange regulations, Renminbi is fully convertible for current account transactions, but is not freely convertible for capital account transactions. Conversion from Renminbi into a foreign currency or vice versa for purposes of capital account transactions requires prior approvals of relevant Chinese Government agencies.

The Company is generally required by law to sell all its foreign exchange revenues to Chinese banks at the exchange rates published by Chinese banks on each business day, which rates may deviate only within a very narrow range from the official rate published daily by the People's Bank of China, China's central bank.

The Company may purchase foreign exchange directly from Chinese banks for any current account transactions, such as trade transactions in its normal course of business, including acquisition of aircraft and flight equipment (such acquisition requires approvals from relevant Chinese Government agencies).

Payment of dividends by the Company to holders of the Company's H Shares and ADSs is considered a current account transaction under Chinese law. Therefore, there is no legal restriction on the conversion of Renminbi into foreign exchange for the purpose of paying dividends to such holders of H Shares and ADSs. In addition, the Company's Articles of Association require the Company to pay dividends to holders of the Company's H Shares and ADSs in foreign exchange.

### **Other Limitations**

There are no limitations on the right of non-resident or foreign owners to hold or vote H Shares or ADSs imposed by Chinese law or by the Articles of Association or other constituent documents of the Company. However, under current Chinese law, foreign ownership of the Company may not exceed 49%.

### **Taxation**

The following is a general summary of certain Chinese tax consequences of the acquisition, ownership and disposition of H Shares and ADSs. This summary is based upon tax laws of China as in effect on the date of this Annual Report, including the income tax treaty between the United States and China (the U.S.-PRC Tax Treaty), all of which are subject to change or different interpretation.

In general, for Chinese tax purposes, holders of 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 taxation under the laws of China.

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This summary does not purport to address all material tax consequences for holders or prospective purchasers of H Shares or ADSs, and does not take into account the specific circumstances of such investors. Investors should consult their own tax advisors as to Chinese or other tax consequences of the acquisition, ownership and disposition of H Shares or ADSs.

### **Dividends**

Chinese tax law generally provides for the imposition of a withholding tax on dividends paid by a Chinese company to a non-Chinese shareholder at a rate of 20%. However, the Chinese tax authorities have temporarily suspended imposition of this withholding tax. Accordingly, dividends paid by the Company to holders of H Shares or ADSs who are foreign individuals not resident in China or which are foreign enterprises with no permanent establishment in China will currently not be subject to Chinese withholding tax. In the event that the suspension of the withholding tax is lifted, such payments will be subject to withholding tax at the 20% rate unless the holder is entitled to a tax waiver or a lower tax rate under an applicable double-taxation treaty.

China currently has double-taxation treaties with a number of countries, including Australia, Canada, France, Germany, Japan, Malaysia, the Netherlands, Singapore, the United Kingdom and the United States. Under the U.S.-PRC Tax Treaty, China may tax a dividend paid by the Company to a U.S. holder up to a maximum of 10% of the gross amount of such dividend.

### **Capital Gains from Transfer or Disposition of Shares**

Chinese tax law generally provides that an individual who transfers or otherwise disposes of a company's shares of capital stock is subject to a 20% capital gains tax. Currently, foreign enterprises and all individuals are temporarily exempt from capital gains tax on transfers of shares of capital stock of joint stock companies, such as the Company. Should such temporary exemption be discontinued, such holders may be subject to a 20% capital gains tax unless reduced by an applicable double-taxation treaty. Under the U.S.-PRC Tax Treaty, for example, China may only impose a 20% capital gains tax from the sale or other disposition by a U.S. holder of H Shares or ADSs representing an interest in the Company of 25% or more.

### **Stamp Duty**

Transfers of shares of capital stock of a company are not subject to Chinese stamp duty if the transfer does not take place within China (excluding Hong Kong, Macau and Taiwan).

## **Dividends and paying Agents**

Not applicable.

## **Statement by Experts**

Not applicable.

## **Documents on Display**

The Company has filed this Annual Report on Form 20-F with the Securities and Exchange Commission under the Securities Exchange Act of 1934, as amended. Statements made in this annual report as to the contents of any document referred to are not necessarily complete. With respect to each such document filed as an exhibit to this annual report, reference is made to the exhibit for a more complete description of the matter involved, and each such statement shall be deemed qualified in its entirety by such reference.

The Company is subject to the informational requirements of the Exchange Act and file reports and other information with the Securities and Exchange Commission. Reports and other information which the Company filed with the Securities and Exchange Commission, including this Annual Report on Form 20-F, may be inspected and copied at the public reference room of the Securities and Exchange Commission at

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450 Fifth Street N.W. Washington D.C. 20549

You can also obtain copies of this material by mail from the Public Reference Section of the Securities and Exchange Commission, 450 Fifth Street, N.W., Washington D.C. 20549, at prescribed rates. Additionally, copies of this material may be obtained from the Securities and Exchange Commission's Internet site at <http://www.sec.gov>. The Commission's telephone number is 1-800-SEC-0330.

**Subsidiary Information**

Not applicable.

**ITEM 11. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.**

The Group is subject to market risks due to fluctuations in interest rates. The majority of the Group's borrowings is in the form of long-term fixed- and variable-rate debts with original maturities ranging from two to 12 years. Fluctuations in interest rates can lead to significant fluctuations in the fair value of such debt instruments. From time to time, the Group may enter into interest rate swaps designed to mitigate exposure relating to interest rate risks. No such contract was outstanding as of December 31, 2003.

The Group is also exposed to foreign currency risk as a result of its aircraft and flight equipment being sourced from overseas suppliers. Specifically, the Group's foreign currency exposure relates primarily to its foreign currency long-term debts used to finance such capital expenditures and its capital commitments. Subject to certain restrictive conditions imposed by the State Administration of Foreign Exchange, the Group may, from time to time, enter into forward foreign exchange contracts to mitigate its foreign currency exposures. No such contract was outstanding as of December 31, 2003.

As of December 31, 2003, the Group operated a total of 83 aircraft under operating and capital leases at rates that are substantially fixed. Such leases expose the Group to market risks; however, in accordance with Item 305 of Regulation S-K, such leases have been excluded from the following market risk tables. Commitments under operating and capital leases are disclosed in Note 17 to the Financial Statements.

The following table provides information regarding the Group's material interest rate sensitive financial instruments as of December 31, 2003 and 2002:

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|                             | As of December 31, 2003 |       |       |       |       |            | As of December 31, 2002 |               |                       |               |
|-----------------------------|-------------------------|-------|-------|-------|-------|------------|-------------------------|---------------|-----------------------|---------------|
|                             | Expected maturity date  |       |       |       |       |            |                         |               |                       |               |
|                             | 2004                    | 2005  | 2006  | 2007  | 2008  | Thereafter | Total recorded amount   | Fair value(2) | Total recorded amount | Fair value(2) |
| Debt                        |                         |       |       |       |       |            |                         |               |                       |               |
| Fixed-rate notes payable    |                         |       |       |       |       |            |                         |               |                       |               |
| In US\$                     | 624                     | 645   | 402   | 370   | 217   | 369        | 2,627                   | 2,915         | 3,429                 | 3,793         |
| Average interest rate       | 6.81%                   | 6.78% | 6.78% | 6.78% | 6.78% | 6.79%      | 6.79%                   |               | 6.86%                 |               |
| Variable-rate notes payable |                         |       |       |       |       |            |                         |               |                       |               |
| In US\$                     | 5,867                   |       |       |       | 229   | 2,276      | 8,372                   | 8,372         | 2,254                 | 2,254         |
| Average interest rate       | 1.91%                   |       |       |       | 1.48% | 1.49%      | 1.63%                   |               | 2.10%                 |               |
| In RMB                      | 606                     | 5     | 2     | 2     | 2     | 3          | 620                     | 620           | 5,393                 | 5,393         |
| Average interest rate       | 4.16%                   | 3.43% | 5.14% | 5.14% | 5.14% | 5.14%      | 4.46%                   |               | 4.65%                 |               |

(1) These interest rates are calculated based on the year end indices.

(2) Fair value of debt instruments was estimated based on the interest rates applicable to similar debt instruments as of December 31, 2003 and 2002.

The following table provides information regarding the Group's material foreign currency sensitive financial instruments and capital commitments as of December 31, 2003 and 2002:

|                          | As of December 31, 2003 |       |       |       |       |            | As of December 31, 2002 |               |                       |               |
|--------------------------|-------------------------|-------|-------|-------|-------|------------|-------------------------|---------------|-----------------------|---------------|
|                          | Expected maturity date  |       |       |       |       |            |                         |               |                       |               |
|                          | 2004                    | 2005  | 2006  | 2007  | 2008  | Thereafter | Total recorded amount   | Fair value(2) | Total recorded amount | Fair value(2) |
| Debt                     |                         |       |       |       |       |            |                         |               |                       |               |
| Fixed-rate notes payable |                         |       |       |       |       |            |                         |               |                       |               |
| In US\$                  | 624                     | 645   | 402   | 370   | 217   | 369        | 2,627                   | 2,915         | 3,429                 | 3,793         |
| Average interest rate    | 6.81%                   | 6.78% | 6.78% | 6.78% | 6.78% | 6.79%      | 6.79%                   |               | 6.86%                 |               |

|                                  |       |       |       |       |        |        |       |       |
|----------------------------------|-------|-------|-------|-------|--------|--------|-------|-------|
| Variable-rate<br>notes payable   |       |       |       |       |        |        |       |       |
| In US\$                          | 5,867 |       | 229   | 2,276 | 8,372  | 8,372  | 2,254 | 2,254 |
| Average interest<br>rate         | 1.91% |       | 1.48% | 1.49% | 1.63%  |        | 2.10% |       |
| Capital<br>commitment<br>in US\$ | 4,585 | 6,030 |       |       | 10,615 | 10,615 | 5,876 | 5,876 |

- (1) These interest rates are calculated based on the year end indices.
- (2) Fair value of debt instruments was estimated based on the floating interest rates applicable to similar debt instruments as of December 31, 2002 and 2003.

**ITEM 12. DESCRIPTION OF SECURITIES OTHER THAN EQUITY SECURITIES.**

Not applicable.

**PART II**

**ITEM 13. DEFAULTS, DIVIDEND ARREARAGES AND DELINQUENCIES.**

None.

**ITEM 14. MATERIAL MODIFICATIONS TO THE RIGHTS OF SECURITY HOLDERS AND USE OF PROCEEDS.**

There were no material modifications affecting the rights of securities holders made during the fiscal year ended December 31, 2003.

**Use of Proceeds**

- (1) Effective date of the Securities Act registration statement for which the use of proceeds information is being disclosed:

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July 23, 1997.

SEC file number assigned to such registration statement: 333-7114.

(2) The offering commenced on July 23, 1997.

(3) The offering was not terminated prior to the sale of any securities registered under the registration statement.

(4) (i) The offering was not terminated prior to the sale of all securities registered under the registration statement.

(ii) Name of the managing underwriter:

Goldman Sachs (Asia) L.L.C. (global coordinator).

(iii) and (iv)

| <b>Title of each<br/>class of<br/>securities registered</b>                                       | <b>Amount<br/>registered(1)</b> | <b>Aggregate<br/>price of<br/>offering<br/>amount<br/>registered(2)</b> | <b>Amount<br/>sold(3)</b> | <b>Aggregate<br/>offering<br/>price of<br/>amount<br/>sold(4)</b> |
|---------------------------------------------------------------------------------------------------|---------------------------------|-------------------------------------------------------------------------|---------------------------|-------------------------------------------------------------------|
| Ordinary H Shares of par value<br>RMB 1.00 per share represented<br>by American Depositary Shares | 861,823,000 shares              | US\$528,469,864                                                         | 851,501,000 shares        | US\$522,140,413                                                   |

Notes:

(1) The amount does not include 322,677,000 H Shares (some of which in the form of ADSs) which have not been registered with the SEC, of which 290,477,000 H Shares were sold to certain corporate investors in Hong Kong as part of the global offering of the Company in July 1997 and 32,200,000 H Shares were sold to certain limited partnership investment funds affiliated with Goldman, Sachs & Co. in a private placement in June 1997 prior to the Company's global offering.

(2) Assumes that all H Shares were sold in the form of ADSs. The price to public for each ADS is US\$30.66. Each ADS represents 50 H Shares.

(3) The amount does not include 322,677,000 H Shares referred to in note (1) above.

(4) The amount does not include US\$197,865,536 which represents the proceeds from the sale of 322,677,000 H Shares referred to in note (1) above. If the latter amount is included, the aggregate amount of proceeds to the Company would be US\$720,005,950. In addition, the aggregate amount is calculated on the assumption that all H Shares were sold in the form of ADSs. Based on the actual sale of H Shares and ADSs, the aggregate amount of proceeds to the Company was US\$719,494,700. The issue price per H Share was HK\$4.70.

(v)

|                                        |                |
|----------------------------------------|----------------|
| Underwriting discounts and commissions | US\$36,593,000 |
| Finder's fees                          |                |
| Expenses paid to or for underwriters   | US\$2,958,000  |
| Other expenses                         | US\$21,411,000 |
| Total expenses                         | US\$60,962,000 |

Note: No direct or indirect payments were made to directors, officers, general partners of the Company or their associates, or to persons owning ten percent or more of any class of equity securities of the Company, or to affiliates of the Company. All payments were made to third parties.

(vi) Net offering proceeds to the Company after deducting the total expenses in item (4)(v) above:

US\$658,532,700

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Note: The amount is calculated on the basis of the actual aggregate amount of proceeds to the Company, and includes the proceeds from the sale of 322,677,000 H Shares referred to in note (1) of item (4)(iv) above.

(vii) As of December 31, 2003, the net offering proceeds to the Company was used up as follows:

|                                                      |                   |
|------------------------------------------------------|-------------------|
| Construction of plant, building and facilities       | US\$41.9 million  |
| Purchase and installation of machinery and equipment | US\$394.6 million |
| Purchase of real estate                              |                   |
| Acquisition of other business(es)                    |                   |
| Repayment of indebtedness                            | US\$192.4 million |
| Working Capital                                      | US\$29.6 million  |

Note: No direct or indirect payments were made to directors, officers, general partners of the Company or their associates, or to persons owning ten percent or more of any class of equity securities of the Company, or to affiliates of the Company. All payments were made to third parties.

(viii) The uses of proceeds do not represent a material change in the use of proceeds described in the prospectus.

### **PART III**

## **ITEM 15. CONTROLS AND PROCEDURES**

Our president and chief financial officer have evaluated the effectiveness of our disclosure controls and procedures (as defined in the Exchange Act Rules 13a-15(e) or 15d-15(e), and concluded that, based on their evaluation, our disclosure controls and procedures are effective as of the end of the period covered by this Annual Report to ensure that material information required to be included in this Annual Report would be made known to them by others on a timely basis.

There has been no significant change in our internal controls or in other factors that could significantly affect these controls subsequent to the Evaluation Date.

## **ITEM 16.**

### **ITEM 16A. AUDIT COMMITTEE FINANCIAL EXPERT**

The Board of Directors has determined that Mr. Wei Ming Hai qualifies as an audit committee financial expert in accordance with the terms of Item 16.A of Form 20-F. See Item 6 Directors, Senior Management and Employees Directors and Senior Management

### **ITEM 16B. CODE OF ETHICS**

As of the date of this Annual Report, the Company does not have, in form, a code of ethics that applies to the president, chief financial officer and principal accounting officer, or collectively, the senior corporate officers. The senior executive officers, all of whom currently serve as our directors, are subject to the director service contracts that they have with the Company. Under the director service contracts, the directors, including the senior corporate officers, agree that each director owes a fiduciary and diligence obligation to the Company and that no such director shall engage in any activities in competition with the Company's business or carry any activities detrimental to the interests of the Company. Each of the directors, including the senior corporate officers, also agreed to perform their respective duties as directors and senior officers in accordance with the Company Law of the PRC, relevant rules and regulations promulgated by China Securities Regulatory Commission and the Mandatory Provisions of Articles of Association of Overseas Listed Companies.

### **ITEM 16C. PRINCIPAL ACCOUNTING FEES AND SERVICES**

The following table sets forth the aggregate audit fees, audit-related fees, tax fees of the Company's principal accountants and all other fees billed for products and services provided by the Company's principal accountants other than the audit fees, audit-related fees and tax fees for each of the fiscal years 2002 and 2003:

|             | <b>Audit<br/>Fees</b> | <b>Audit-Related<br/>Fees</b> | <b>Tax Fees</b> | <b>Other Fees</b> |
|-------------|-----------------------|-------------------------------|-----------------|-------------------|
| <b>2002</b> | RMB8.2 million        | RMB4.1 million                | RMB0.14 million |                   |
| <b>2003</b> | RMB8.2 million        | RMB7.0 million                | RMB0.17 million | RMB1.1 million    |

*Audit-related fees*

Services provided primarily consist of the following:

- a) Review of the Group's 2003 interim financial report prepared under IFRS;
- b) Audits of the Group's financial statements prepared under PRC Accounting Rules and Regulations in connection with the Company's listing of its A shares in the PRC; and
- c) Audits of the financial statements of China Northern Airlines Company and Xinjiang Airlines Company in connection with the Company's proposed acquisition of these airlines.

*Tax fees*

Services provided primarily consist of tax compliance services.

*Others*

Services provided primarily consist of services to assist the Group in documenting its internal controls over financial reporting and provide observations and recommendations.

Before our principal accountants were engaged by the Company to render audit or non-audit services, the engagement has been approved by our audit committee.

**Exemptions from the Listing Standards for Audit Committee**

Not applicable.

**ITEM 16D. PURCHASES OF EQUITY SECURITIES BY THE ISSUER AND AFFILIATED PURCHASERS**

The Company and its affiliated companies have not purchased any issued common shares of the Company during 2003 and up to the date of this Annual Report.

**PART IV**

**ITEM 17. FINANCIAL STATEMENTS.**

Not applicable.

**ITEM 18. FINANCIAL STATEMENTS.**

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**ITEM 19. EXHIBITS.**

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| <b>Exhibit No.</b> | <b>Description of Exhibit</b>                                                                                                        |
|--------------------|--------------------------------------------------------------------------------------------------------------------------------------|
| 1                  | Articles of Association                                                                                                              |
| 4.1                | Form of Director's Service Agreement is incorporated by reference in Exhibit 4(c).1 of Form 20-F for the year of 2003.               |
| 4.2                | Form of Non-Executive Director's Service Agreement is incorporated by reference in Exhibit 4(c).2 of Form 20-F for the year of 2003. |
| 8                  | Subsidiaries of the Company                                                                                                          |
| 12.1               | Section 302 Certification of Chairman                                                                                                |
| 12.2               | Section 302 Certification of President                                                                                               |
| 12.3               | Section 302 Certification of Chief Financial Officer                                                                                 |
| 13.1               | Section 906 Certification of Chairman                                                                                                |
| 13.2               | Section 906 Certification of President                                                                                               |
| 13.3               | Section 906 Certification of Chief Financial Officer                                                                                 |

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**CHINA SOUTHERN AIRLINES COMPANY LIMITED  
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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

The Board of Directors and Shareholders of  
China Southern Airlines Company Limited:

We have audited the accompanying consolidated balance sheets of China Southern Airlines Company Limited and its subsidiaries as of December 31, 2002 and 2003, and the related consolidated statements of operations, cash flows and changes in shareholders' equity for each of the years in the three-year period ended December 31, 2003, all expressed in Renminbi. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the 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 Southern Airlines Company Limited and its subsidiaries as of December 31, 2002 and 2003, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2003 in conformity with International Financial Reporting Standards promulgated by the International Accounting Standards Board.

International Financial Reporting Standards vary in certain significant respects from accounting principles generally accepted in the United States of America. Information relating to the nature and effect of such differences is presented in Note 33 to the consolidated financial statements.

The accompanying consolidated financial statements as of and for the year ended December 31, 2003 have been translated into United States dollars solely for the convenience of the reader. We have audited the translation, and in our opinion, the consolidated financial statements expressed in Renminbi have been translated into United States dollars on the basis set forth in Note 1 to the consolidated financial statements.

**KPMG**  
Hong Kong  
April 23, 2004

**Table of Contents****CHINA SOUTHERN AIRLINES COMPANY LIMITED  
AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF OPERATIONS  
For the years ended December 31, 2001, 2002 and 2003****(Amounts in thousands, except per share data)**

|                                            | <b>Note</b> | <b>2001</b>       | <b>2002</b>       | <b>2003</b>       | <b>2003</b>         |
|--------------------------------------------|-------------|-------------------|-------------------|-------------------|---------------------|
|                                            |             | <b>RMB</b>        | <b>RMB</b>        | <b>RMB</b>        | <b>U.S. dollars</b> |
| Operating revenue:                         |             |                   |                   |                   |                     |
| Traffic revenue, net                       | 3           | 16,461,532        | 17,481,892        | 16,964,800        | 2,049,706           |
| Other revenue                              | 4           | 418,126           | 536,728           | 505,323           | 61,053              |
|                                            |             | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u>   |
| Total operating revenue                    |             | <u>16,879,658</u> | <u>18,018,620</u> | <u>17,470,123</u> | <u>2,110,759</u>    |
| Operating expenses:                        |             |                   |                   |                   |                     |
| Flight operations                          | 5           | 6,905,628         | 6,732,543         | 7,070,031         | 854,209             |
| Maintenance                                | 6           | 2,014,579         | 2,333,419         | 2,588,613         | 312,759             |
| Aircraft and traffic servicing             | 7           | 2,297,521         | 2,511,284         | 2,767,488         | 334,371             |
| Promotion and sales                        | 8           | 1,540,780         | 1,499,587         | 1,480,168         | 178,836             |
| General and administrative                 | 9           | 892,233           | 1,060,010         | 1,053,319         | 127,263             |
| Depreciation and amortization              |             | 1,814,974         | 1,839,871         | 2,037,971         | 246,230             |
| Other                                      |             | 13,270            | 15,829            | 16,804            | 2,029               |
|                                            |             | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u>   |
| Total operating expenses                   |             | <u>15,478,985</u> | <u>15,992,543</u> | <u>17,014,394</u> | <u>2,055,697</u>    |
| Operating income                           |             | <u>1,400,673</u>  | <u>2,026,077</u>  | <u>455,729</u>    | <u>55,062</u>       |
| Non-operating income/(expenses):           |             |                   |                   |                   |                     |
| Equity income of affiliated companies      |             | 53,077            | 36,988            | 47,798            | 5,775               |
| Equity loss of jointly controlled entities |             | (4,034)           | (3,352)           | (39,495)          | (4,772)             |
| (Loss)/gain on sale of fixed assets        | 13, 24      | (55,889)          | 170,740           | (22,217)          | (2,684)             |
| Interest income                            |             | 49,878            | 52,618            | 13,061            | 1,578               |
| Interest expense                           | 16          | (933,717)         | (959,193)         | (823,725)         | (99,523)            |
| Exchange gain/(loss), net                  |             | 296,777           | (175,451)         | (164,443)         | (19,868)            |
| Other, net                                 |             | (11,509)          | (9,328)           | 21,682            | 2,619               |
|                                            |             | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u>   |
| Total non-operating expenses               |             | <u>(605,417)</u>  | <u>(886,978)</u>  | <u>(967,339)</u>  | <u>(116,875)</u>    |

|                                                      |      |                   |                   |                   |                   |
|------------------------------------------------------|------|-------------------|-------------------|-------------------|-------------------|
| Income/(loss) before taxation and minority interests |      | 795,256           | 1,139,099         | (511,610)         | (61,813)          |
| Taxation (expense)/credit                            | 10   | (320,519)         | (398,227)         | 324,277           | 39,179            |
|                                                      |      | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |
| Income/(loss) before minority interests              |      | 474,737           | 740,872           | (187,333)         | (22,634)          |
| Minority interests                                   |      | (134,512)         | (165,111)         | (170,934)         | (20,652)          |
|                                                      |      | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |
| Net income/(loss)                                    |      | <u>340,225</u>    | <u>575,761</u>    | <u>(358,267)</u>  | <u>(43,286)</u>   |
| Basic earnings/(loss) per share                      | 2(w) | <u>0.10</u>       | <u>0.17</u>       | <u>(0.09)</u>     | <u>(0.01)</u>     |

See accompanying notes to consolidated financial statements

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**CHINA SOUTHERN AIRLINES COMPANY LIMITED  
AND SUBSIDIARIES**

**CONSOLIDATED BALANCE SHEETS  
As of December 31, 2002 and 2003**

(Amounts in thousands)

|                                                                          | Note | 2002       | 2003       | 2003         |
|--------------------------------------------------------------------------|------|------------|------------|--------------|
|                                                                          |      | RMB        | RMB        | U.S. dollars |
| <b>ASSETS</b>                                                            |      |            |            |              |
| <b>CURRENT ASSETS</b>                                                    |      |            |            |              |
| Cash and cash equivalents                                                | 11   | 3,771,043  | 2,080,174  | 251,329      |
| Trade receivables                                                        | 12   | 671,776    | 833,604    | 100,717      |
| Other receivables                                                        |      | 372,586    | 296,047    | 35,769       |
| Inventories                                                              |      | 545,700    | 543,777    | 65,700       |
| Prepaid expenses and other current assets                                |      | 244,690    | 247,926    | 29,954       |
|                                                                          |      | <hr/>      | <hr/>      | <hr/>        |
| <b>TOTAL CURRENT ASSETS</b>                                              |      | 5,605,795  | 4,001,528  | 483,469      |
| <b>FIXED ASSETS</b>                                                      | 13   | 26,920,829 | 28,535,907 | 3,447,739    |
| <b>CONSTRUCTION IN PROGRESS</b>                                          | 14   | 661,352    | 1,629,689  | 196,901      |
| <b>LEASE PREPAYMENTS</b>                                                 |      | 201,854    | 348,652    | 42,124       |
| <b>INVESTMENTS</b>                                                       | 15   | 1,355,842  | 1,358,495  | 164,135      |
| <b>LEASE AND EQUIPMENT DEPOSITS</b>                                      |      | 2,147,038  | 2,932,591  | 354,319      |
| <b>OTHER ASSETS</b>                                                      |      | 295,337    | 255,233    | 30,838       |
|                                                                          |      | <hr/>      | <hr/>      | <hr/>        |
| <b>TOTAL ASSETS</b>                                                      |      | 37,188,047 | 39,062,095 | 4,719,525    |
|                                                                          |      | <hr/>      | <hr/>      | <hr/>        |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>                              |      |            |            |              |
| <b>CURRENT LIABILITIES</b>                                               |      |            |            |              |
| Notes payable, including current installments of long-term notes payable | 16   | 5,240,726  | 7,096,846  | 857,449      |
| Current installments of obligations under capital leases                 | 17   | 1,566,698  | 1,297,855  | 156,808      |
| Accounts payable                                                         |      | 532,480    | 928,093    | 112,133      |
| Bills payable                                                            |      | 1,299,680  | 438,135    | 52,936       |
| Sales in advance of carriage                                             |      | 390,531    | 466,087    | 56,313       |
| Taxes payable                                                            |      | 78,145     | 89,954     | 10,868       |
| Amounts due to related companies                                         |      | 525,090    | 929,003    | 112,243      |
| Accrued expenses                                                         | 18   | 2,341,454  | 2,527,794  | 305,411      |
| Other liabilities                                                        |      | 646,989    | 1,019,811  | 123,215      |
|                                                                          |      | <hr/>      | <hr/>      | <hr/>        |
| <b>TOTAL CURRENT LIABILITIES</b>                                         |      | 12,621,793 | 14,793,578 | 1,787,376    |

|                                                                     |       |                   |                   |                   |
|---------------------------------------------------------------------|-------|-------------------|-------------------|-------------------|
| NOTES PAYABLE, EXCLUDING CURRENT<br>INSTALLMENTS                    | 16    | 5,835,434         | 4,521,735         | 546,321           |
| OBLIGATIONS UNDER CAPITAL LEASES,<br>EXCLUDING CURRENT INSTALLMENTS | 17    | 6,631,751         | 5,543,084         | 669,722           |
| PROVISION FOR MAJOR OVERHAULS                                       | 6     | 141,887           | 189,464           | 22,891            |
| DEFERRED CREDITS                                                    | 19    | 48,095            | 46,554            | 5,625             |
| DEFERRED TAXATION                                                   | 20    | 779,234           | 398,305           | 48,124            |
|                                                                     |       | <u>          </u> | <u>          </u> | <u>          </u> |
| TOTAL LIABILITIES                                                   |       | 26,058,194        | 25,492,720        | 3,080,059         |
| MINORITY INTERESTS                                                  |       | 1,516,646         | 1,673,668         | 202,214           |
| SHAREHOLDERS' EQUITY                                                | 21,22 | 9,613,207         | 11,895,707        | 1,437,252         |
|                                                                     |       | <u>          </u> | <u>          </u> | <u>          </u> |
| TOTAL LIABILITIES AND SHAREHOLDERS<br>EQUITY                        |       | 37,188,047        | 39,062,095        | 4,719,525         |
|                                                                     |       | <u>          </u> | <u>          </u> | <u>          </u> |

See accompanying notes to consolidated financial statements.

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**CHINA SOUTHERN AIRLINES COMPANY LIMITED  
AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF CASH FLOWS  
For the years ended December 31, 2001, 2002 and 2003**

(Amounts in thousands)

|                                                                                  | Note  | 2001               | 2002               | 2003               | 2003             |
|----------------------------------------------------------------------------------|-------|--------------------|--------------------|--------------------|------------------|
|                                                                                  |       | RMB                | RMB                | RMB                | U.S. dollars     |
| Cash inflows from operations                                                     | 28(a) | 3,185,523          | 4,762,923          | 3,074,718          | 371,491          |
| Interest received                                                                |       | 49,878             | 52,618             | 13,061             | 1,578            |
| Interest paid                                                                    |       | (970,734)          | (1,051,027)        | (923,901)          | (111,627)        |
| Income tax paid                                                                  |       | (40,724)           | (66,970)           | (35,129)           | (4,244)          |
|                                                                                  |       | <u>2,223,943</u>   | <u>3,697,544</u>   | <u>2,128,749</u>   | <u>257,198</u>   |
| Net cash inflows from operating activities                                       |       |                    |                    |                    |                  |
| Investing activities:                                                            |       |                    |                    |                    |                  |
| Proceeds from sale of aircraft                                                   |       | 566,493            | 778,047            | 29,275             | 3,537            |
| Proceeds from sale of other fixed assets                                         |       | 38,892             | 47,150             | 27,802             | 3,359            |
| Proceeds from sale of investments in equity securities                           |       |                    | 68                 |                    |                  |
| Dividends received from affiliated companies                                     |       | 5,946              | 3,093              |                    |                  |
| (Increase)/decrease in other assets                                              |       | (345)              | (943)              | 5,654              | 683              |
| Payment of lease and equipment deposits                                          |       | (2,027,063)        | (1,999,233)        | (1,851,726)        | (223,727)        |
| Refund of lease and equipment deposits                                           |       | 200,029            | 2,117,386          | 1,066,086          | 128,806          |
| Capital expenditures                                                             |       | (1,492,126)        | (6,351,030)        | (4,706,740)        | (568,674)        |
| Purchase of investments in equity securities                                     |       | (1,241)            | (6,721)            | (1,065)            | (129)            |
| Investments in affiliated companies                                              |       | (147,875)          | (136,500)          |                    |                  |
| Investments in jointly controlled entities                                       |       | (178,372)          | (295,670)          | (2,999)            | (362)            |
| Governmental subsidy for safety related capital expenditures                     |       |                    | 40,240             |                    |                  |
| Effect of acquisition of subsidiaries, net of cash and cash equivalents acquired | 28(c) |                    | (90,491)           |                    |                  |
|                                                                                  |       | <u>(3,035,662)</u> | <u>(5,894,604)</u> | <u>(5,433,713)</u> | <u>(656,507)</u> |
| Net cash used in investing activities                                            |       |                    |                    |                    |                  |
| Net cash outflows before financing activities                                    |       | <u>(811,719)</u>   | <u>(2,197,060)</u> | <u>(3,304,964)</u> | <u>(399,309)</u> |

Financing activities:

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|                                                        |                   |                   |                   |                   |
|--------------------------------------------------------|-------------------|-------------------|-------------------|-------------------|
| Proceeds from A share issue, net of issuance costs     |                   |                   | 2,640,767         | 319,060           |
| Proceeds from bank notes payable                       | 2,123,613         | 6,996,780         | 8,913,992         | 1,076,998         |
| Repayment of bank notes payable                        | (890,228)         | (2,194,630)       | (8,371,362)       | (1,011,437)       |
| Repayment of principal under capital lease obligations | (1,756,098)       | (1,546,185)       | (1,555,390)       | (187,924)         |
| Minority shareholders' contributions                   | 707               | 10,625            | 1,050             | 127               |
| Dividends paid to shareholders                         |                   | (67,484)          |                   |                   |
| Dividends paid to minority shareholders                | (45,867)          | (48,866)          | (14,962)          | (1,807)           |
|                                                        | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |
| Net cash (outflows)/inflows from financing activities  | (567,873)         | 3,150,240         | 1,614,095         | 195,017           |
|                                                        | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |
| (Decrease)/increase in cash and cash equivalents       | (1,379,592)       | 953,180           | (1,690,869)       | (204,292)         |
| Cash and cash equivalents at beginning of year         | 4,197,455         | 2,817,863         | 3,771,043         | 455,621           |
|                                                        | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |
| Cash and cash equivalents at end of year               | 2,817,863         | 3,771,043         | 2,080,174         | 251,329           |
|                                                        | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |

See accompanying notes to consolidated financial statements.

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**CHINA SOUTHERN AIRLINES COMPANY LIMITED  
AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY  
For the years ended December 31, 2001, 2002 and 2003**

(Amounts in thousands)

|                                                             | Note  | Share<br>capital | Share<br>premium | Other<br>reserves | Retained<br>profits | Total      |
|-------------------------------------------------------------|-------|------------------|------------------|-------------------|---------------------|------------|
|                                                             |       | RMB              | RMB              | RMB               | RMB                 | RMB        |
| Shareholders' equity at January 1, 2001                     |       | 3,374,178        | 3,813,659        | 664,945           | 1,028,656           | 8,881,438  |
| Net income                                                  |       |                  |                  |                   | 340,225             | 340,225    |
| Appropriations to reserves                                  |       |                  |                  | 22,229            | (22,229)            |            |
|                                                             |       |                  |                  |                   |                     |            |
| Shareholders' equity at December 31, 2001                   |       | 3,374,178        | 3,813,659        | 687,174           | 1,346,652           | 9,221,663  |
| Land use rights adjustment                                  | 22(f) |                  | (129,703)        |                   | 12,970              | (116,733)  |
| Adjustments from adoption of new PRC accounting regulations | 22(c) |                  |                  | (185,540)         | 185,540             |            |
| Dividend paid                                               |       |                  |                  |                   | (67,484)            | (67,484)   |
| Net income                                                  |       |                  |                  |                   | 575,761             | 575,761    |
| Appropriations to reserves                                  |       |                  |                  | 83,738            | (83,738)            |            |
|                                                             |       |                  |                  |                   |                     |            |
| Shareholders' equity at December 31, 2002                   |       | 3,374,178        | 3,683,956        | 585,372           | 1,969,701           | 9,613,207  |
| Issue of A shares                                           | 21    | 1,000,000        | 1,640,767        |                   |                     | 2,640,767  |
| Net loss                                                    |       |                  |                  |                   | (358,267)           | (358,267)  |
| Appropriations to reserves                                  |       |                  |                  | 24,969            | (24,969)            |            |
|                                                             |       |                  |                  |                   |                     |            |
| Shareholders' equity at December 31, 2003                   |       | 4,374,178        | 5,324,723        | 610,341           | 1,586,465           | 11,895,707 |
|                                                             |       |                  |                  |                   |                     |            |
| Shareholders' equity at December 31, 2003 in U.S. dollars   |       | 528,493          | 643,339          | 73,741            | 191,679             | 1,437,252  |

See accompanying notes to consolidated financial statements.



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**CHINA SOUTHERN AIRLINES COMPANY LIMITED  
AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Amounts in thousands, except share data)**

**1. BASIS OF PRESENTATION**

China Southern Airlines Company Limited (the "Company") and its subsidiary companies (hereinafter collectively referred to as the "Group") are principally engaged in the provision of domestic, Hong Kong regional and international passenger, and cargo and mail airline services, with flights operating primarily from the Guangzhou Baiyun International Airport, which is both the main hub of the Group's route network and the location of its corporate headquarters.

The Company was established in the People's Republic of China (the "PRC", "China" or the "State") on March 25, 1995 as a joint stock limited company as part of the Reorganization (the "Reorganization") of the Company's holding company, China Southern Air Holding Company ("CSAHC"). CSAHC is a state-owned enterprise under the supervision of the PRC central government.

The Company's H Shares and American Depositary Shares ("ADS") (each ADS representing 50 H Shares) are listed on the Stock Exchange of Hong Kong Limited and the New York Stock Exchange, respectively, since July 1997. In July 2003, the Company issued 1,000,000,000 A shares which are listed on the Shanghai Stock Exchange.

The consolidated financial statements have been prepared in Renminbi ("RMB"), the national currency of China. Solely for the convenience of the reader, the 2003 financial statements have been translated into United States dollars at the rate of US\$ 1.00 = RMB 8.2767, the rate quoted by the People's Bank of China on December 31, 2003. No representation is made that the RMB amounts could have been, or could be, converted into United States dollars ("US\$") at that rate or at any other certain rate on December 31, 2003 or at any other certain date.

**2. PRINCIPAL ACCOUNTING POLICIES**

**(a) Statement of compliance**

The consolidated financial statements of the Group have been prepared in accordance with International Financial Reporting Standards ("IFRS") promulgated by the International Accounting Standards Board. IFRS includes International Accounting Standards ("IAS") and related interpretations.

Information relating to the nature and effect of the significant differences between IFRS and accounting principles generally accepted in the United States of America ("U.S. GAAP") are set forth in Note 33.

**(b) Basis of preparation**

The consolidated financial statements of the Group are prepared on the historical cost basis as modified by the revaluation of certain fixed assets (Note 13). The accounting policies have been consistently applied by the Group and except for a change in accounting policy for land use rights in 2002 (Note 22(f)), are consistent with those used in previous years.

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**CHINA SOUTHERN AIRLINES COMPANY LIMITED  
AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (Continued)**  
**(Amounts in thousands, except share data)**

**(c) Basis of consolidation**

The consolidated financial statements include the financial statements of the Company and all of its subsidiaries (see Note 29 for details of the Company's principal subsidiaries) made up to December 31, each year. Subsidiaries are those enterprises controlled by the Group. Control exists when the Group has the power, directly or indirectly, to govern the financial and operating policies of an enterprise so as to obtain benefits from its activities. The financial statements of subsidiaries are included in the consolidated financial statements from the date that control effectively commences until the date that control effectively ceases.

The results of subsidiary companies are included in the consolidated statements of operations, and the share attributable to minority shareholders is deducted from or added to the consolidated income after taxation. Losses attributable to minority shareholders of partly owned subsidiaries are accounted for based on the respective equity owned by the minority shareholders up to the amount of the capital contribution and reserves attributable to the minority shareholders. Thereafter, all further losses are assumed by the Company.

All significant intercompany balances and transactions have been eliminated on consolidation.

**(d) Interest-bearing borrowings**

Interest-bearing borrowings are recognized initially at cost, less attributable transaction costs. Subsequent to initial recognition, interest-bearing borrowings are stated at amortized cost with any difference between cost and redemption value being recognized in the consolidated statements of operations over the period of the borrowings on an effective interest basis.

**(e) Cash and cash equivalents**

Cash and cash equivalents consist of cash in hand and balances with banks and other financial institutions with an original maturity within three months. For the purposes of the consolidated statements of cash flows, the Group considers all highly liquid debt instruments purchased with an original maturity of three months or less to be cash equivalents. None of the Group's cash and cash equivalents is restricted as to withdrawal.

**(f) Trade and other receivables**

Trade and other receivables are stated at cost less allowance for doubtful accounts. Allowance for doubtful accounts are established based on evaluation of the recoverability of these accounts at the balance sheet date. In establishing such allowance, the Group considers various factors including its historical write-off experience and industry economic trend. Past due balances over a specific period and balances over a specific amount are reviewed individually for collectibility. All other balances are reviewed on a pooled basis.

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**CHINA SOUTHERN AIRLINES COMPANY LIMITED  
AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (Continued)**  
**(Amounts in thousands, except share data)**

**(g) Inventories**

Inventories, which consist primarily of expendable spare parts and supplies, are stated at cost less any applicable provision for obsolescence, and are expensed when used in operations. Cost represents the average unit cost. Inventories held for disposal is stated at the lower of cost and net realizable value. Net realizable value represents estimated resale price.

**(h) Fixed assets and depreciation**

Fixed assets are stated at cost or revalued amounts less accumulated depreciation and impairment losses (refer to accounting policy n). Revaluations are performed periodically to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet date.

Depreciation is provided to write off the costs, or revalued amounts where appropriate, of the fixed assets on a straight line basis over their estimated useful lives, to residual values, as follows:

|                                      | <b>Depreciable life</b> | <b>Residual value</b> |
|--------------------------------------|-------------------------|-----------------------|
| Buildings                            | 15 to 40 years          | Nil                   |
| Owned and leased aircraft            | 8 to 15 years           | 28.75%                |
| Other flight equipment               |                         |                       |
| - Jet engines                        | 8 to 15 years           | 3%                    |
| - Others, including rotatable spares | 8 to 15 years           | Nil                   |
| Machinery and equipment              | 5 to 10 years           | 3%                    |
| Vehicles                             | 6 years                 | 3%                    |

No depreciation is provided in respect of construction in progress.

**(i) Leased assets**

Flight equipment under capital leases is stated at an amount equal to lower of its fair value and the present value of minimum lease payments at inception of the lease, and is amortized on a straight line basis over the shorter of the lease term or estimated useful life of the asset to residual values. In cases where title to the asset will be acquired by the Group at the end of the lease, the asset is amortized on a straight line basis over the estimated useful life of the asset to its residual value.

Amounts payable in respect of capital leases are apportioned between interest charges and reductions of obligations based on the interest rates implicit in the leases. Interest charges are included in the consolidated statements of operations to provide a constant periodic rate of charge over the lease term.



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**CHINA SOUTHERN AIRLINES COMPANY LIMITED  
AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (Continued)**  
**(Amounts in thousands, except share data)**

Gains on aircraft sale and leaseback transactions which result in capital leases are deferred and amortized over the terms of the related leases. Gains on other aircraft sale and leaseback transactions are recognized as income immediately if the transactions are established at fair value. Any excess of the sales price over fair value is deferred and amortized over the period the assets are expected to be used.

Operating lease payments are charged to the consolidated statements of operations on a straight line basis over the terms of the related leases.

**(j) Construction in progress**

Construction in progress represents office buildings, various infrastructure projects under construction and equipment pending installation, and is stated at cost. Cost comprises direct costs of construction as well as interest charges during the periods of construction and installation. Capitalization of these costs ceases and the construction in progress is transferred to fixed assets when the asset is substantially ready for its intended use, notwithstanding any delays in the issue of the relevant commissioning certificates by the relevant PRC authorities.

**(k) Lease prepayments**

Lease prepayments represent the purchase costs of land use rights and are amortized on a straight line basis over the period of land use rights (Note 22(f)).

**(l) Investments**

An affiliated company is an entity in which the Group has significant influence, but not control or joint control, over its management, including participating in the financial and operating policy decisions.

A jointly controlled entity is an entity over whose activities the Group has joint control, established by contractual agreement.

The consolidated statements of operations include the Group's share of the results of its affiliated companies and jointly controlled entities for the year. In the consolidated balance sheets, the investments in affiliated companies and jointly controlled entities are stated at the Group's attributable share of net assets. When the Group's share of losses exceeds the carrying amount of the affiliated company or jointly controlled entity, the carrying amount is reduced to nil and recognition of further losses is discontinued except to the extent that the Group has incurred obligations in respect of the affiliated company or jointly controlled entity.

Other investments are stated at cost less impairment losses (refer to accounting policy n). Other investments represent unquoted available-for-sale equity securities of companies established in the PRC. There is no quoted market price for such equity securities and accordingly a reasonable estimate of the fair value could not be made without incurring excessive costs.

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**CHINA SOUTHERN AIRLINES COMPANY LIMITED  
AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (Continued)**  
**(Amounts in thousands, except share data)**

**(m) Deferred expenditure**

Custom duties and other direct costs in relation to modifying, introducing and certifying certain operating leased aircraft are deferred and amortized over the terms of the related leases.

Lump sum housing benefits payable to employees of the Group are deferred and amortized on a straight line basis over a period of 10 years, which represents the vesting benefit period of the employees.

**(n) Impairment loss**

The carrying amounts of the Group's assets, other than inventories (refer to accounting policy g) and deferred tax assets (refer to accounting policy u) are reviewed periodically in order to assess whether the recoverable amounts have declined below the carrying amounts. These assets are tested for impairment whenever events or changes in circumstances indicate that their recorded carrying amounts may not be recoverable. When such a decline has occurred, the carrying amount is reduced to the recoverable amount. The recoverable amount is the greater of the net selling price and the value in use. In determining the value in use, expected future cash flows generated by the asset are discounted to their present value. The amount of the reduction is recognized as an expense in the consolidated statements of operations.

The Group assesses at each balance sheet date whether there is any indication that an impairment loss recognized for an asset in prior years may no longer exist. An impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount. A subsequent increase in the recoverable amount of an asset, when the circumstances and events that led to the write-down or write-off cease to exist, is recognized as income. The reversal is reduced by the amount that would have been recognized as depreciation had the write-down or write-off not occurred.

**(o) Deferred credits**

In connection with the acquisition or operating lease of certain aircraft and engines, the Group receives various credits. Such credits are deferred until the aircraft and engines are delivered, at which time they are either applied as a reduction of the cost of acquiring the aircraft and engines, resulting in a reduction of future depreciation, or amortized as a reduction of rental expense for aircraft and engines under operating leases.

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**CHINA SOUTHERN AIRLINES COMPANY LIMITED  
AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (Continued)**  
**(Amounts in thousands, except share data)**

**(p) Revenue recognition**

Passenger, cargo and mail revenues are recognized when the transportation is provided. Ticket sales for transportation not yet provided are included in current liabilities of the consolidated balance sheets as sales in advance of carriage. Revenue from airline-related business is recognized when services are rendered. Revenue is stated net of sales tax and contributions to the Civil Aviation Administration of China ( CAAC ) Infrastructure Development Fund.

Interest income is recognized as it accrues unless collectibility is in doubt. Dividend income is recognized when the Group's right to receive payment is established.

Operating lease income is recognized on a straight line basis over the terms of the respective leases.

**(q) Traffic commissions**

Traffic commissions are expensed when the transportation is provided and the related revenue is recognized. Traffic commissions for transportation not yet provided are recorded in the consolidated balance sheets as a prepaid expense.

**(r) Maintenance and overhaul costs**

Routine maintenance and repairs, and overhauls in respect of owned aircraft and aircraft held under capital leases are expensed in the consolidated statements of operations as and when incurred. In respect of aircraft held under operating leases, a provision is made over the lease term for the estimated cost of scheduled overhauls required to be performed on the related aircraft prior to their return to the lessors.

**(s) Translation of foreign currencies**

Foreign currency transactions during the year are translated into Renminbi at the applicable rates of exchange prevailing on the transaction dates.

Foreign currency monetary balances at the balance sheet date are translated into Renminbi at the exchange rates quoted by the People's Bank of China ruling at the balance sheet date. Exchange differences are dealt with in the consolidated statements of operations.

**(t) Borrowing costs**

Borrowing costs are expensed in the consolidated statements of operations as and when incurred, except to the extent that they are capitalized as being directly attributable to the acquisition or construction of an asset which necessarily takes a substantial period of time to get ready for its intended use.

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**(u) Deferred taxation**

Deferred tax is provided using the balance sheet liability method on all temporary differences between the carrying amounts for financial reporting purposes and the amounts used for taxation purposes, except differences relating to the initial recognition of assets or liabilities which affect neither accounting nor taxable profit/loss.

The tax value of losses expected to be available for utilization against future taxable income is recognized as a deferred tax asset and offset against the deferred tax liability attributable to the same legal tax unit and jurisdiction. Net deferred tax assets are reduced to the extent that it is no longer probable that the related tax benefit will be realized.

**(v) Retirement benefits**

Contributions to retirement schemes and additional retirement benefits paid to retired employees are charged to the consolidated statements of operations as and when incurred (Note 24).

**(w) Basic earnings/(loss) per share**

Basic earnings/(loss) per share for the years ended December 31, 2001, 2002 and 2003 have been computed by dividing net income/(loss) of RMB340,225, RMB575,761 and RMB(358,267), respectively, by the weighted average number of shares in issue of 3,374,178,000 in 2001 and 2002, and 3,831,712,000 in 2003, respectively.

The amount of diluted earnings/(loss) per share is not presented, as there were no dilutive potential ordinary shares in existence during the years ended December 31, 2001, 2002 and 2003.

**(x) Frequent flyer award programs**

The Group maintains two frequent flyer award programs, namely, the China Southern Airlines Sky Pearl Club and Egret Mileage Plus, which provide travel awards to members based on accumulated mileage. The estimated incremental cost to provide free travel is recognized as an expense and accrued as a current liability as members accumulate mileage. As members redeem awards or their entitlements expire, the incremental cost liability is reduced accordingly to reflect the acquittal of the outstanding obligations.

Revenue from mileage sales to third parties under the frequent flyer award programs is recognized when the related transportation services are provided.

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**(y) Provisions**

A provision is recognized in the consolidated balance sheets when the Group has a legal or constructive obligation as a result of a past event, and it is probable that an outflow of economic benefits will be required to settle the obligations. If the effect is material, provisions are determined by discounting the expected future cash flows at a pre-tax rate that reflects current market assessments of the time value of money and, where appropriate, the risks specific to the liability.

**(z) Related parties**

For the purposes of these consolidated financial statements, parties are considered to be related to the Group if the Group has the ability, directly or indirectly, to control the party or exercise significant influence over the party in making financial and operating decisions, or vice versa, or where the Group and the party are subject to common control or common significant influence. Related parties may be individuals or entities.

**(aa) Segmental reporting**

The Group operates principally as a single business segment for the provision of air transportation services. The analysis of operating revenue and operating income by geographical segment is based on the following criteria:

- (i) Traffic revenue from domestic services within the PRC (excluding Hong Kong) is attributed to the domestic operation. Traffic revenue from inbound/outbound services between the PRC and Hong Kong, and the PRC and overseas destinations is attributed to the Hong Kong regional operation and international operation, respectively.
- (ii) Other revenue from ticket selling, general aviation and ground services, air catering and other miscellaneous services is attributed on the basis of where the services are performed.

**(ab) Use of estimates**

The preparation of the consolidated financial statements of the Group in accordance with IFRS requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

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**3. TRAFFIC REVENUE**

Traffic revenue is stated net of sales tax and levies paid to PRC authorities and consists of:

|                | <b>Year ended December 31,</b> |                   |                   |
|----------------|--------------------------------|-------------------|-------------------|
|                | <b>2001</b>                    | <b>2002</b>       | <b>2003</b>       |
|                | <b>RMB</b>                     | <b>RMB</b>        | <b>RMB</b>        |
| Passenger      | 15,055,496                     | 15,695,622        | 15,009,885        |
| Cargo and mail | 1,406,036                      | 1,786,270         | 1,954,915         |
|                | <b>16,461,532</b>              | <b>17,481,892</b> | <b>16,964,800</b> |

Pursuant to various PRC revenue tax rules and regulations, the Group is required to pay sales tax to national and local tax authorities at the rate of approximately 3% of the ticket value in respect of flights originated in the PRC during the years ended December 31, 2001, 2002 and 2003, except for the period from May 1, 2003 to December 31, 2003 during which passenger revenue was exempted from sales tax. Sales tax incurred by the Group for the years ended December 31, 2001, 2002 and 2003 amounted to RMB535,473, RMB557,784 and RMB205,925, respectively.

In addition, the Group is required to pay contributions to the CAAC Infrastructure Development Fund which were calculated at the rates of 5% and 2%, respectively, of the domestic and international/Hong Kong regional traffic revenue during the years ended December 31, 2001, 2002 and 2003, except for the period from May 1, 2003 to December 31, 2003 during which the Group was exempted from paying the contributions. Contributions to the CAAC Infrastructure Development Fund payable by the Group for the years ended December 31, 2001, 2002 and 2003 totaled RMB759,385, RMB798,386 and RMB250,802, respectively.

Pursuant to approval documents issued by the CAAC, the Group imposes a fuel surcharge on passengers carried by its domestic and Hong Kong regional flights at certain prescribed rates on ticket fares. The fuel surcharge forms part of the traffic revenue of the Group. For the years ended December 31, 2001, 2002 and 2003, the fuel surcharge revenue totaled RMB1,001,000, RMB554,000 and RMB740,000, respectively.

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**4. OTHER OPERATING REVENUE**

|                                              | <b>Year ended December 31,</b> |                |                |
|----------------------------------------------|--------------------------------|----------------|----------------|
|                                              | <b>2001</b>                    | <b>2002</b>    | <b>2003</b>    |
|                                              | <b>RMB</b>                     | <b>RMB</b>     | <b>RMB</b>     |
| Commission income                            | 129,157                        | 137,928        | 140,180        |
| General aviation income                      | 61,292                         | 68,225         | 40,309         |
| Ground services income                       | 55,388                         | 78,616         | 99,130         |
| Air catering income                          | 29,523                         | 38,077         | 30,756         |
| Net income from lease arrangements (Note 13) |                                | 51,682         | 69,121         |
| Rental income                                |                                |                | 40,307         |
| Aircraft lease income                        | 65,486                         | 46,640         |                |
| Other                                        | 77,280                         | 115,560        | 85,520         |
|                                              | <b>418,126</b>                 | <b>536,728</b> | <b>505,323</b> |

**5. FLIGHT OPERATIONS EXPENSES**

|                                      | <b>Year ended December 31,</b> |                  |                  |
|--------------------------------------|--------------------------------|------------------|------------------|
|                                      | <b>2001</b>                    | <b>2002</b>      | <b>2003</b>      |
|                                      | <b>RMB</b>                     | <b>RMB</b>       | <b>RMB</b>       |
| Fuel costs                           | 3,548,860                      | 3,519,005        | 3,866,932        |
| Operating lease rentals              | 1,912,832                      | 1,416,524        | 1,536,466        |
| Air catering expenses                | 554,165                        | 625,489          | 509,839          |
| Aircraft insurance                   | 123,439                        | 256,238          | 195,700          |
| Flight personnel payroll and welfare | 657,193                        | 781,223          | 728,175          |
| Training expenses                    | 24,374                         | 38,908           | 123,438          |
| Other                                | 84,765                         | 95,156           | 109,481          |
|                                      | <b>6,905,628</b>               | <b>6,732,543</b> | <b>7,070,031</b> |



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**6. MAINTENANCE EXPENSES**

|                                   | <b>Year ended December 31,</b> |                  |                  |
|-----------------------------------|--------------------------------|------------------|------------------|
|                                   | <b>2001</b>                    | <b>2002</b>      | <b>2003</b>      |
|                                   | <b>RMB</b>                     | <b>RMB</b>       | <b>RMB</b>       |
| Repairing and maintenance charges | 1,558,331                      | 1,842,213        | 2,076,916        |
| Maintenance materials             | 286,505                        | 292,492          | 299,719          |
| Labor costs                       | 104,949                        | 130,254          | 139,355          |
| Other                             | 64,794                         | 68,460           | 72,623           |
|                                   | <b>2,014,579</b>               | <b>2,333,419</b> | <b>2,588,613</b> |

An analysis of provision for major overhauls in respect of aircraft held under operating leases is as follows:

|                              | <b>Year ended December 31,</b> |                |                |
|------------------------------|--------------------------------|----------------|----------------|
|                              | <b>2001</b>                    | <b>2002</b>    | <b>2003</b>    |
|                              | <b>RMB</b>                     | <b>RMB</b>     | <b>RMB</b>     |
| Balance at beginning of year | 241,895                        | 187,125        | 193,887        |
| Additional amount provided   | 12,889                         | 49,051         | 68,620         |
| Amount utilized              | (67,659)                       | (42,289)       | (62,326)       |
|                              | <b>187,125</b>                 | <b>193,887</b> | <b>200,181</b> |

Balance of provision for major overhauls at December 31, 2002 and 2003 consisted of:

| <b>December 31,</b> |
|---------------------|
| <b>2002</b>         |
| <b>2003</b>         |

|                                                          | <b>RMB</b>     | <b>RMB</b>     |
|----------------------------------------------------------|----------------|----------------|
| Current portion (included in accrued expenses) (Note 18) | 52,000         | 10,717         |
| Non-current portion                                      | 141,887        | 189,464        |
|                                                          | <u>193,887</u> | <u>200,181</u> |

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**7. AIRCRAFT AND TRAFFIC SERVICING EXPENSES**

|                             |  | Year ended December 31, |                  |                  |
|-----------------------------|--|-------------------------|------------------|------------------|
|                             |  | 2001                    | 2002             | 2003             |
|                             |  | RMB                     | RMB              | RMB              |
| Landing and navigation fees |  | 2,157,392               | 2,353,412        | 2,562,488        |
| Ground service charges      |  | 140,129                 | 157,872          | 205,000          |
|                             |  | <u>2,297,521</u>        | <u>2,511,284</u> | <u>2,767,488</u> |

**8. PROMOTION AND SALES EXPENSES**

|                               |  | Year ended December 31, |                  |                  |
|-------------------------------|--|-------------------------|------------------|------------------|
|                               |  | 2001                    | 2002             | 2003             |
|                               |  | RMB                     | RMB              | RMB              |
| Sales commissions             |  | 891,646                 | 749,953          | 757,423          |
| Ticket office expenses        |  | 440,445                 | 515,648          | 503,623          |
| Computer reservation services |  | 153,409                 | 174,547          | 175,197          |
| Advertising and promotion     |  | 26,434                  | 31,513           | 23,756           |
| Other                         |  | 28,846                  | 27,926           | 20,169           |
|                               |  | <u>1,540,780</u>        | <u>1,499,587</u> | <u>1,480,168</u> |

**9. GENERAL AND ADMINISTRATIVE EXPENSES**

|  |  | Year ended December 31, |      |      |
|--|--|-------------------------|------|------|
|  |  | 2001                    | 2002 | 2003 |

|                                           | <b>RMB</b>     | <b>RMB</b>       | <b>RMB</b>       |
|-------------------------------------------|----------------|------------------|------------------|
| General corporate expenses                | 557,083        | 658,833          | 680,141          |
| Salaries and welfare                      | 312,396        | 379,406          | 339,343          |
| Provision for doubtful accounts (Note 32) | 1,729          | 1,304            | 12,031           |
| Other taxes and levies                    | 21,025         | 20,467           | 21,804           |
|                                           | <u>892,233</u> | <u>1,060,010</u> | <u>1,053,319</u> |

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**10. TAXATION EXPENSE/(CREDIT)**

On October 17, 2003, the Company's registered address was moved to Guangzhou Economic & Technology Development Zone. In accordance with the Rules and Regulations for Implementation of Income Tax for Foreign Investment Enterprises and Foreign Enterprises of the PRC and a taxation approval document Guangzhou Municipal State Tax Bureau Suo De Shui Zi Que 020043, the Company is entitled to enjoy the preferential tax policy implemented in the Guangzhou Economic & Technology Development Zone effective October 1, 2003. As a result, the Company's income tax rate has been changed to 15% from 33% beginning from that date.

As a result of the reduction in income tax rate, the Company's net deferred taxation liability balance brought forward from December 31, 2002 of RMB507,077 was reduced by RMB392,137 and a net deferred tax credit of RMB392,137 was recognized for such reduction in income tax rate in the consolidated statement of operations for the year ended December 31, 2003.

In respect of the Group's overseas airline activities, the Group has either obtained exemptions from overseas taxation pursuant to the bilateral aviation agreements between the overseas governments and PRC governments, or has sustained tax losses in these overseas jurisdictions. Accordingly, no provision for overseas tax has been made for the years ended December 31, 2001, 2002 and 2003.

Taxation expense/(credit) consisted of:

|                                            | <b>Year ended December 31,</b> |             |             |
|--------------------------------------------|--------------------------------|-------------|-------------|
|                                            | <b>2001</b>                    | <b>2002</b> | <b>2003</b> |
|                                            | <b>RMB</b>                     | <b>RMB</b>  | <b>RMB</b>  |
| Provision for PRC income tax:              |                                |             |             |
| Company and subsidiaries                   | 37,032                         | 71,651      | 46,938      |
| Affiliated companies                       | 8,085                          | 9,424       | 3,342       |
| Jointly controlled entities                |                                |             | 6,372       |
|                                            | <hr/>                          | <hr/>       | <hr/>       |
|                                            | 45,117                         | 81,075      | 56,652      |
| Deferred taxation (Note 20)                |                                |             |             |
| - current year                             | 275,402                        | 317,152     | 11,208      |
| - adjustment for change in income tax rate |                                |             | (392,137)   |
|                                            | <hr/>                          | <hr/>       | <hr/>       |
|                                            | 320,519                        | 398,227     | (324,277)   |
|                                            | <hr/>                          | <hr/>       | <hr/>       |



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Actual taxation amount in the consolidated statements of operations for the years ended December 31, 2001, 2002 and 2003 differed from the amounts computed by applying the PRC income tax rate of 33%, 33% and 15%, respectively, to income/(loss) before taxation and minority interests as a result of the following:

|                                                                 | <b>Year ended December 31,</b> |                |                  |
|-----------------------------------------------------------------|--------------------------------|----------------|------------------|
|                                                                 | <b>2001</b>                    | <b>2002</b>    | <b>2003</b>      |
|                                                                 | <b>RMB</b>                     | <b>RMB</b>     | <b>RMB</b>       |
| Expected PRC taxation expense/(credit)                          | 262,434                        | 375,903        | (76,742)         |
| Adjustments:                                                    |                                |                |                  |
| Gains on sale and leaseback transactions and their amortization | (5,075)                        | (851)          |                  |
| Effect on change in income tax rate on deferred taxation        |                                |                | (392,137)        |
| Rate differential on subsidiaries                               | (51,245)                       | (60,530)       | 5,140            |
| Non-deductible expenses                                         | 154,152                        | 61,454         | 79,907           |
| Unrecognized tax losses                                         |                                |                | 21,894           |
| Expired tax losses                                              |                                |                | 34,218           |
| Other, net                                                      | (39,747)                       | 22,251         | 3,443            |
|                                                                 | <b>320,519</b>                 | <b>398,227</b> | <b>(324,277)</b> |

In accordance with relevant PRC tax regulations, a PRC lessee is liable to pay PRC withholding tax in respect of any lease payments regularly made to an overseas lessor. Depending on the circumstances, this tax is generally imposed at a fixed rate ranging from 10% to 20% of the lease payments, or in certain cases, the interest components of such payments. Pursuant to an approval document from the State Taxation Bureau, lease arrangements executed prior to September 1, 1999 are exempted from PRC withholding tax.

The PRC withholding tax payable in respect of the operating leases executed after September 1, 1999 of RMB11,962, RMB14,305 and RMB7,706, respectively, during 2001, 2002 and 2003 has been included as part of the operating lease rentals.

## **11. CASH AND CASH EQUIVALENTS**

As of December 31, 2002 and 2003, cash and cash equivalents comprise cash at bank and in hand and deposits with Southern Airlines Group Finance Company Limited ( SA Finance ), a PRC authorized financial institution controlled by CSAHC and an affiliated company of the Group. In accordance with the financial agreement dated

May 22, 1997 between the Company and SA Finance, all the Group's deposits accepted by SA Finance as of December 31, 2002 and 2003 were simultaneously placed with several designated major PRC banks by SA Finance. As of December 31, 2002 and 2003, the Group's deposits with SA Finance totaled RMB900,979 and RMB365,906, respectively (Note 25).

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**12. TRADE RECEIVABLES**

|                                                 | <b>December 31,</b> |                |
|-------------------------------------------------|---------------------|----------------|
|                                                 | <b>2002</b>         | <b>2003</b>    |
|                                                 | <b>RMB</b>          | <b>RMB</b>     |
| Trade receivables, principally traffic          | 731,894             | 903,601        |
| Less: Allowance for doubtful accounts (Note 32) | 60,118              | 69,997         |
|                                                 | <b>671,776</b>      | <b>833,604</b> |

**13. FIXED ASSETS**

|                                                 | <b>December 31,</b> |                   |
|-------------------------------------------------|---------------------|-------------------|
|                                                 | <b>2002</b>         | <b>2003</b>       |
|                                                 | <b>RMB</b>          | <b>RMB</b>        |
| Buildings                                       | 3,160,073           | 3,287,593         |
| Aircraft                                        | 24,970,695          | 27,684,935        |
| Flight equipment, including rotatable spares    | 6,283,470           | 6,842,064         |
| Machinery, equipment and vehicles               | 1,782,400           | 1,930,273         |
|                                                 | <b>36,196,638</b>   | <b>39,744,865</b> |
| Less: Accumulated depreciation and amortization | 9,275,809           | 11,208,958        |
|                                                 | <b>26,920,829</b>   | <b>28,535,907</b> |

Substantially all of the Group's buildings are located in the PRC. The Group was formally granted the rights to use the twenty one parcels of land in Guangzhou, Shenzhen, Zhuhai, Beihai, Changsha, Shantou, Haikou, Zhengzhou, Guiyang and Wuhan by the relevant PRC authorities for a period of 30 to 70 years, which expire between 2020 and 2068. For other land in the PRC on which the Group's buildings are erected, the Group was formally granted the rights

to use such land for periods of one to five years commencing in the second quarter of 1997 pursuant to various lease agreements between the Group and CSAHC. The leases with initial one-year term are automatically renewable for another one-year period unless the Group gives appropriate notice of termination. In this connection, rental payments totaling RMB15,224 were paid to CSAHC for each of the years ended December 31, 2001, 2002 and 2003 in respect of these leases (Note 23).

The Group is obligated under various capital leases for aircraft that expire at various dates during the next six years. The gross amount of aircraft and related accumulated amortization recorded under capital leases are as follows:

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|                                | <b>December 31,</b> |                  |
|--------------------------------|---------------------|------------------|
|                                | <b>2002</b>         | <b>2003</b>      |
|                                | <b>RMB</b>          | <b>RMB</b>       |
| Aircraft                       | 11,459,978          | 10,462,575       |
| Less: Accumulated amortization | 2,499,495           | 2,605,406        |
|                                | <b>8,960,483</b>    | <b>7,857,169</b> |

As of December 31, 2002 and 2003, certain aircraft of the Group with an aggregate carrying amount of approximately RMB5,822,076 and RMB6,718,737, respectively, were pledged as security under certain loan agreements (Note 16).

In compliance with the PRC rules and regulations governing initial public offering of shares by PRC joint stock limited companies, the fixed assets of the Group as of December 31, 1996 were revalued. This revaluation was conducted by Guangzhou Assets Appraisal Corp., a firm of independent valuers registered in the PRC, on a depreciated replacement cost basis, and approved by the China State-owned Assets Administration Bureau.

In accordance with IAS 16 Property, Plant and Equipment, subsequent to the 1996 revaluation, which was based on replacement costs, the fixed assets of the Group are carried at revalued amounts, being the fair value at the date of the revaluation less any subsequent accumulated depreciation and impairment losses. Revaluation is performed periodically to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet date. In accordance with the revaluation performed by the directors in respect of fixed assets held by the Group as of December 31, 2000, the carrying amounts of fixed assets did not differ materially from their respective fair value.

The effect of the above revaluations was to increase annual depreciation charges by approximately RMB65,000, RMB33,000 and RMB 33,000, respectively, for 2001, 2002 and 2003.

During 2003, the Group incurred a loss of RMB20,405 on early retirement of two old Boeing 737-200 aircraft. During 2001 and 2002, pursuant to certain sale and leaseback arrangements, the Group sold two Airbus 320-200 aircraft and four Boeing 757-200 aircraft, respectively, to independent third parties and then entered into operating leases with such parties to lease back the aircraft for a period of eight to nine years. The Group recognized a gain of RMB59,855 and RMB199,394, respectively, in 2001 and 2002, being the excess of the sale proceeds which approximated the aircraft's fair value on the date of disposal over the aircraft's net book value and related disposal costs. Such loss/gain was included under the sub-item (Loss)/gain on sale of fixed assets under Non-operating income/(expenses) in the consolidated statements of operations.

During 2003, the Group entered into operating lease arrangements to lease certain flight training facilities and buildings to Zhuhai Xiang Yi Aviation Technology Company Limited ( Zhuhai Xiang Yi ), a jointly controlled entity of the Group. The leases with initial one-year term are automatically renewable for another one year unless either party gives appropriate notice of

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termination. In this connection, rental income totaling RMB34,175 was received by the Group during 2003 in respect of the leases. As of December 31, 2003, the cost and accumulated amortization of the relevant fixed assets totaled RMB787,432 and RMB462,281, respectively. As of December 31, 2003, the Group's rental receivable in respect of the leases due in 2004 amounted to RMB34,175.

During 2001 and 2002, the Group entered into arrangements to lease several of its aircraft to independent third parties. The terms of such leases generally range from one to twelve months.

The Group entered into two separate arrangements (the Arrangements) with certain independent third parties during each of 2002 and 2003. Under each of the Arrangements, the Group sold an aircraft and then immediately leased back the aircraft for an agreed period. As agreed, the lease payment obligations, with pre-determined net present value, are to be satisfied solely out of the sale proceeds and such amount has been placed irrevocably by the Group in form of deposits and debt securities in favour of the lessors. The Group has an option to purchase the aircraft at a pre-determined date and an agreed purchase price to be satisfied by the balances of the deposits and debt securities outstanding at that date. In the event that the lease agreement is early terminated by the Group, the Group is liable to pay a pre-determined penalty to the lessor. As long as the Group complies with the lease agreements, the Group is entitled to the continued possession and operation of the aircraft. Since the Group retains substantially all risks and rewards incident to ownership of the aircraft and enjoys substantially the same rights to their use as before the Arrangements, no adjustment has been made to the fixed assets. As of December 31, 2002 and 2003, the net present value of the lease commitments and the corresponding defeased deposits and debt securities amounted to RMB1,322,843 and RMB2,409,252, respectively. As a result of the Arrangements, the Group received net cash benefits of RMB51,682 and RMB69,121 in 2002 and 2003, respectively, which have been recognized as income for the respective years.

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**14. CONSTRUCTION IN PROGRESS**

As of December 31, 2002 and 2003, included in construction in progress was an amount of RMB432,580 and RMB1,445,760, respectively, in relation to the construction of Guangzhou New Airport.

**15. INVESTMENTS**

|                                                    | <b>December 31,</b> |                  |
|----------------------------------------------------|---------------------|------------------|
|                                                    | <b>2002</b>         | <b>2003</b>      |
|                                                    | <b>RMB</b>          | <b>RMB</b>       |
| Share of net assets in affiliated companies        | 692,026             | 422,201          |
| Share of net assets in jointly controlled entities | 461,962             | 731,323          |
| Other investments, at cost                         | 201,854             | 204,971          |
|                                                    | <b>1,355,842</b>    | <b>1,358,495</b> |

Details of the Group's principal affiliated companies and jointly controlled entities are set out in Note 29.

**16. DEBT****Short-term notes payable**

|                          | <b>December 31,</b> |             |
|--------------------------|---------------------|-------------|
|                          | <b>2002</b>         | <b>2003</b> |
|                          | <b>RMB</b>          | <b>RMB</b>  |
| Short-term notes payable | 4,422,926           | 6,408,806   |

As of December 31, 2002 and 2003, borrowings under short-term notes payable of the Group totaling RMB1,450,000 and RMB130,500, respectively, were guaranteed by CSAHC. In addition, as of December 31, 2003, borrowings under short-term notes payable of the Group totaling RMB63,000 and RMB21,000 were guaranteed by Guangzhou Baiyun International Airport Company Limited and Shenzhen Yingshun Investment Development

Company Limited, respectively.

Borrowings under short-term notes payable are used primarily to finance working capital needs and are repayable in full on the respective due dates with interest rates ranging from 1.42% to 5.31%. The Group's weighted average interest rate on short-term notes payable was 3.11% and 1.76%, respectively, as of December 31, 2002 and 2003.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (Continued)**  
**(Amounts in thousands, except share data)**

**Long-term notes payable**

|                                        |                                                                                                                      | <b>December 31,</b> |                  |
|----------------------------------------|----------------------------------------------------------------------------------------------------------------------|---------------------|------------------|
|                                        |                                                                                                                      | <b>2002</b>         | <b>2003</b>      |
|                                        |                                                                                                                      | <b>RMB</b>          | <b>RMB</b>       |
| Renminbi denominated notes payable:    |                                                                                                                      |                     |                  |
| Loans for construction projects        | Floating interest rates ranging from 4.94% to 5.25% per annum as of December 31, 2003, with maturities through 2009. | 893,838             | 12,357           |
|                                        | Non-interest bearing loan from a municipal government authority, repayable in 2005                                   | 3,000               | 3,000            |
| Loans for purchase of aircraft         | Floating interest rate of 5.49% per annum as of December 31, 2003, with maturities through 2004                      | 2,310,268           | 63,500           |
| U.S. dollar denominated notes payable: |                                                                                                                      |                     |                  |
| Loans for purchase of aircraft         | Fixed interest rates ranging from 5.00% to 8.33% per annum as of December 31, 2003, with maturities through 2011.    | 3,426,038           | 2,612,687        |
|                                        | Floating interest rates ranging from 1.48% to 1.50% per annum as of December 31, 2003 with maturities through 2013   |                     | 2,505,134        |
| Loan for purchase of flight equipment  | Fixed interest rate of 8.35% per annum as of December 31, 2003, with maturity in 2004                                | 20,090              | 13,097           |
|                                        |                                                                                                                      | <u>6,653,234</u>    | <u>5,209,775</u> |
| Less: current installments             |                                                                                                                      | <u>(817,800)</u>    | <u>(688,040)</u> |

|                             |                             |
|-----------------------------|-----------------------------|
| 5,835,434                   | 4,521,735                   |
| <u>                    </u> | <u>                    </u> |

As of December 31, 2002 and 2003, borrowings under long-term notes payable of the Group totaling RMB3,360,945 and RMB2,564,586, respectively, were guaranteed by certain financial institutions and secured by the mortgages over certain of the Group's aircraft. In addition, as of December 31, 2002 and 2003, borrowings under long-term notes payable of the Group totaling RMB1,890,118 and RMB228,800, respectively, were guaranteed by CSAHC and RMB561,531 and RMB10,052, respectively, were guaranteed by SA Finance.

As of December 31, 2003, the Group had banking facilities with several PRC commercial banks for providing loan finance up to an amount of RMB9,860,000. As of December 31, 2003, an amount of approximately RMB4,412,000 was utilized.

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The aggregate annual maturities of long-term notes payable for each of the five years subsequent to December 31, 2003 and thereafter are as follows:

|                                 | <b>RMB</b> |
|---------------------------------|------------|
| <b>Year ending December 31,</b> |            |
| 2004                            | 688,040    |
| 2005                            | 649,492    |
| 2006                            | 403,994    |
| 2007                            | 372,251    |
| 2008                            | 447,465    |
| Thereafter                      | 2,648,533  |
|                                 | <hr/>      |
|                                 | 5,209,775  |
|                                 | <hr/>      |

Interest expense, net of the amounts capitalized, represents:

|                      | <b>Year ended December 31,</b> |             |             |
|----------------------|--------------------------------|-------------|-------------|
|                      | <b>2001</b>                    | <b>2002</b> | <b>2003</b> |
|                      | <hr/>                          | <hr/>       | <hr/>       |
|                      | <b>RMB</b>                     | <b>RMB</b>  | <b>RMB</b>  |
| Interest incurred    | 938,944                        | 1,023,379   | 906,802     |
| Interest capitalized | (5,227)                        | (64,186)    | (83,077)    |
|                      | <hr/>                          | <hr/>       | <hr/>       |
| Interest expense     | 933,717                        | 959,193     | 823,725     |
|                      | <hr/>                          | <hr/>       | <hr/>       |

Interest rates per annum at which borrowing costs were capitalized were 5.70%, 5.70% and 1.62% to 5.46%, respectively, for the years ended December 31, 2001, 2002 and 2003.

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**17. LEASE OBLIGATIONS****Capital leases**

As of December 31, 2003, the Group leased 29 aircraft under capital leases. The majority of these leases have terms of 10 to 15 years, and expiration dates range from 2004 through 2009.

As of December 31, 2003, future scheduled minimum lease payments under capital leases, which were 74% and 26%, respectively, denominated in U.S. dollars and Japanese yen, are as follows:

|                                                               | <b>Payments<br/>RMB</b> | <b>*Interest<br/>RMB</b> | <b>Obligations<br/>RMB</b> |
|---------------------------------------------------------------|-------------------------|--------------------------|----------------------------|
| <b>Year ending December 31,</b>                               |                         |                          |                            |
| 2004                                                          | 1,648,141               | 350,286                  | 1,297,855                  |
| 2005                                                          | 1,356,614               | 290,163                  | 1,066,451                  |
| 2006                                                          | 1,405,424               | 208,566                  | 1,196,858                  |
| 2007                                                          | 1,445,207               | 157,349                  | 1,287,858                  |
| 2008                                                          | 1,497,604               | 73,503                   | 1,424,101                  |
| Thereafter                                                    | 608,124                 | 40,308                   | 567,816                    |
|                                                               | <hr/>                   | <hr/>                    | <hr/>                      |
|                                                               | 7,961,114               | 1,120,175                | 6,840,939                  |
|                                                               | <hr/>                   | <hr/>                    | <hr/>                      |
| Less: current instalments of obligations under capital leases |                         |                          | (1,297,855)                |
|                                                               |                         |                          | <hr/>                      |
|                                                               |                         |                          | 5,543,084                  |
|                                                               |                         |                          | <hr/>                      |

\*Interest rates ranged from 2.23% to 9.36%.

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.

Security, including charges over the assets concerned and relevant insurance policies, is provided to the lessors.

In addition to the assets mortgaged as security under certain loan agreements (Note 13), certain of the Group's aircraft with an aggregate carrying amount of RMB8,960,483 and RMB7,857,169, respectively, as of December 31,

2002 and 2003 were mortgaged to secure facilities with financial institutions granted to lessors totaling RMB8,198,449 and RMB6,840,939, respectively, on these dates.

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**Operating leases**

As of December 31, 2003, future minimum lease payments under non-cancellable aircraft and flight equipment operating leases were as follows (principally denominated in U.S. dollars):

|                                 | <b>RMB</b> |
|---------------------------------|------------|
| <b>Year ending December 31,</b> |            |
| 2004                            | 1,482,888  |
| 2005                            | 1,411,520  |
| 2006                            | 1,143,745  |
| 2007                            | 921,456    |
| 2008                            | 771,374    |
| Thereafter                      | 2,388,874  |
|                                 | <hr/>      |
| Total minimum lease payments    | 8,119,857  |
|                                 | <hr/>      |

Amounts charged to rental expenses for operating leases for the years ended December 31, 2001, 2002 and 2003 totaled RMB1,723,338, RMB1,348,277 and RMB1,408,574, respectively.

All of the Group's obligations under capital and operating leases are guaranteed by financial institutions.

**18. ACCRUED EXPENSES**

|                                                           | <b>December 31,</b> |             |
|-----------------------------------------------------------|---------------------|-------------|
|                                                           | <b>2002</b>         | <b>2003</b> |
|                                                           | <hr/>               | <hr/>       |
|                                                           | <b>RMB</b>          | <b>RMB</b>  |
| Landing and navigation fees                               | 497,372             | 825,811     |
| Duties and levies                                         | 360,827             | 336,839     |
| Fuel                                                      | 297,626             | 254,801     |
| Interest                                                  | 174,626             | 157,527     |
| Lease charges                                             | 40,900              | 18,144      |
| Accrued salaries, wages and benefits                      | 245,124             | 197,332     |
| Repairs and maintenance                                   | 198,465             | 286,636     |
| Current portion of provision for major overhauls (Note 6) | 52,000              | 10,717      |
| Lump sum housing benefits payable (Note 24)               | 213,675             | 129,521     |

|       |                  |                  |
|-------|------------------|------------------|
| Other | <u>260,839</u>   | <u>310,466</u>   |
|       | <u>2,341,454</u> | <u>2,527,794</u> |

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**19. DEFERRED CREDITS**

|                                                              | <b>December 31,</b> |               |
|--------------------------------------------------------------|---------------------|---------------|
|                                                              | <b>2002</b>         | <b>2003</b>   |
|                                                              | <b>RMB</b>          | <b>RMB</b>    |
| Operating lease rebates                                      | 7,857               | 6,316         |
| Governmental subsidy for safety related capital expenditures | 40,238              | 40,238        |
|                                                              | <u>48,095</u>       | <u>46,554</u> |
| Movements during the year are as follows:                    |                     |               |
| Balance at beginning of year                                 | 15,072              | 48,095        |
| Additions during the year                                    | 40,238              |               |
| Transferred to consolidated statement of operations          | (7,215)             | (1,541)       |
|                                                              | <u>48,095</u>       | <u>46,554</u> |

**Operating lease rebates**

Pursuant to several operating lease arrangements for aircraft commenced in January 1998, the Group received cash rebates totaling RMB24,838 from an operating lessor in 1998. Such rebates have been deferred and amortized over the terms of the respective lease to reduce the future operating lease charges.

**Governmental subsidy for safety related capital expenditures**

During 2002, the Group received governmental subsidy for safety related capital expenditures amounting to RMB40,240 for enhancing future flight protection and safety standards. Such governmental subsidy is to be amortized over the depreciable lives of the related fixed assets.

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**20. DEFERRED TAXATION**

Movements in net deferred tax liabilities are as follows:

|                                                               | <b>December 31,</b> |             |
|---------------------------------------------------------------|---------------------|-------------|
|                                                               | <b>2002</b>         | <b>2003</b> |
|                                                               | <b>RMB</b>          | <b>RMB</b>  |
| Balance at beginning of year                                  | (519,577)           | (779,234)   |
| Land use rights adjustment (Note 22(f))                       | 57,495              |             |
| Transferred to consolidated statement of operations (Note 10) |                     |             |
| - current year                                                | (317,152)           | (11,208)    |
| - adjustment for change in income tax rate                    |                     | 392,137     |
|                                                               | <hr/>               | <hr/>       |
| Balance at end of year                                        | (779,234)           | (398,305)   |
|                                                               | <hr/>               | <hr/>       |

The net deferred tax liabilities were made up of the following taxation effects:

|                                                             | <b>December 31,</b> |             |
|-------------------------------------------------------------|---------------------|-------------|
|                                                             | <b>2002</b>         | <b>2003</b> |
|                                                             | <b>RMB</b>          | <b>RMB</b>  |
| Deferred tax assets:                                        |                     |             |
| Tax losses carried forward                                  | 149,338             | 222,936     |
| Fixed assets, principally due to repair charges capitalized | 319,697             | 261,312     |
| Accrued expenses                                            | 375,789             | 106,491     |
| Other                                                       | 129,423             | 8,989       |
|                                                             | <hr/>               | <hr/>       |
| Total deferred tax assets                                   | 974,247             | 599,728     |
|                                                             | <hr/>               | <hr/>       |
| Deferred tax liabilities:                                   |                     |             |
| Undistributed profits of subsidiaries                       | 254,210             |             |
| Accrued expenses                                            | 78,083              | 80,545      |

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|                                                             |                   |                   |
|-------------------------------------------------------------|-------------------|-------------------|
| Fixed assets, principally due to difference in depreciation | 1,403,278         | 847,781           |
| Other                                                       | 17,910            | 69,707            |
|                                                             | <u>          </u> | <u>          </u> |
| Total deferred tax liabilities                              | 1,753,481         | 998,033           |
|                                                             | <u>          </u> | <u>          </u> |
| Net deferred tax liabilities                                | (779,234)         | (398,305)         |
|                                                             | <u>          </u> | <u>          </u> |

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In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable profits during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities and projected future taxable profits in making this assessment. Based upon the projections for future taxable profits over the periods in which the deferred tax assets are deductible, management believes it is more likely than not that the Group will realize the benefits of these deductible differences. The amount of the deferred tax assets considered realizable, however, could be reduced in the near term if estimates of future taxable profits during the carryforward period are reduced.

As of December 31, 2003, the Group had tax losses for PRC income tax purposes totaling approximately RMB1,486,240. Such tax losses are available for carry forward to set-off against future PRC assessable income for a maximum period of five years. Of these tax losses, approximately RMB262,957, RMB106,156 and RMB1,117,127 will expire after December 31, 2004, 2007 and 2008, respectively. As of December 31, 2003, the Group recorded a deferred tax asset of RMB222,936 for such tax losses.

As of December 31, 2003, the Group had tax losses of approximately RMB303,000 available for offset against future assessable profits arising from Hong Kong profits, if any, over an indefinite period. The Group has not recognized a deferred tax asset in respect of such tax losses as it would not be probable that future taxable profits will be available against which the taxable losses can be utilized.

**21. SHARE CAPITAL**

|                                                | <b>December 31,</b> |             |
|------------------------------------------------|---------------------|-------------|
|                                                | <b>2002</b>         | <b>2003</b> |
|                                                | <b>RMB</b>          | <b>RMB</b>  |
| Registered capital as of December 31:          |                     |             |
| 2,200,000,000 domestic shares of RMB 1.00 each | 2,200,000           | 2,200,000   |
| 1,174,178,000 H shares of RMB 1.00 each        | 1,174,178           | 1,174,178   |
| 1,000,000,000 A share of RMB1.00 each          |                     | 1,000,000   |
|                                                | <hr/>               | <hr/>       |
|                                                | 3,374,178           | 4,374,178   |
|                                                | <hr/>               | <hr/>       |
| Issued and paid up capital as of December 31:  |                     |             |
| 2,200,000,000 domestic shares of RMB 1.00 each | 2,200,000           | 2,200,000   |
| 1,174,178,000 H shares of RMB 1.00 each        | 1,174,178           | 1,174,178   |
| 1,000,000,000 A share of RMB1.00 each          |                     | 1,000,000   |
|                                                | <hr/>               | <hr/>       |

|           |           |
|-----------|-----------|
| 3,374,178 | 4,374,178 |
|-----------|-----------|

In July 2003, the Company issued 1,000,000,000 A shares with a par value of RMB1.00 each at issue price of RMB2.70 by way of a public offering to natural persons and institutional investors in the PRC. The share premium received by the Company, net of the issuance costs of RMB59,233, amounted to RMB1,640,767 and was credited to share premium account.

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All the domestic, H and A shares rank pari passu in all material respects.

As of December 31, 2002 and 2003, the retained earnings of the Group included RMB135,010 and RMB112,985, respectively, of undistributed earnings of companies which are 50% or less owned by the Group and accounted for under the equity method.

**22. RESERVES**

Movements of reserves are as follows:

|                                                                    | <b>December 31,</b> |                |
|--------------------------------------------------------------------|---------------------|----------------|
|                                                                    | <b>2002</b>         | <b>2003</b>    |
|                                                                    | <b>RMB</b>          | <b>RMB</b>     |
| <b>Statutory surplus reserve (Note (a))</b>                        |                     |                |
| Balance at beginning of year                                       | 391,867             | 337,195        |
| Adjustments from adoption of PRC accounting regulations (Note (c)) | (106,007)           |                |
| Transferred from consolidated statement of operations              | 51,335              | 23,856         |
|                                                                    | <u>337,195</u>      | <u>361,051</u> |
| Balance at end of year                                             | <u>337,195</u>      | <u>361,051</u> |
| <b>Statutory public welfare fund (Note (b))</b>                    |                     |                |
| Balance at beginning of year                                       | 225,440             | 171,574        |
| Adjustments from adoption of PRC accounting regulations (Note (c)) | (79,533)            |                |
| Transferred from consolidated statement of operations              | 25,667              | 1,113          |
|                                                                    | <u>171,574</u>      | <u>172,687</u> |
| Balance at end of year                                             | <u>171,574</u>      | <u>172,687</u> |
| <b>Discretionary surplus reserve (Note (d))</b>                    |                     |                |
| Balance at beginning of year                                       | 69,867              | 76,603         |
| Transferred from consolidated statement of operations              | 6,736               |                |
|                                                                    | <u>76,603</u>       | <u>76,603</u>  |
| Balance at end of year                                             | <u>76,603</u>       | <u>76,603</u>  |

|         |         |
|---------|---------|
|         |         |
| 585,372 | 610,341 |

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**Notes:**

(a) According to the PRC Company Law and the Articles of Association of the Company and certain of its subsidiaries, the Company and the relevant subsidiaries are required to transfer 10% of their annual net income after taxation, as determined under relevant PRC accounting regulations, to a statutory surplus reserve until the reserve balance reaches 50% of the registered capital. The transfer to this reserve must be made before distribution of a dividend to shareholders.

Statutory surplus reserve can be used to offset prior years' losses, if any, and may be converted into share capital by the issue of new shares to shareholders in proportion to their existing shareholding or by increasing 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) According to the PRC Company Law and the Articles of Association of the Company and certain of its subsidiaries, the Company and the relevant subsidiaries are required to transfer between 5% to 10% of their annual net income after taxation, as determined under PRC accounting regulations, to the statutory public welfare fund. This fund can only be utilized on capital items for the collective benefits of the Company's and the relevant subsidiaries' employees such as the construction of dormitories, canteen and other staff welfare facilities. This fund is non-distributable other than in liquidation. The transfer to this reserve must be made before distribution of a dividend to shareholders.

(c) During 2002, the Group adopted certain new PRC accounting regulations which resulted in adjustments to the amounts of the Group's income determined under PRC accounting regulations in respect of prior years and corresponding adjustments to amounts appropriated to the statutory surplus reserve, statutory public welfare fund and discretionary surplus reserve for the prior years.

(d) The usage of this reserve is similar to that of statutory surplus reserve.

(e) Dividend distributions may be proposed at the discretion of the Company's Board of Directors, after consideration of the transfers referred to above and making up cumulative prior years' losses, if any. Pursuant to the Company's Articles of Association, the net income of the Company for the purpose of dividend distribution is deemed to be the lesser of net income determined in accordance with (i) PRC accounting principles and financial regulations, and (ii) IFRS; or if the financial statements of the Company are not prepared in accordance with IFRS, the accounting standards of one of the countries in which its shares are listed (Note 27).

(f) The Group adopted IAS 40 Investment Property in 2002. According to IAS 40, the land use rights which were previously included in fixed assets at revaluation base are now presented as lease prepayments and carried at historical cost base with effect from January 1, 2002. Accordingly, the unamortized surplus on previous revaluations of the land use rights, net of related deferred tax asset, are reversed to the share premium and retained profits accounts. The IAS 40 was adopted prospectively in 2002 as the effect of this change did not have a material impact on the Group's financial condition and results of operations in the periods prior to the change.



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**23. COMMITMENTS AND CONTINGENCIES**

The Company has been advised by its Chinese legal counsel that, except for liabilities constituting or arising out of or relating to the business assumed by the Company in the Reorganization (Note 1), no other liabilities were assumed by the Company, and the Company is not jointly and severally liable for other debts and obligations incurred by CSAHC prior to the Reorganization, except for certain loans from PRC banks which were fully repaid by CSAHC. There are not, however, any definitive PRC regulations or other pronouncements confirming such conclusion.

The Group leases from CSAHC certain land in Guangzhou and certain land and buildings in Wuhan, Haikou and Zhengzhou. The Group has a significant investment in buildings and other leasehold improvements located on such land. However, such land in Guangzhou and such land and buildings in Wuhan, Haikou and Zhengzhou lack adequate documentation evidencing CSAHC's rights thereto and the lease agreements between CSAHC and the Group may not be registered with the relevant authorities. Lack of registration may affect the validity of such lease agreements.

With respect to the facilities in Guangzhou, CSAHC has received written assurance from the CAAC to the effect that CSAHC is entitled to continued use and occupancy of the land in Guangzhou. The Group understands that the CAAC is basing its conclusion on an agreement among certain government authorities relating to such land. Such assurance does not constitute formal evidence of CSAHC's right to transfer, mortgage or lease such real property interests. The Group cannot predict the magnitude of the effect on its financial condition or results of operations to the extent that its use of one or more of these parcels of land or the related facilities were successfully challenged. CSAHC has agreed to indemnify the Group against any loss or damage caused by any challenge or interference with the Group's use of any of its land and buildings.

The Group is currently involved in a civil litigation (the "Litigation"). According to the writ of summons for the Litigation, the plaintiff, claimed against the Group for unspecified damages for breach of certain agreement. Given that the Litigation is still at its preliminary stage, it is pre-matured to predict the outcome. Based on the opinion given by the Company's instructing solicitors, the directors of the Company consider that the Group has a reasonable chance of success in its defense to the claim. Accordingly, the directors of the Company consider that a provision for such claim and/or the associated legal costs is not required.

As of December 31, 2003, the Group had on order two Boeing 757-200 aircraft, thirteen Boeing 737-700 aircraft, four Airbus 330-200 aircraft, six Embraer ERJ-145 aircraft and certain flight equipment, scheduled for deliveries in 2004 to 2005. Deposits of RMB2,494,853 have been made towards the purchase of these aircraft and related equipment. As of December 31, 2003, the aggregate future payments, including estimated amounts for price escalation through anticipated delivery dates for these aircraft and related equipment totaled approximately RMB10,615,079.

As of December 31, 2003, additional capital expenditures of approximately RMB3,012,607 have been authorized, of which approximately RMB849,847 have been committed, for the Group's principal facilities. Such expenditures comprised mainly RMB2,071,938 for facilities and equipment at the Guangzhou New Airport and RMB940,669 for other airport and office facilities and equipment, overhaul and maintenance bases and training centers.

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As of December 31, 2003, the Group was committed to make a capital contribution of approximately RMB446,000 to jointly controlled entities.

The Group has taken steps towards the purchase of the airline business of China Northern Airlines Company and Xinjiang Airlines Company. No contractual obligations existed as of December 31, 2003 and up to the date of approval of these consolidated financial statements. The purchase price has not yet been determined.

**24. RETIREMENT AND POST-RETIREMENT MEDICAL BENEFITS**

Employees of the Group participate in several defined contribution retirement schemes organized separately by PRC municipal governments in regions where the major operations of the Group are located. The Group is required to contribute to these schemes at the rates ranging from 14% to 17% for 2001, 14% to 19% for 2002 and 2003 of salary costs including certain allowances. A member of the retirement schemes is entitled to pension benefits equal to a fixed proportion of the salary at the retirement date. The retirement benefit obligations of all existing and future retired staff of the Group are assumed by these schemes. Contributions to the retirement schemes are charged to consolidated statements of operations as and when incurred. Contributions to the retirement schemes amounted to RMB62,833, RMB112,285 and RMB131,327, respectively, during 2001, 2002 and 2003.

In addition, the Group was selected as one of the pilot enterprises to establish a supplementary defined contribution retirement scheme for the benefit of employees. In this connection, employees of the Group participate in a supplementary defined contribution retirement scheme whereby the Group is required to make defined contributions at the rate of 4.5% of total salaries. The Group has no obligation for the payment of pension benefits beyond the contributions described above. Contributions to the retirement schemes are charged to consolidated statements of operations as and when incurred. Contributions to the retirement schemes amounted to RMB15,000, RMB19,337 and RMB19,120, respectively, during 2001, 2002 and 2003.

Furthermore, pursuant to the comprehensive services agreement (the Services Agreement ) dated May 22, 1997 between the Company and CSAHC, CSAHC agrees to provide adequate quarters to eligible employees of the Group as and when required. In return, the Group agrees to pay a fixed annual fee of RMB85,000 to CSAHC for a ten-year period effective January 1, 1995.

During 2001 and 2002, the Group provided additional quarters at its own expense to certain employees who are not eligible for quarters pursuant to the Services Agreement. These quarters were provided to the employees in accordance with the relevant PRC housing reform policy. In 2001 and 2002, the Group recognized a loss of RMB110,723 and RMB17,624, respectively, being the excess of the cost of these quarters over the considerations received by the Group from the employees, under the sub-item (Loss)/gain on sale of fixed assets under Non-operating income/(expenses) in the consolidated statements of operations.

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Subsequently, pursuant to an additional staff housing benefit scheme effective September 2002, the Group has agreed to pay lump sum housing allowances to certain employees who have not received quarters from CSAHC or the Group according to the relevant PRC housing reform policy, for subsidizing their purchases of housing. Such expenditure has been deferred and amortized on a straight line basis over a period of 10 years, which represents the vesting benefit period of the employees. An employee who quits prior to the end of the vesting benefit period is required to pay back a portion of the lump sum housing benefits determined on a pro-rata basis of the vesting benefit period remained. The Group has the right to effect a charge on the employee's house and to enforce repayment through selling the house in the event of default in repayment. Any shortfall in repayment would be charged against consolidated statements of operations. As of December 31, 2003, the Group already made payments totaling RMB130,479 under the scheme and recorded its remaining contractual liabilities totaling RMB129,521 as accrued liabilities on the consolidated balance sheets (Note 18).

**25. RELATED PARTY TRANSACTIONS**

The Group obtained various operational and financial services provided by CSAHC and its affiliates, and the Group's affiliated companies and jointly controlled entities during the normal course of its business. In the past, CSAHC was under the direct control of the CAAC. However, such control has been shifted to the State Assets Administration Committee since early 2003. Consequently, transactions with the CAAC and its affiliates beginning from 2003 are no longer presented as related party transactions of the Group. The principal related party transactions are described as follows:

**Allocation of routes and air fares**

Both domestic and international routes on which the Group and other PRC airlines offer scheduled services are allocated by the CAAC.

International air fares are subject to bilateral agreements between the CAAC, acting on behalf of the PRC government, and other governments. Domestic air fares are regulated jointly by the CAAC and the PRC Price Administrative Bureau.

**Procurement of aircraft, flight equipment and other airline-related facilities**

Certain PRC airlines, including the Group, were granted permission to acquire aircraft, flight equipment and other airline-related facilities directly from manufacturers subject to the approval of their fleet expansion plans by the relevant PRC government authorities.

The Group acquires aircraft, flight equipment and other airline-related facilities through Southern Airlines (Group) Import and Export Trading Company (SAIETC), a wholly-owned subsidiary of CSAHC. Total purchases amounted to RMB324,998, RMB583,548 and RMB1,154,553, respectively, for 2001, 2002 and 2003. Handling fees totaling RMB16,161, RMB 36,306 and RMB27,051, respectively, were paid to SAIETC for 2001, 2002 and 2003.

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**Jet fuel supplies**

Jet fuel is subject to allocation in the PRC. The Group is required to purchase jet fuel domestically from the China Aviation Oil Supply Company and Lan Tian Oil Supply Company, companies controlled by the CAAC, at prices set by such suppliers in conjunction with the CAAC and other PRC government authorities. During the periods presented, such prices exceeded the international market prices. The cost of jet fuel purchased by the Group in accordance with such allocation was RMB2,586,688 and RMB2,373,956, respectively, during 2001 and 2002. The remainder of the Group's jet fuel was purchased from domestic markets and, to a lesser extent, from international markets.

**Aircraft insurance**

Aviation insurance covering hull, war and passenger liability risk is arranged by the CAAC on behalf of all PRC airlines with the People's Insurance (Property) Company of China (PICC) under a master policy. PICC reinsures a substantial portion of its aircraft insurance business through the international reinsurance market. Insurance premiums are allocated to each individual PRC airline by the CAAC based on the value of the airline's aircraft and after taking into account the claims history of the airline. Insurance premiums totaling RMB123,439 and RMB256,238, respectively, were incurred by the Group during 2001 and 2002.

**Financial arrangements**

The Group's obligations under various lease and bank loan arrangements in connection with aircraft acquisitions are secured by guarantees provided by certain PRC financial institutions which obtained back-to-back guarantees from the CAAC. Guarantee fees totaling RMB1,490 and RMB1,025, respectively, were paid to these financial institutions during 2001 and 2002.

Interest income is received from short-term deposits with SA Finance. The applicable interest rate is determined in accordance with the savings rate published by the People's Bank of China. Interest income totaling RMB13,771, RMB10,530 and RMB3,100, respectively, was earned by the Group on such deposits during 2001, 2002 and 2003 (Note 11).

During 2003, CSAHC made short-term advances to the Group. These advances are unsecured, non-interest bearing and repayable on demand. As of 31 December, 2003, the advances amounted to RMB165,995.

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**Airline-related services**

The Group, jointly with other PRC airlines, participates in the CAAC's computer reservation system, under which the Group purchases computer reservation services from the CAAC at rates determined based on the utilization of the system. Service fees paid by the Group to the CAAC during 2001 and 2002 totaled RMB110,134 and RMB107,234, respectively.

The Group utilizes the passenger departure and cargo handling computer systems installed by the CAAC at certain PRC airports. Service fees are levied by the CAAC based on the utilization of these systems. Service fees totaling RMB57,424 and RMB62,111, respectively, were paid by the Group to the CAAC during 2001 and 2002.

The Group is required to pay landing and navigation fees to various PRC airports in respect of take-off and landing slots allocated to the Group and other ancillary services provided. Fees are payable by the Group based on the scale rates published by the CAAC. Landing and navigation fees totaling RMB1,527,600 and RMB1,667,706, respectively, were paid to various PRC airports during 2001 and 2002.

The Group purchases certain inflight meals and related services from Shenzhen Air Catering Company Limited, a cooperative joint venture established in the PRC, in respect of which CSAHC is entitled to 33% of its income after tax. Such purchases amounted to RMB22,707, RMB29,058 and RMB28,199, respectively, during 2001, 2002 and 2003.

Commission is earned by certain subsidiaries of CSAHC in connection with the air tickets sold by them on behalf of the Group. Commission is calculated based on a fixed rate ranging from 1.5% to 12% on the ticket value. Commission expenses incurred by the Group in respect of tickets sold by certain subsidiaries of CSAHC totaled RMB37,017, RMB16,725 and RMB4,896, respectively, during 2001, 2002 and 2003.

Commission is earned by the CAAC's sales offices and various PRC airlines in connection with the air tickets sold by them on behalf of the Group. Commission is calculated based on a fixed rate ranging from 1.5% to 12% on the ticket value. Commission expenses incurred by the Group in respect of tickets sold by the CAAC's sales offices and various PRC airlines totaled RMB510,169 and RMB464,721, respectively, during 2001 and 2002. Commission income received from other PRC airlines in connection with air tickets sold by the Group, calculated based on a fixed rate ranging from 3% to 9% on the ticket value, totaled RMB89,842 and RMB81,931, respectively, during 2001 and 2002.

Ground service fees are received from other PRC airlines in respect of ground services provided by the Group and Baiyun International Airport Group at Guangzhou Baiyun International Airport. The Group was entitled to 50% of the service fees. The Group's share of ground service fees received totaled RMB23,513 and RMB39,735, respectively, during 2001 and 2002.

The Group has a 50% equity interest in both Guangzhou Aircraft Maintenance Engineering Company Limited (GAMECO) and MTU Maintenance Zhuhai Co., Ltd (MTU Zhuhai), which provide comprehensive maintenance services to the Group. Maintenance fees totaling RMB534,828, RMB592,311 and RMB693,303, respectively, were incurred by the Group for services provided by GAMECO and MTU Zhuhai during 2001, 2002 and 2003.



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Certain aircraft sundry supplies are purchased from Southern Airlines (Group) Economic Development Company ( SAGEDC ), a subsidiary of CSAHC. Supplies totaling RMB86,386, RMB101,350 and RMB42,389, respectively, were purchased by the Group from SAGEDC during 2001, 2002 and 2003.

The Group has a 51% equity interest in Zhuhai Xiang Yi, which provides flight simulation services to the Group. Flight simulation service charges totaling RMB101,355 were incurred by the Group for services provided by Zhuhai Xiang Yi during 2003. In addition, the Group entered into operating lease agreements to lease certain flight training facilities and buildings to Zhuhai Xiang Yi. Rental income received by the Group amounted to RMB34,175 during 2003 (Note 13).

**Advertising services**

Advertising services are provided by Southern Airlines Advertising Company ( SA Advertising ). SA Advertising was a subsidiary of CSAHC up to July 2002. In August 2002, the Group acquired 90% equity interest in SA Advertising from CSAHC. Expenses totaling RMB9,940 and RMB3,275, respectively, were incurred by the Group for services provided by SA Advertising during 2001 and 2002.

**Wet lease rentals**

Pursuant to certain wet lease arrangements effected in August and November 2000, the Group incurred RMB300,000 during 2001 in respect of five Boeing 737-300/37K aircraft leased from Zhongyuan Airlines, a subsidiary of CSAHC. Such lease arrangements were terminated in January 2002.

During 2002 and 2003, wet lease rentals totaling RMB26,164 and RMB35,751, respectively, were paid to Xinjiang Airlines Company, a subsidiary of CSAHC, pursuant to a wet lease agreement in respect of a Boeing 757-200 aircraft effective October 2002. The wet lease agreement was terminated in April 2003.

During the period from August to October 2002, the Group received wet lease rentals totaling RMB27,599 from wet leasing of an Airbus 320-200 aircraft to Sichuan Airlines Corporation Limited, an affiliated company of the Group.

**Refund of medical benefit payments**

Prior to January 1, 2002, the Group paid a fixed annual fee to CSAHC in return for CSAHC providing medical benefit, transportation subsidies and other welfare facilities to the retirees of the Group. Such arrangement was terminated on January 1, 2002. During 2003, CSAHC refunded RMB58,120 to the Group which represented the difference between the aggregate fixed annual fees received from the Group and the aggregate cost of services incurred by CSAHC under the above arrangement.

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**Acquisition of aircraft and related spare parts and vehicles**

During 2002, the Group acquired five Boeing 737-300/37K aircraft and related spare parts and certain vehicles from Zhongyuan Airlines, a subsidiary of CSAHC, at a consideration of approximately RMB1,096,866. The consideration was satisfied by cash of approximately RMB132,130 together with an assumption by the Group of Zhongyuan Airlines' debts of approximately RMB964,736. In addition, the Group received reimbursements of wet lease rentals totaling RMB150,000 which it paid to Zhongyuan Airlines during the period from July 1, 2001 to December 31, 2001. Such reimbursements have been applied to reduce the purchase costs of the acquired assets.

**Acquisition of subsidiaries**

In August 2002, the Group acquired 90% equity interest in each of Guangzhou Aviation Hotel, Southern Airlines Advertising Company and South China International Aviation & Travel Services Company from CSAHC at an aggregate cash consideration of approximately RMB107,846. Such consideration is determined by reference to the valuation reports prepared by GZAA Incorporated, a firm of independent valuers registered in the PRC. These acquisitions are not considered significant in the context of the Group.

**Amounts due to related companies**

Amounts due to related companies, which represent balance with CSAHC and its affiliates, and the Group's affiliated companies and jointly controlled entities, are unsecured, non-interest bearing and repayable within one year. The balance as of December 31, 2002 also included balances with the CAAC and its affiliates. Balances with other State-owned enterprises are excluded from this caption, as other State-owned enterprises are not considered related parties of the Group.

In addition to the above, certain business undertakings of CSAHC also provided hotel and other services to the Group. The total amount involved is not material to the results of the Group.

The directors of the Company are of the opinion that the above transactions with related parties were entered into in the normal course of business and on normal commercial terms or in accordance with the agreements governing such transactions.

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**26. FAIR VALUE OF FINANCIAL INSTRUMENTS AND CONCENTRATIONS OF RISK**

Financial assets of the Group include cash and cash equivalents, investments, trade receivables and other receivables. Financial liabilities of the Group include notes payable, accounts payable, bills payable, sales in advance of carriage, amounts due to related companies, accrual expenses, other liabilities and obligations under capital leases.

**Liquidity risk**

As of December 31, 2002 and 2003, the Group's net current liabilities amounted to RMB7,015,998 and RMB10,792,050, respectively. For the years ended December 31, 2001, 2002 and 2003, the Group recorded a net cash inflow from operating activities of RMB2,223,943, RMB3,697,544 and RMB2,128,749, respectively, a net cash outflow from investing activities and financing activities of RMB3,603,535, RMB2,744,364 and RMB3,819,618, respectively, and a (decrease)/increase in cash and cash equivalents of RMB(1,379,592), RMB953,180 and RMB(1,690,869), respectively.

With regard to 2004 and thereafter, the liquidity of the Group is primarily dependent on its ability to maintain adequate cash inflow from operations to meet its debt obligations as they fall due, and on its ability to obtain adequate external finance to meet its committed future capital expenditures. With regard to its short-term notes payable outstanding as of December 31, 2003, the Group has obtained firm commitments from its principal bankers to renew relevant loans as they fall due during 2004. With regard to its future capital commitments and other financing requirements, the Group has already entered into loan financing agreements with several PRC banks to provide loan finance up to an approximate amount of RMB8,450,000 during 2004 and thereafter. The directors of the Company believe that such financing will be available to the Group.

The directors of the Company have carried out a detailed review of the cash flow forecast of the Group for the twelve months ending December 31, 2004. Based on such forecast, the directors have determined that adequate liquidity exists to finance the working capital and capital expenditure requirements of the Group during that period. In preparing the cash flow forecast, the directors have considered historical cash requirements of the Group as well as other key factors, including the availability of the above-mentioned loan finance which may impact the operations of the Group during the next twelve-month period. The directors are of the opinion that the assumptions and sensitivities which are included in the cash flow forecast are reasonable. However, as with all assumptions in regard to future events, these are subject to inherent limitations and uncertainties and some or all of these assumptions may not be realized.

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**Business risk**

The Group conducts its principal operations in PRC and accordingly is subject to special considerations and significant risks not typically associated with investments in equity securities of the United States of America and Western European companies. These include risks associated with, among others, the political, economic and legal environment, influence of the CAAC over many aspects of its operations and competition in the passenger, cargo and mail airline services industry.

**Interest rate risk**

The interest rates and terms of repayment of the notes payable and obligations under capital leases of the Group are disclosed in Notes 16 and 17, respectively.

**Foreign currency risk**

The Group has significant exposure to foreign currency as substantially all of the Group's lease obligations and notes payable are denominated in foreign currencies, principally US dollars, and to a lesser extent, Japanese yen. Depreciation or appreciation of the Renminbi against foreign currencies affects the Group's results significantly because the Group's foreign currency payments generally exceed its foreign currency receipts. The Group is not able to hedge its foreign currency exposure effectively other than by retaining its foreign currency denominated earnings and receipts to the extent permitted by the State Administration of Foreign Exchange (SAFE), or subject to certain restrictive conditions, entering into forward foreign exchange contracts with authorized PRC banks.

**Credit risk**

Substantially all of the Group's cash and cash equivalents are deposited with PRC financial institutions.

A significant portion of the Group's air tickets are sold by agents participating in the Billing and Settlement Plan (BSP), a clearing scheme between airlines and sales agents organized by International Air Transportation Association. As of December 31, 2002 and 2003, the balance due from BSP amounted to RMB353,246 and RMB446,399, respectively.

**Self insurance risk**

The Group maintains a limited amount of property insurance in respect of certain personal and real property.

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**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.

|                                                                          | December 31,       |               |                    |               |
|--------------------------------------------------------------------------|--------------------|---------------|--------------------|---------------|
|                                                                          | 2002               |               | 2003               |               |
|                                                                          | Carrying<br>amount | Fair<br>value | Carrying<br>amount | Fair<br>value |
|                                                                          | RMB                | RMB           | RMB                | RMB           |
| Cash and cash equivalents                                                | 3,771,043          | 3,771,043     | 2,080,174          | 2,080,174     |
| Trade receivables                                                        | 671,776            | 671,776       | 833,604            | 833,604       |
| Other receivables                                                        | 372,586            | 372,586       | 296,047            | 296,047       |
| Notes payable, including current installments of long-term notes payable | 5,240,726          | 5,326,511     | 7,096,846          | 7,164,216     |
| Accounts payable                                                         | 532,480            | 532,480       | 928,093            | 928,093       |
| Bills payable                                                            | 1,299,680          | 1,299,680     | 438,135            | 438,135       |
| Sales in advance of carriage                                             | 390,531            | 390,531       | 466,087            | 466,087       |
| Amounts due to related companies                                         | 525,090            | 525,090       | 929,003            | 929,003       |
| Accrued expenses                                                         | 2,341,454          | 2,341,454     | 2,527,794          | 2,527,794     |
| Other liabilities                                                        | 646,989            | 646,989       | 1,019,811          | 1,019,811     |
| Notes payable, excluding current installments                            | 5,835,434          | 6,111,052     | 4,521,735          | 4,743,128     |

The following methods and assumptions were used to estimate the fair value for each class of financial instrument:

(i) *Cash and cash equivalents, trade receivables, other receivables, short-term notes payable, accounts payable, bills payable, sales in advance of carriage, amounts due to related companies, accrued expenses and other liabilities*  
The carrying amounts approximate fair value because of the short maturities of these instruments.

(ii) *Long-term notes payable*

The fair value has been estimated by applying a discounted cash flow approach using interest rates available to the Group for similar indebtedness.

The economic characteristics of the Group's capital leases vary from lease to lease. It is impractical to compare such leases with those prevailing in the market within the constraints of timeliness and cost for the purpose of estimating the fair value of such leases. Investments are unquoted equity securities of companies established in the PRC. There is no quoted market price for such equity securities and accordingly a reasonable estimate of the fair value could not be made without incurring excessive costs.



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Fair value estimates are made at a specific point in time and based on relevant market information about the financial instruments. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

**27. FOREIGN CURRENCY EXCHANGE**

The Renminbi is not freely convertible into foreign currencies. All foreign exchange transactions involving Renminbi must take place either through the People's Bank of China or other institutions authorized to buy and sell foreign exchange or at a swap center.

The Group currently maintains bank accounts in currencies other than the Renminbi to engage in foreign exchange transactions. The amount of foreign exchange that can be retained by the Group under this system is determined by the SAFE based on the Group's expected payment obligations in foreign currencies for lease and debt payments and for dividends. Any amounts of foreign exchange that the Group receives in excess of such amount must be converted into Renminbi at the rate prevailing in the PRC inter-bank market. The Group will have access to foreign currency through the inter-bank system, subject to the approval of the SAFE, to satisfy its foreign exchange requirements where these exceed the amount of foreign exchange that the Group has retained.

The Articles of Association of the Company require cash dividends be declared in Renminbi and paid to holders of the H shares in Hong Kong dollars at the average closing exchange rate for Hong Kong dollars as announced by the People's Bank of China for the calendar week preceding the date of the dividend declaration. To the extent that the Company is unable to pay dividends in foreign currency out of its own resources, it will have to obtain foreign currency through the swap centers and PRC banks. Hong Kong dollar dividend payments will be converted by the depositary and distributed to holders of American Depositary Shares in United States dollars.

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**28. RECONCILIATION AND SUPPLEMENTARY STATEMENTS OF CASH FLOWS INFORMATION**

(a) The reconciliation of income/(loss) before taxation and minority interests to cash inflows from operations is as follows:

|                                                                                                                | <b>Year ended December 31,</b> |                  |                  |
|----------------------------------------------------------------------------------------------------------------|--------------------------------|------------------|------------------|
|                                                                                                                | <b>2001</b>                    | <b>2002</b>      | <b>2003</b>      |
|                                                                                                                | <b>RMB</b>                     | <b>RMB</b>       | <b>RMB</b>       |
| Income/(loss) before taxation and minority interests                                                           | 795,256                        | 1,139,099        | (511,610)        |
| Adjustments to reconcile income/(loss) before taxation and minority interests to cash inflows from operations: |                                |                  |                  |
| Depreciation and amortization of fixed assets                                                                  | 1,802,462                      | 1,839,293        | 1,997,882        |
| Other amortization                                                                                             | 12,512                         | 9,816            | 40,089           |
| Amortization of deferred credits                                                                               | (18,483)                       | (7,217)          | (1,541)          |
| Equity income of affiliated companies                                                                          | (53,077)                       | (36,988)         | (47,798)         |
| Equity loss of jointly controlled entities                                                                     | 4,034                          | 3,352            | 39,495           |
| (Gain)/loss on sale of aircraft                                                                                | (59,855)                       | (199,394)        | 20,405           |
| Loss on sale of other fixed assets                                                                             | 115,744                        | 28,654           | 1,812            |
| Interest income                                                                                                | (49,878)                       | (52,618)         | (13,061)         |
| Interest expense                                                                                               | 933,717                        | 959,193          | 823,725          |
| Non-cash exchange (gain)/loss, net                                                                             | (292,630)                      | 174,978          | 177,356          |
| Decrease/(increase) in trade receivables                                                                       | 232,228                        | (110,749)        | (161,828)        |
| Decrease/(increase) in other receivables                                                                       | 42,938                         | (166,004)        | 76,539           |
| (Increase)/decrease in inventories                                                                             | (2,033)                        | (76,472)         | 1,923            |
| (Increase)/decrease in prepaid expenses and other current assets                                               | (136,600)                      | 123,924          | (6,045)          |
| (Decrease)/increase in accounts payable                                                                        | (167,599)                      | (61,843)         | 395,613          |
| Increase/(decrease) in bills payable                                                                           |                                | 1,299,680        | (861,545)        |
| Increase in sales in advance of carriage                                                                       | 31,036                         | 19,985           | 75,556           |
| Increase/(decrease) in amounts due to related companies                                                        | 98,040                         | (193,175)        | 403,913          |
| (Decrease)/increase in accrued expenses                                                                        | (132,121)                      | 86,215           | 203,439          |
| Increase/(decrease) in other liabilities                                                                       | 70,254                         | (33,032)         | 372,822          |
| (Decrease)/increase in provision for major overhauls                                                           | (40,422)                       | 16,226           | 47,577           |
|                                                                                                                | <hr/>                          | <hr/>            | <hr/>            |
| Cash inflows from operations                                                                                   | <b>3,185,523</b>               | <b>4,762,923</b> | <b>3,074,718</b> |

(b) Disclosure of non-cash investing and financing activities:

During 2002, the Group assumed from Zhongyuan Airlines debts totaling RMB964,736 in partial satisfaction of the consideration payable for acquisition of five Boeing 737-300/37K aircraft and other assets from Zhongyuan Airlines (Note 25).

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(c) Effect of acquisition of subsidiaries:

|                                                   | Year ended December 31, |         |      |
|---------------------------------------------------|-------------------------|---------|------|
|                                                   | 2001                    | 2002    | 2003 |
|                                                   | RMB                     | RMB     | RMB  |
| Net assets acquired:                              |                         |         |      |
| Fixed assets                                      |                         | 96,636  |      |
| Cash and cash equivalents                         |                         | 17,355  |      |
| Trade receivables and other current assets        |                         | 20,681  |      |
|                                                   |                         |         |      |
|                                                   |                         | 134,672 |      |
|                                                   |                         |         |      |
| Accounts payable                                  |                         | 3,623   |      |
| Accrued expenses and other liabilities            |                         | 11,220  |      |
|                                                   |                         |         |      |
|                                                   |                         | 14,843  |      |
|                                                   |                         |         |      |
| Net assets value                                  |                         | 119,829 |      |
| Minority interests share of net assets value      |                         | 11,983  |      |
|                                                   |                         |         |      |
| Net assets value acquired by the Group            |                         | 107,846 |      |
|                                                   |                         |         |      |
| Consideration paid                                |                         | 107,846 |      |
| Cash and cash equivalents acquired                |                         | 17,355  |      |
|                                                   |                         |         |      |
| Net cash outflow from acquisition of subsidiaries |                         | 90,491  |      |

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**29. PRINCIPAL SUBSIDIARIES, AFFILIATED COMPANIES AND JOINTLY CONTROLLED ENTITIES**

Details of the Company's principal subsidiaries, affiliated companies and jointly controlled entities as of December 31, 2003 are as follows:

| Name of company                                                   | Place of establishment /operation | Attributable equity interest |            | Principal activities                                  |
|-------------------------------------------------------------------|-----------------------------------|------------------------------|------------|-------------------------------------------------------|
|                                                                   |                                   | Direct %                     | Indirect % |                                                       |
| Subsidiaries                                                      |                                   |                              |            |                                                       |
| Guangxi Airlines Company Limited                                  | PRC                               | 60                           |            | Airline                                               |
| Southern Airlines Group Shantou Airlines Company Limited          | PRC                               | 60                           |            | Airline                                               |
| Zhuhai Airlines Company Limited                                   | PRC                               | 60                           |            | Airline                                               |
| Guizhou Airlines Company Limited                                  | PRC                               | 60                           |            | Airline                                               |
| Xiamen Airlines Company Limited                                   | PRC                               | 60                           |            | Airline                                               |
| Guangzhou Nanland Air Catering Company Limited                    | PRC                               | 51                           |            | Air catering                                          |
| Affiliated companies                                              |                                   |                              |            |                                                       |
| Southern Airlines Group Finance Company Limited                   | PRC                               | 32                           | 15.42      | Provision of financial services                       |
| Sichuan Airlines Corporation Limited                              | PRC                               | 39                           |            | Airline                                               |
| Jointly controlled entities                                       |                                   |                              |            |                                                       |
| Guangzhou Aircraft Maintenance Engineering Company Limited (Note) | PRC                               | 50                           |            | Provision of aircraft repair and maintenance services |
| MTU Maintenance Zhuhai Co. Ltd.                                   | PRC                               | 50                           |            | Provision of engine repair and maintenance services   |
| China Postal Airlines Limited                                     | PRC                               | 49                           |            | Airline                                               |
| Zhuhai Xiang Yi Aviation Technology Company Limited               | PRC                               | 51                           |            | Provision of flight simulation services               |

Note: Guangzhou Aircraft Maintenance Engineering Company Limited has been reclassified from an affiliated company to a jointly controlled entity since 2003 due to a change in the composition of its shareholders in 2003.

Certain of the Company's subsidiaries, affiliated companies and jointly controlled entities are PRC joint ventures which have limited lives pursuant to PRC law.



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**CHINA SOUTHERN AIRLINES COMPANY LIMITED  
AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (Continued)**  
**(Amounts in thousands, except share data)**

**30. SEGMENTAL INFORMATION**

The Group operates primarily as a single business segment for the provision of air transportation services. Geographic information about the Group's operating revenue and income are as follows:

|                                     | <u>Domestic</u>   | <u>Hong Kong</u> | <u>International*</u> | <u>Total</u>      |
|-------------------------------------|-------------------|------------------|-----------------------|-------------------|
|                                     | <b>RMB</b>        | <b>RMB</b>       | <b>RMB</b>            | <b>RMB</b>        |
| <b>Year ended December 31, 2001</b> |                   |                  |                       |                   |
| Traffic revenue                     | 12,924,892        | 1,182,492        | 2,354,148             | 16,461,532        |
| Other revenue                       | 359,895           | 58,231           |                       | 418,126           |
|                                     | <u>13,284,787</u> | <u>1,240,723</u> | <u>2,354,148</u>      | <u>16,879,658</u> |
| Operating income                    | <u>1,090,154</u>  | <u>219,686</u>   | <u>90,833</u>         | <u>1,400,673</u>  |
| <b>Year ended December 31, 2002</b> |                   |                  |                       |                   |
| Traffic revenue                     | 13,197,589        | 1,118,695        | 3,165,608             | 17,481,892        |
| Other revenue                       | 485,046           |                  | 51,682                | 536,728           |
|                                     | <u>13,682,635</u> | <u>1,118,695</u> | <u>3,217,290</u>      | <u>18,018,620</u> |
| Operating income                    | <u>1,614,975</u>  | <u>193,440</u>   | <u>217,662</u>        | <u>2,026,077</u>  |
| <b>Year ended December 31, 2003</b> |                   |                  |                       |                   |
| Traffic revenue                     | 13,086,939        | 807,677          | 3,070,184             | 16,964,800        |
| Other revenue                       | 436,122           |                  | 69,201                | 505,323           |
|                                     | <u>13,523,061</u> | <u>807,677</u>   | <u>3,139,385</u>      | <u>17,470,123</u> |
| Operating income / (loss)           | <u>440,158</u>    | <u>(29,210)</u>  | <u>44,781</u>         | <u>455,729</u>    |

- \* Asian market accounted for approximately 75%, 70% and 70%, respectively, of the Group's total international traffic revenue for the years ended December 31, 2001, 2002 and 2003. The remaining portion was mainly derived from the Group's flights to/from European and North American regions.

The major revenue-earning assets of the Group are its aircraft fleet, most of which are registered in the PRC. Since the Group's aircraft fleet is employed flexibly across its route network, there is no suitable basis of allocating such assets to geographic segments. Substantially all of the Group's non-aircraft identifiable assets are located in PRC.

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AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (Continued)**  
**(Amounts in thousands, except share data)****31. SUBSEQUENT EVENTS**

In April 2004, the Company entered into a purchase agreement with Airbus SNC for the acquisition of fifteen Airbus 320-200 aircraft and six Airbus 319-100 aircraft, scheduled for deliveries in 2005 and 2006.

**32. SUPPLEMENTARY INFORMATION**

Movements in allowance for doubtful accounts comprise:

|                                          | <b>Year ended December 31,</b> |               |               |
|------------------------------------------|--------------------------------|---------------|---------------|
|                                          | <b>2001</b>                    | <b>2002</b>   | <b>2003</b>   |
|                                          | <b>RMB</b>                     | <b>RMB</b>    | <b>RMB</b>    |
| Balance at beginning of year             | 72,644                         | 59,019        | 60,118        |
| Provision for doubtful accounts (Note 9) | 1,729                          | 1,304         | 12,031        |
| Doubtful accounts written-off            | (15,354)                       | (205)         | (2,152)       |
|                                          | <b>59,019</b>                  | <b>60,118</b> | <b>69,997</b> |

**33. SIGNIFICANT DIFFERENCES BETWEEN IFRS AND U.S. GAAP**

The Group's accounting policies conform with IFRS which differ in certain material respects from U.S. GAAP. Information relating to the nature and effect of such differences are set out below.

**(a) Sale and leaseback accounting**

Under IFRS, gains on sale and leaseback transactions where the subsequent lease is an operating lease are recognized as income immediately, if the transactions are established at fair value. Differences between the sale price and fair value are deferred and amortized over the period for which the assets are expected to be used. Under U.S. GAAP, such gains are deferred and amortized over the term of the lease.

**(b) Lease arrangements**

As disclosed in Note 13 to the consolidated financial statements, during 2002 and 2003, the Group entered into two separate arrangements with certain independent third parties under which the Group sold aircraft and then immediately leased back the aircraft for a pre-determined period. As a result of the arrangements, the Group received a net cash benefit of RMB51,682 and RMB69,121 in 2002 and 2003, respectively, which has been recognized as

income under IFRS. Under U.S. GAAP, such benefits are deferred and amortized over the minimum lease period.

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In addition, under the lease arrangements, the commitments by the Group to make long-term lease payments have been defeased by the placement of security deposits. As such, under IFRS, such commitments and deposits are not recognized on the consolidated balance sheets. Under U.S. GAAP, such commitments and deposits amounting to RMB1,322,843 and RMB2,409,252 as of December 31, 2002 and 2003, respectively, would be recognized on the consolidated balance sheets, as such commitments are not deemed as extinguished by the placement of security deposits.

**(c) Capitalized interest**

Under IFRS, the Group capitalizes interest costs to the extent the related borrowings are directly attributable to the acquisition or construction of an asset.

Under U.S. GAAP, interest costs capitalized are determined based on specific borrowings related to the acquisition or construction of an asset, if an entity's financing plans associate a specific new borrowing with a qualifying asset. If average accumulated expenditures for the asset exceed the amounts of specific new borrowings associated with the asset, additional interest costs capitalized are based on the weighted average interest rate applicable to other borrowings of the entity.

**(d) Revaluation of fixed assets**

In connection with the Reorganization in 1996, the fixed assets of the Group were revalued as of December 31, 1996 (see Notes 1 and 13 to the consolidated financial statements). Such fixed asset revaluation resulted in an increase in shareholders' equity with respect to the increase in carrying amount of certain fixed assets above their historical cost bases, while a charge to the consolidated statement of operations was recorded with respect to the reduction in carrying amount of certain fixed assets below their historical cost bases. In addition, the revalued fixed asset amounts serve as the tax bases of fixed assets for years beginning in 1997. Accordingly, the fixed asset revaluation eliminated certain of the temporary differences which gave rise to a deferred tax asset as of December 31, 1996. Such tax asset was offset against the revaluation surplus.

Under U.S. GAAP, fixed assets are stated at their historical cost unless an impairment loss has been recorded. An impairment loss on fixed assets is recorded under U.S. GAAP if the carrying amount of such asset exceeds its future undiscounted cash flows, excluding finance costs. The future undiscounted cash flows, excluding finance costs, of the Group's fixed assets whose carrying amount was reduced in connection with the Reorganization, exceed their historical cost carrying amount and, therefore, impairment of such assets is not appropriate under U.S. GAAP. Accordingly, the revaluation reserve recorded directly to shareholders' equity and the charge recorded under IFRS in 1996 and the additional depreciation charges recorded in the seven years ended December 31, 2003, as a result of the Reorganization are reversed for U.S. GAAP purposes.

However, as a result of the tax deductibility of the net revaluation reserve, a deferred tax asset related to the reversal of the net revaluation reserve is created under U.S. GAAP with a corresponding increase in shareholders' equity as of December 31, 1996. Such deferred tax asset will be reversed upon depreciation of the net revaluation surplus included in the fixed assets beginning 1997.



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**(Amounts in thousands, except share data)**

**(e) Investments in affiliated company and jointly controlled entity**

During 2002, the Group invested in an affiliated company and a jointly controlled entity, which were PRC state-owned enterprises. Under IFRS, such investments are initially recorded on a fair value basis at the cost of purchases borne by the Group. In the consolidated statements of operations, the equity share of results of the investees are measured based on the fair value of underlying net assets determined on the date of acquisitions.

Under U.S. GAAP, such transactions would be considered to be combinations of businesses under common control. Under U.S. GAAP, such investments are initially recorded at the Group's equity share of net assets of the investees determined on a historical cost basis. The differences between such amounts and the cost of purchases are reflected as movements in the shareholders' equity. In the consolidated statements of operations, the equity share of results of the investees are measured based on the historical cost basis.

**(f) Acquisition of subsidiaries from CSAHC**

During 2002, the Group acquired 90% equity interest in certain subsidiaries from CSAHC. Under IFRS, the purchase method of accounting was applied to such business combination such that as from the date of combination, the results of the acquired subsidiaries and their assets and liabilities are included in the consolidated financial statements of the Group.

Under U.S. GAAP, such transaction would be considered to be a combination of entities under common control. Under U.S. GAAP, combination of entities under common control are accounted for under the as if pooling-of-interests method where assets and liabilities are accounted for at historical cost and financial statements of previously separate entities for periods prior to the combination generally are restated on a combined basis. The effect of this difference was not material to the years presented.

**(g) Provision for major overhauls**

As disclosed in Notes 2(r) and 6 to the consolidated financial statements prepared under IFRS, in respect of aircraft held under operating leases, a provision is made over the lease term for the estimated cost of scheduled overhauls required to be performed on the related aircraft prior to their return to the lessors.

Under U.S. GAAP, a liability would be recorded at the outset of the operating leases for the fair value of contractual obligations to perform the overhauls and a deferred asset would be recorded for the corresponding amount, which would be amortized over the term of the operating leases. The carrying amounts of such liability and asset would amount to approximately RMB486,660 and RMB292,773 respectively as of December 31, 2002 and RMB569,860 and RMB369,679 respectively as of December 31, 2003.

The effect of above difference on the net income/(loss) and shareholders' equity reported under U.S. GAAP was not material to the years presented.

**(h) Financial statements presentation and disclosure**

In the consolidated statements of operations presented under IFRS, (loss)/gain on sale of fixed assets is classified under Non-operating income/(expenses) . Under U.S. GAAP, such (loss)/gain would be classified under Operating income/(expenses) General and administrative .

As disclosed in Note 20 to the consolidated financial statements, deferred tax assets are presented on a net basis under IFRS. Under U.S. GAAP, the gross amounts of such deferred tax assets and any applicable valuation allowances would be separately disclosed. As of December 31, 2002 and 2003, the amount of valuation allowances which have been netted off with deferred tax assets amounted to approximately RMB48,480 and RMB53,000, respectively.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (Continued)**  
**(Amounts in thousands, except share data)**

**(i) New accounting pronouncements**

**FIN 46R**

In December 2003, the FASB issued FASB Interpretation No. 46 (revised December 2003) Consolidation of Variable Interest Entities which addresses how a business enterprise should evaluate whether it has a controlling financial interest in an entity through means other than voting rights and accordingly should consolidate the entity. FIN 46R replaces FASB Interpretation No. 46 Consolidation of Variable Interest Entities which was issued in January 2003. The Group will be required to apply FIN 46R to variable interests in VIEs created after December 31, 2003. For variable interests in VIEs created before January 1, 2004, the Interpretation will be applied beginning on January 1, 2005. For any VIEs that must be consolidated under FIN 46R that were created before January 1, 2004, the assets, liabilities and noncontrolling interests of the VIE initially would be measured at their carrying amounts with any difference between the net amount added to the consolidated balance sheets and any previously recognized interest being recognized as the cumulative effect of an accounting change. If determining the carrying amounts is not practicable, fair value at the date FIN 46R first applies may be used to measure the assets, liabilities and noncontrolling interest of the VIE. The Group is evaluating the impact of applying FIN 46R to existing VIEs in which it has variable interests and has not yet completed this evaluation.

**FASB No. 150**

FASB Statement No. 150 Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity was issued in May 2003. This Statement establishes standards for the classification and measurement of certain financial instruments with characteristics of both liabilities and equity. The Statement also includes required disclosures for financial instruments within its scope. For the Group, the Statement was effective for instruments entered into or modified after May 31, 2003 and otherwise will be effective as of January 1, 2004, except for mandatorily redeemable financial instruments. For certain mandatorily redeemable financial instruments, the Statement will be effective for the Group on January 1, 2005. The effective date has been deferred indefinitely for certain other types of mandatorily redeemable financial instruments. The Group currently does not have any financial instruments that are within the scope of this Statement.

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**CHINA SOUTHERN AIRLINES COMPANY LIMITED  
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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (Continued)**  
**(Amounts in thousands, except share data)**

Effect on net income/(loss) of significant differences between IFRS and U.S. GAAP is as follows:

|                                                                                 | Reference<br>in Note<br>above | Year ended December 31, |                |                  |                 |
|---------------------------------------------------------------------------------|-------------------------------|-------------------------|----------------|------------------|-----------------|
|                                                                                 |                               | 2001                    | 2002           | 2003             | 2003            |
|                                                                                 |                               | RMB                     | RMB            | RMB              | U.S.<br>dollars |
| Net income/(loss) under IFRS                                                    |                               | 340,225                 | 575,761        | (358,267)        | (43,286)        |
| U.S. GAAP adjustments:                                                          |                               |                         |                |                  |                 |
| Sale and leaseback accounting                                                   | (a)                           | 54,254                  | (100,664)      | 114,635          | 13,850          |
| Lease arrangements                                                              | (b)                           |                         | (49,960)       | (64,140)         | (7,749)         |
| Capitalized interest                                                            | (c)                           | 18,000                  | (31,473)       | (32,961)         | (3,982)         |
| Reversal of additional depreciation arising from<br>revaluation of fixed assets | (d)                           | 65,000                  | 33,000         | 33,000           | 3,987           |
| Investments in affiliated company and jointly<br>controlled entity              | (e)                           | 3,546                   | (541)          | 7,044            | 851             |
| Deferred tax effects                                                            |                               |                         |                |                  |                 |
| - current year                                                                  |                               | (50,369)                | 47,849         | (7,580)          | (916)           |
| - effect on change in income tax rate on deferred<br>taxation                   |                               |                         |                | (51,368)         | (6,206)         |
|                                                                                 |                               | <u>430,656</u>          | <u>473,972</u> | <u>(359,637)</u> | <u>(43,451)</u> |
| Net income/(loss) under U.S. GAAP                                               |                               |                         |                |                  |                 |
| Basic earnings/(loss) per share under U.S.<br>GAAP                              |                               | <u>0.13</u>             | <u>0.14</u>    | <u>(0.09)</u>    | <u>(0.01)</u>   |
| Basic earnings/(loss) per ADS under U.S.<br>GAAP*                               |                               | <u>6.38</u>             | <u>7.02</u>    | <u>(4.69)</u>    | <u>(0.57)</u>   |

\*Basic earnings/(loss) per ADS is calculated on the basis that one ADS is equivalent to 50 H shares.

Effect on shareholders' equity of significant differences between IFRS and U.S. GAAP is as follows:

|                                                                 | Reference<br>in Note<br>above | December 31,     |                   |                  |
|-----------------------------------------------------------------|-------------------------------|------------------|-------------------|------------------|
|                                                                 |                               | 2002             | 2003              | 2003             |
|                                                                 |                               | RMB              | RMB               | U.S. Dollars     |
| Shareholders' equity under IFRS                                 |                               | 9,613,207        | 11,895,707        | 1,437,252        |
| U.S. GAAP adjustments:                                          |                               |                  |                   |                  |
| Sale and leaseback accounting                                   | (a)                           | (586,989)        | (472,354)         | (57,070)         |
| Lease arrangements                                              | (b)                           | (49,960)         | (114,100)         | (13,786)         |
| Capitalized interest                                            | (c)                           | 381,021          | 348,060           | 42,053           |
| Revaluation of fixed assets, net of depreciation                | (d)                           | (46,120)         | (13,120)          | (1,585)          |
| Investments in affiliated company and jointly controlled entity | (e)                           | (118,003)        | (110,959)         | (13,406)         |
| Deferred tax effects                                            |                               | 94,175           | 35,227            | 4,256            |
|                                                                 |                               | <u>9,287,331</u> | <u>11,568,461</u> | <u>1,397,714</u> |
| Shareholders' equity under U.S. GAAP                            |                               |                  |                   |                  |

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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 SOUTHERN AIRLINES COMPANY LIMITED

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*(Registrant)*

/s/ Yan Zhi Qing

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Name: Yan Zhi Qing  
Title: Chairman of the Board of Directors

Date: June 30, 2004

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**EXHIBIT INDEX**

| <b>Exhibit No.</b> | <b>Description of Exhibit</b>                        |
|--------------------|------------------------------------------------------|
| 1                  | Articles of Association                              |
| 4.1                | Form of Director's Service Agreement                 |
| 4.2                | Form of Non-Executive Director's Service Agreement   |
| 8                  | Subsidiaries of the Company                          |
| 12.1               | Section 302 Certification of Chairman                |
| 12.2               | Section 302 Certification of President               |
| 12.3               | Section 302 Certification of Chief Financial Officer |
| 13.1               | Section 906 Certification of Chairman                |
| 13.2               | Section 906 Certification of President               |
| 13.3               | Section 906 Certification of Chief Financial Officer |