



FINANCIAL STATEMENTS CCB ANNUAL REPORT 2004

> China Construction Bank Corporation Annual Report 2004 >



12 Financial Statements

Auditors' report	89
Balance sheet	90
Income statement	92
Statement of changes in owners' equity	93
Cash flow statement	94
Notes to the financial statements	98

Auditors' report

KPMG-A (2005) AR No.0350

To all shareholders of China Construction Bank Corporation (the "Bank"):

We have audited the attached balance sheets as at 31 December 2003 and 2004, and the related income statements, statements of changes in owners' equity and cash flow statements of the Bank for the years then ended. The preparation of these financial statements is the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with China's Independent Auditing Standards of the Certified Public Accountants. 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 the Bank's management, as well as evaluating the overall financial statements presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the above mentioned financial statements comply with the requirements of the Accounting Standards for Business Enterprises, *the Accounting Regulations for Financial Enterprises* issued by the Ministry of Finance of the People's Republic of China and present fairly, in all material respects, the financial positions of the Bank as at 31 December 2003 and 2004, and the results of operations and cash flows of the Bank for the years then ended.

KPMG Huazhen

Certified Public Accountants
Registered in the People's Republic of China

Jin Naiwen

8th Floor, Tower E2
Oriental Plaza
No.1, East Chang'an Avenue
Beijing, The People's Republic of China
Postcode: 100738

Zhang Bohui

6 June 2005

Balance sheet

Expressed in millions of Renminbi

ASSETS	Note	2004	2003
Current assets			
Cash		27,080	24,410
Deposits with central banks	5	372,286	306,338
Deposits with banks and other financial institutions	6	6,516	10,900
Placements with banks and other financial institutions	7	69,981	205,527
Short-term loans	8	687,530	715,000
Trade finance	9	5,762	5,150
Interest receivable		10,329	7,393
Other receivables	10	30,417	151,688
Discounted bills	11	157,319	103,863
Short-term investments	12	149,880	82,398
Amounts held under resale agreements	13	37,022	21,603
Long-term debt investments maturing within one year	14	35,473	38,700
Total current assets		1,589,595	1,672,970
Long-term assets			
Medium and long-term loans	15	1,306,604	1,118,286
Non-accrual loans	16	68,370	53,691
Less: Provision for loan losses	17	(53,829)	(54,359)
Long-term debt investments	18	905,882	652,773
Long-term equity investments	19	16,433	29,989
Fixed assets at cost		85,842	83,999
Less: Accumulated depreciation		(19,053)	(13,686)
Less: Provision for impairment of fixed assets		(490)	-
Fixed assets at net book value	20	66,299	70,313
Construction in progress		764	963
Total long-term assets		2,310,523	1,871,656
Intangible assets and other assets			
Intangible assets		1,336	1,619
Long-term deferred expenses		469	654
Repossessed assets	21	2,862	6,171
Total intangible assets and other assets		4,667	8,444
TOTAL ASSETS		3,904,785	3,553,070

The notes on pages 98 to 145 form part of these financial statements.

Balance sheet (continued)

Expressed in millions of Renminbi

LIABILITIES AND SHAREHOLDERS' / OWNER'S EQUITY	Note	2004	2003
Current liabilities			
Short-term deposits	22	1,688,645	1,538,543
Short-term savings deposits	23	1,326,249	1,217,702
Fiscal balances		2,408	1,665
Amounts due to central banks		2,222	2,222
Deposits from banks and other financial institutions	24	88,854	89,293
Placements from banks and other financial institutions	25	23,270	19,693
Amounts sold under repurchase agreements	26	125	3,760
Outward remittances		29,134	29,280
Inward remittances		6,098	7,833
Interest payable		23,480	21,720
Salaries payable		2,669	2,151
Accrued welfare expenses		1,275	590
Dividends payable		2,914	-
Tax payable	27	4,446	2,264
Other payables	28	27,678	26,643
Long-term liabilities due within one year	29	183,567	153,568
Total current liabilities		3,413,034	3,116,927
Long-term liabilities			
Long-term deposits	30	39,480	55,961
Long-term savings deposits	31	199,430	184,239
Long-term pledged deposits	32	5,546	7,130
Structured foreign currency deposits		9,892	994
Certificates of deposit issued		2,659	1,589
Subordinated bonds issued	33	40,000	-
Total long-term liabilities		297,007	249,913
Total liabilities		3,710,041	3,366,840
Share capital		194,230	-
Surplus reserve		514	-
Owner's equity		-	186,230
Total shareholders' / owner's equity	34	194,744	186,230
TOTAL LIABILITIES AND SHAREHOLDERS' / OWNER'S EQUITY		3,904,785	3,553,070

These financial statements have been approved by the Board of Directors of the Bank.

Guo Shuqing
Authorised representative

Fan Yifei
Officer in charge of Accounting

Wang Guiya
General Manager of
the Planning & Financial Department

Lu Kegui
General Manager of
the Accounting Department

6 June 2005

The notes on pages 98 to 145 form part of these financial statements.

Income statement

Expressed in millions of Renminbi

	Note	2004	2003
Operating income			
Interest income	35	110,025	99,494
Interest income from deposits and placements with banks and other financial institutions	36	8,408	8,123
Fee and commission income		7,352	5,159
Other operating income		1,168	1,209
Total operating income		126,953	113,985
Operating expenses			
Interest expense	37	(43,577)	(39,251)
Interest expense on deposits and placements from banks and other financial institutions	38	(1,851)	(2,107)
Fee and commission expense		(984)	(578)
Other operating expenses		(325)	(256)
Total operating expenses		(46,737)	(42,192)
General and administrative expenses	39	(43,960)	(39,711)
Investment income	40	30,703	23,908
Operating profit		66,959	55,990
Less: Business tax and surcharges		(6,459)	(5,516)
Add: Non-operating income		1,433	545
Less: Non-operating expenses	41	(2,887)	(5,377)
Total profit before provisions for impairment		59,046	45,642
Less: Provisions for impairment	42	(8,830)	(8,169)
Total profit after provisions for impairment		50,216	37,473
Less: Income tax	43	(1,828)	(15,086)
Net profit		48,388	22,387

These financial statements have been approved by the Board of Directors of the Bank.

Guo Shuqing
Authorised representative

Fan Yifei
Officer in charge of Accounting

Wang Guiya
General Manager of
the Planning & Financial Department

Lu Kegui
General Manager of
the Accounting Department

6 June 2005

The notes on pages 98 to 145 form part of these financial statements.

Statement of changes in owners' equity

Expressed in millions of Renminbi

	Note	Share capital	Surplus reserves	Retained profits	Owner's equity	Total
As at 1 January 2003		-	-	-	(134,322)	(134,322)
Net profit		-	-	-	22,387	22,387
Profit distribution	34 (a)	-	-	-	(3,542)	(3,542)
Restructuring	1,34 (b)					
- Capital injection by owner		-	-	-	186,230	186,230
- Disposal of non-performing loans		-	-	-	35,818	35,818
- Receivable from the government		-	-	-	65,499	65,499
- Surplus on valuation		-	-	-	14,160	14,160
As at 31 December 2003		-	-	-	186,230	186,230
Shares issued upon incorporation of the Bank	34 (c)	194,230	-	-	(186,230)	8,000
Net profit		-	-	48,388	-	48,388
Profit distribution	34 (d)	-	514	(48,388)	-	(47,874)
As at 31 December 2004		194,230	514	-	-	194,744

These financial statements have been approved by the Board of Directors of the Bank.

Guo Shuqing
Authorised representative

Fan Yifei
Officer in charge of Accounting

Wang Guiya
General Manager of
the Planning & Financial Department

Lu Kegui
General Manager of
the Accounting Department

6 June 2005

The notes on pages 98 to 145 form part of these financial statements.

Cash flow statement

Expressed in millions of Renminbi

	Note to the cash flow statement	2004	2003
Cash flows from operating activities			
Repayment of medium and long-term loans		442,244	393,186
Net amount of current deposits taken		78,108	182,809
Non-current deposits taken		4,452,560	3,971,128
Net increase in deposits from banks and other financial institutions		-	100
Net increase in placements from banks and other financial institutions		-	5,796
Net decrease in placements with banks and other financial institutions		-	50,146
Interest and commission received		125,352	112,661
Recoveries of loans written off in prior years		653	2,117
Proceeds from certificates of deposit issued		2,131	3,755
Cash inflow from other operating activities		33,167	10,045
Sub-total of cash inflow		5,134,215	4,731,743
Net increase in statutory deposits with central banks		(45,499)	(49,831)
Medium and long-term loans drawn		(474,621)	(544,918)
Net amount of short-term loans drawn		(168,937)	(257,253)
Repayment of non-current deposits		(4,232,618)	(3,781,419)
Net decrease in deposits from banks and other financial institutions		(439)	-
Net decrease in placements from banks and other financial institutions		(58)	-
Net increase in placements with banks and other financial institutions		(20,937)	-
Interest and commission paid		(44,546)	(40,516)
Cash paid to and on behalf of employees		(22,337)	(22,850)
Payment of all types of taxes		(6,658)	(6,236)
Repayment of certificates of deposit		(2,797)	(1,149)
Net borrowings from central banks		-	(185)
Cash outflow from other operating activities		(17,915)	(15,418)
Sub-total of cash outflow		(5,037,362)	(4,719,775)
Net cash inflow from operating activities	(I)	96,853	11,968

The notes on pages 98 to 145 form part of these financial statements.

Cash flow statement (continued)

Expressed in millions of Renminbi

	Note to the cash flow statement	2004	2003
Cash flows from investing activities			
Cash received from disposal of equity investments		13,502	2,022
Cash received from disposal and redemption of debt investments		528,661	279,216
Cash received from dividends		777	997
Cash received from interest on debt investments		21,499	21,888
Net cash received from disposal of fixed assets and other assets		2,701	3,174
Sub-total of cash inflow		567,140	307,297
Cash paid for acquisition of equity investments		(143)	(113)
Cash paid for acquisition of debt investments		(823,971)	(330,936)
Cash paid for acquisition of fixed assets and other assets		(7,099)	(8,163)
Sub-total of cash outflow		(831,213)	(339,212)
Net cash outflow from investing activities		(264,073)	(31,915)
Cash flows from financing activities			
Cash received from capital injection/shares issued		8,000	186,230
Cash received from subordinated bonds issued		40,000	-
Sub-total of cash inflow		48,000	186,230
Distribution to the owner in connection with the Restructuring		-	(60)
Cash paid for expenses for the issue of subordinated bonds		(106)	-
Sub-total of cash outflow		(106)	(60)
Net cash inflow from financing activities		47,894	186,170
Effect of exchange rate changes on cash held		(3)	1
Net (decrease)/ increase in cash and cash equivalents	(II)	(119,329)	166,224

The notes on pages 98 to 145 form part of these financial statements.

Cash flow statement (continued)

Notes to the cash flow statement

Expressed in millions of Renminbi

	2004	2003
(I) Reconciliation of net profit to cash flows from operating activities		
Net profit	48,388	22,387
Add: Provision for loan losses	5,586	7,657
Provision for impairment on other assets	3,244	512
Depreciation of fixed assets and amortisation of intangible assets and long-term deferred expenses	8,532	7,122
Net loss on disposal of fixed assets, intangible assets and other assets	210	730
Investment income	(30,703)	(23,908)
Decrease in deferred tax assets	-	14,887
Fees on issue of subordinated bonds	106	-
Increase in operating receivables	(234,163)	(503,138)
Increase in operating payables	295,653	485,719
Net cash inflow from operating activities	96,853	11,968
(II) Net (decrease) / increase in cash and cash equivalents		
Cash and cash equivalents at the end of the year	220,106	339,435
Less: Cash and cash equivalents at the beginning of the year	(339,435)	(173,211)
Net (decrease) / increase in cash and cash equivalents	(119,329)	166,224
(III) Cash and cash equivalents		
Cash	27,080	24,410
Cash equivalents		
- Deposits with central banks	123,540	100,299
- Deposits with banks and other financial institutions	6,516	10,900
- Placements with banks and other financial institutions	62,970	203,826
Sub-total of cash equivalents	193,026	315,025
Total	220,106	339,435

The notes on pages 98 to 145 form part of these financial statements.

Cash flow statement (continued)

Notes to the cash flow statement (continued)

(IV) Activities that do not involve cash receipts and payments

(i) Assets and liabilities separated at the Restructuring	(Notes 1 and 34 (b))
(ii) Receivables settled by bills	(Note 1)
(iii) Recognition and replenishment of a receivable from the government	(Notes 1 and 10)
(iv) Interest repaid on special government bonds	(Note 34 (a))

These financial statements have been approved by the Board of Directors of the Bank.

Guo Shuqing

Authorised representative

Fan Yifei

Officer in charge of Accounting

Wang Guiya

General Manager of
the Planning & Financial Department

Lu Kegui

General Manager of
the Accounting Department

6 June 2005

The notes on pages 98 to 145 form part of these financial statements.

Notes to the financial statements

(Expressed in millions of Renminbi, unless otherwise stated)

1 Company status

China Construction Bank Corporation (the "Bank") is a joint stock company with limited liability incorporated in Beijing in the People's Republic of China ("PRC") on 17 September 2004. The Bank obtained a financial service certificate B10411000H0001 on 15 September 2004, as approved by the China Banking Regulatory Commission ("CBRC"), and business license 1000001003912 on 17 September 2004, as approved by the State Administration for Industry and Commerce of the PRC. The Bank is under the supervision of the banking regulatory bodies empowered by the State Council of the PRC ("the State Council").

With the approval of the State Council on 30 December 2003, China Construction Bank ("CCB") underwent a restructuring (the "Restructuring"), whereby CCB received a capital injection of USD 22,500 million (equivalent to RMB 186,230 million) from China SAFE Investments Limited, previously known as Central Huijin Investment Co., Ltd. ("Huijin"), in cash on 30 December 2003 as CCB's paid-in capital. CCB eliminated all paid-in capital (excluding the above mentioned paid-in capital), capital reserve and surplus reserve as at 31 December 2003 together with the net profit for the year ended 31 December 2003 against the accumulated losses as at 31 December 2003. As a result, Huijin became the sole owner of CCB.

As part of the Restructuring, the State Council also approved the following:

— The disposal of non-performing loans with a principal amount of RMB 128,900 million outstanding as at 31 December 2003 at 50% of the principal amount. The People's Bank of China ("PBOC") has been designated by the State Council to temporarily receive these loans. As such, the Bank recognised the transaction immediately on the basis that substantially all the risks and rewards of these loans have been transferred. Disposal proceeds of RMB 64,450 million were recognised as a receivable (Note 10) and the difference of RMB 35,818 million between the disposal proceeds and the net carrying value of the loans was directly credited to owner's equity as an equity contribution by the owner (Note 34).

In June 2004, China Cinda Asset Management Company ("Cinda") was chosen as the receiver of these loans by the PBOC. On 28 June 2004, Cinda entered into an ownership transfer contract with CCB to purchase these loans at the above mentioned price.

Disposal proceeds of RMB 64,450 million were fully settled by Cinda on 30 June 2004, of which RMB 63,354 million was used to subscribe to a bill issued by the PBOC at par value on the same day. The bill will mature in June 2009 and bears a fixed interest rate of 1.89% per annum. The PBOC has a right to early redeem this bill (Note 18).

— The PBOC issued a bill to CCB with a nominal value of RMB 21,000 million on 30 June 2004 to settle receivables arising from acting as the receiver, appointed by the State Council and the PBOC, for the liquidation of a trust and investment company. The bill will mature in June 2007 with a right of the PBOC to early redeem subject to certain conditions, and bears a fixed interest rate of 1.89% per annum (Notes 10 and 18).

— An agreement to replenish CCB's remaining accumulated losses of RMB 65,499 million. This will be repaid in the short term and is recorded as a receivable from the PRC government (Note 10).

— Financial support by the Ministry of Finance (the "MOF") for the payment of interest and support by the MOF for the repayment of principal of a bond with a nominal value of RMB 247,000 million, issued by Cinda, which is held by the Bank. The bond will mature in September 2009 and bears a fixed interest rate of 2.25% per annum (Note 18).

— An adjustment of the interest rate of a special government bond which is held by the Bank, with a nominal value of RMB 49,200 million, to a fixed interest rate of 2.25% per annum effective 1 December 2004. The related bond interest is settled periodically in cash (Note 18).

— The issuance of subordinated bonds with a total nominal value of RMB 40,000 million to strengthen the capital base.

Pursuant to the separation agreement signed by Huijin, China Jianyin Investment Limited ("Jianyin") (a state owned company which is directly and wholly owned by Huijin) and the Bank on 15 September 2004 ("Separation Agreement"), the Bank succeeded to substantially all the commercial banking businesses and related operations, together with the relevant assets and liabilities (the "Succeeding Business") of CCB as at 31 December 2003. Businesses that were not related to the commercial banking businesses, including the entrusted lending business transacted prior to 20 October 2000 (excluding the entrusted housing fund mortgage business), and certain assets and liabilities (the "Non-core Business") were transferred to Jianyin as a distribution to the owner (Note 34).

The above mentioned net assets of CCB, to which the Bank succeeded, were valued at RMB 186,230 million (including the above mentioned receivable from the government) by China Consultants of Accounting and Financial Management Co., Ltd (“CCAFM”). On 14 September 2004, the MOF approved the above valuation by issuing Cai Jin [2004] No. 84 “MOF’s Approval on the Asset Valuation Project for the Incorporation of China Construction Bank Corporation”. In accordance with the relevant regulations relating to the Restructuring, the Bank restated the related assets at the valuation amount as at 31 December 2003.

Upon incorporation on 17 September 2004, the Bank issued 165,538 million and 20,692 million promoters’ shares with a par value of RMB 1 each to Huijin and Jianyin respectively as consideration for the Succeeding Business and related assets and liabilities. On the same date, the Bank issued a total of 8,000 million promoters’ shares with a par value of RMB 1 each for cash to three other promoters, State Grid Corporation of China (“State Grid”), Shanghai Baosteel Group Corporation (“Shanghai Baosteel”) and China Yangtze Power Co., Ltd. (“Yangtze Power”). In total, the Bank issued 194,230 million shares with a par value of RMB 1 each. All shares rank pari passu.

Commercial banking activities referred to above include deposit taking, lending, payment settlement and other financial services in Renminbi and foreign currencies as approved by the CBRC.

2 Basis of preparation

The financial statements have been prepared as if the Bank had been in existence throughout the period from 1 January 2003 to 16 September 2004 and on the basis of the accounting policies stated in Note 3. The accounting policies adopted by the Bank are based on the Accounting Standards for Business Enterprises, *the Accounting Regulations for Financial Enterprises* (in 2001) issued by the MOF, and other relevant regulations.

In accordance with the Separation Agreement, the effective date of separation was 31 December 2003. The comparative figures of the Bank’s income statement for the year ended 31 December 2003 include the profits arising from the Succeeding Business and the Non-core Business. The assets and liabilities transferred to Jianyin (Non-core Business) are not included in the balance sheet as at 31 December 2003 and are accounted for as a distribution to the owner as at 31 December 2003 (Note 34). From 1 January 2004, the financial statements include only the assets and liabilities, the income and expenses and the cash flow of the Bank’s Succeeding Business.

The previously issued statutory financial statements of CCB for the year ended 31 December 2003 include the income and expenses for the year then ended and the assets and liabilities as at the date of the businesses succeeded by both the Bank and Jianyin from CCB. These financial statements were prepared in accordance with accounting policies which conform to the Accounting Standards for Business Enterprises issued by the MOF (limited to those standards effective for all enterprises), *the Accounting Regulations for Financial Enterprises* issued by the MOF and the PBOC in 1993 and other relevant regulations. Due to the Restructuring and the adoption of different accounting policies adopted by the Bank and CCB respectively, the financial information contained in the statutory financial statements for the year ended 31 December 2003 in this report are not comparable with the financial statements of CCB for the same period. As a result, the Bank has appointed KPMG Huazhen to audit the financial statements for the year ended 31 December 2004 as well as comparative figures for the year ended 31 December 2003.

3 Significant accounting policies

(a) Accounting year

The accounting year of the Bank is from 1 January to 31 December.

(b) Basis of preparation of the financial statements

The Bank's financial statements have been prepared based on the individual financial statements and other relevant information of its 38 tier-1 domestic branches, the head office Banking Department and 6 overseas branches. All material inter-branch transactions and balances have been eliminated during consolidation.

(c) Accounting basis and measurement principles

The financial statements of the Bank have been prepared on an accruals basis. Unless otherwise stated, the measurement basis used is historical cost.

(d) Reporting currency

The Bank's reporting currency is the Renminbi.

(e) Accounting for foreign currency transactions and foreign currency translation

Foreign currency transactions are recorded in multi-currency ledgers. For the purpose of compiling the financial statements at the balance sheet date, financial statements denominated in foreign currencies are translated into Renminbi and consolidated with the financial statements denominated in Renminbi.

All balance sheet items denominated in foreign currencies, except for equity, are translated into Renminbi at the exchange rates ruling at the balance sheet date. Equity items are translated into Renminbi at the exchange rates ruling at the historical transaction dates. The resulting exchange differences are dealt with as a foreign exchange gain or loss and disclosed as a separate equity item. The income statements were translated into Renminbi at the exchange rates ruling at the period end.

The Bank adopts the exchange rates quoted by the PBOC or other recognised exchange rates.

(f) Loans

(i) Loan classification

Short, medium and long-term loans: Loans are classified according to their original maturity terms. Except for non-accrual loans, loans originally maturing within one year are classified as short-term loans, whilst those originally maturing after one year are classified as medium and long-term loans.

Non-accrual loans: Loans are classified as non-accrual loans when the principal or interest is overdue for more than 90 days.

(ii) Loan recognition

Loans are stated at the amount actually drawn.

(iii) Provision for loan losses

A provision for credit impairment is made if there is objective evidence that the Bank will be unable to collect all amounts due from on and off balance sheet risk-bearing credits. Credit subject to impairment provisioning includes loans (including loans secured by tangible

assets other than monetary assets, loans pledged by monetary assets, guaranteed loans and unsecured loans), bank card overdrafts, discounted bills, trade bills and credit advances (e.g. bank acceptance bills, guarantees and letters of credit).

A provision for credit impairment is reported as a reduction in the carrying value of an on balance sheet item, whereas for off balance sheet items such a provision for credit impairment is reported in other payables. Provisions for credit impairment are recognised as profit or loss for the current period.

Provisions for credit impairment are evaluated at a counterparty-specific and a portfolio-general level based on the following principles:

Counterparty-specific: credit is considered impaired if management considers that it is probable that the bank will not be able to collect all amounts due based on the original contractual terms or an equivalent amount. Individual credit exposures are evaluated based upon the borrower's willingness to pay, the payment history, the market value of the security pledged and the ability and the intention of the guarantor. The estimated recoverable amount is the present value of expected future cash flows. Impairment is measured as a difference between the carrying amount and the estimated recoverable amount.

Portfolio-general: if there are indications of significant probable losses in the credit portfolio that have not been individually identified, a provision for credit impairment would also be recognised on a portfolio basis.

All impaired credits are reviewed and assessed at least annually with any subsequent changes to the estimated recoverable amounts resulting in changes in the provisions for credit impairment.

A provision for impairment is reversed only if the credit quality has improved such that there is a reasonable assurance of collection of the principal and interest.

(iv) Loan write-off

A write-off is made when management determines that the credit is uncollectible after the completion of legal or other procedures to collect the loan or credit. Write-offs are charged against the previously made provisions for credit impairment. Recoveries of amounts previously written off are netted against provisions for credit impairment expensed in the current period.

(g) Discounted bills

Discounted bills are unmatured bills discounted by the Bank. The interest income from discounted bills is calculated based on the face value of the bill, the maturity period and the relevant interest rate. Unaccrued interest income from discounted bills is deferred. The discounted bills are shown on the balance sheet at face value net of any deferred interest income at the balance sheet date.

(h) Amounts held under resale and repurchase agreements

In resale and repurchase agreements, the cash advanced or received is recognised as amounts held under resale and repurchase agreements on the balance sheet. Securities received or delivered under these agreements are in general not recognised on or derecognised from the balance sheet.

Interest earned and incurred on these agreements is recognised over the period of these agreements as interest income and expenses from deposits and placements with banks and other financial institutions respectively.

(i) Short-term investments

Short-term investments represent investments readily realisable with intended holding periods of within one year. Short-term investments are carried at the lower of cost and market value. The cost of a short-term investment is the total price paid on acquisition of the investment. However, it does not include unpaid interest on debt securities which was due at the time of acquisition.

Provisions for diminution in value are made on an item-by-item basis for any shortfall in the market value below the cost of short-term investments.

With the exception of interest on debt securities, which is due but not yet paid at the time of acquisition, interest is set off against the carrying amount of short-term investments when received by the Bank. Upon the disposal or redemption of short-term investments, the difference between the carrying amount of the short-term investments and the proceeds received is recognised as profit or loss for the current period.

(i) Long-term investments

Long-term investments are investments other than short-term investments.

Upon the disposal or transfer of long-term investments, the difference between the proceeds received and the carrying amount of the investments is recognised in the income statement.

(i) Long-term equity investments

Where the Bank has the power to control, jointly control or exercise significant influence over an investee enterprise, the investment is accounted for under the equity method of accounting whereby the investment is initially recorded at cost and adjusted thereafter for any post acquisition change in the Bank's share of the investors' equity in the investee enterprise.

Where the Bank does not control, jointly control or exercise significant influence over an investee enterprise, the investment is accounted for under the cost method whereby it is stated at the initial investment cost. Investment income is recognised when the investee enterprise declares a cash dividend or distributes profits.

Long-term investments are accounted for in the balance sheet at cost less provision for impairment (Note 3 (p)).

(ii) Long-term debt investments

The initial investment cost of a long-term debt investment is the total price paid on the acquisition of the investment. However, this excludes any due but unpaid interest receivable at the time of acquisition.

If long-term debt investments have been purchased at a premium or discount, those premiums and discounts are amortised through the income statement over the period from the date of acquisition to the date of maturity. These securities are included in the balance sheet at cost adjusted for the amortisation of premiums and discounts arising on acquisition.

Transaction costs associated with the acquisition of long-term debt investments are expensed.

Accrued interest on long-term debt investments with periodic interest payments that are not yet due at the balance sheet date is separately accounted for under interest receivable within current assets. Accrued interest on long-term investments with interest payable upon maturity is separately accounted for under interest receivable of long-term debt investments.

At the period end, long-term investments are accounted for in the balance sheet as the principal, plus the interest receivable from bonds with interest payable upon maturity and unamortised premiums and discounts, less any provision for impairment (Note 3 (p)).

(k) Fixed assets and construction in progress

Fixed assets are assets with comparatively high unit values held by the Bank for developing its banking business. They are expected to be used for more than one year.

Fixed assets are stated in the balance sheet at cost or valuation amount (Note 1) less accumulated depreciation and provision for impairment (Note 3 (p)). Construction in progress is stated in the balance sheet at cost or valuation amount less provision for impairment (Note 3 (p)).

All direct and indirect costs that are related to the construction of fixed assets and incurred before the assets are ready for their intended use are capitalised as construction in progress. Construction in progress is transferred to fixed assets when it is ready for its intended use. No depreciation is provided against construction in progress.

Fixed assets are depreciated using the straight-line method over their estimated useful lives, after taking into account of their estimated residual value. The respective estimated useful lives for the Bank's fixed assets are as follows:

Asset category	Estimated useful life
Land use rights	30 - 50 years
Bank premises	30 - 35 years
Computer equipment	3 - 8 years
Others	4 - 11 years

(l) Intangible assets

Intangible assets are stated in the balance sheet at cost or valuation amount (Note 1) less accumulated amortisation and provision for impairment (Note 3 (p)). The cost or valuation amount of the intangible assets is amortised on a straight-line basis over their estimated useful lives which range from 3 to 50 years.

(m) Long-term deferred expenses

Long-term deferred expenses are amortised on a straight-line basis over their beneficial

periods which range from 2 to 10 years. During the beneficial periods, unamortised amounts of any long-term deferred assets that are no longer deemed useful are fully charged to the income statement in the current period.

(n) Repossessed assets

Repossessed assets are recorded at the amount of the related loan principal value plus any recognised interest receivable and the relating taxes paid arising from the acquisition of the assets. At the same time, all the corresponding loan provisions are transferred to provisions for impairment of repossessed assets. At the period end, repossessed assets are stated in the balance sheet at cost less provision for impairment (Note 3(p)).

(o) Provision for bad debts

Provisions for bad debts against all types of receivable items (including deposits, placements and other receivables, etc.) are made on an item-by-item basis when they are estimated to be unrecoverable. The Bank accounts for bad debt losses through provisioning.

(p) Provision for impairment

The carrying amounts of assets (including long-term investments, fixed assets, construction in progress, intangible assets and repossessed assets) are reviewed regularly at each balance sheet date to determine whether their recoverable amounts have declined below their carrying amounts. 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, provisions for impairment are recognised on an item-by-item basis for the deficit between the recoverable amount and the carrying amount. Changes in the provision for impairment are recognised as a profit or loss in the income statement. The recoverable amount is the greater of the net selling price and the present value of the estimated future cash flows arising from the continuous use of the asset and from the disposal of the asset at the end of its useful life.

If there is an indication that there has been a change in the estimates used to determine the recoverable amount and as a result the estimated recoverable amount is greater than the carrying amount of the asset, the impairment loss recognised in prior periods is reversed. Reversals of impairment losses are recognised in the income statement. An impairment loss is reversed only to the extent of the asset's carrying amount that would have been determined

had no impairment loss been recognised in prior years.

(q) Subordinated bonds issued

Subordinated bonds issued are recognised as a liability for the total proceeds received upon issuance. The difference between the total proceeds and the face value of the debt securities represent the premium or discount of the debt securities, which is amortised through the income statement over the maturity period. The amount of expenses arising from the issuance of the debt securities which exceeds the interest income accrued during the blocked issue period is recognised in the income statement.

Interest payable for subordinated bonds issued is recognised on an accruals basis. Interest expenses and the amortisation of the discount and premium are recognised in the related period.

(r) Entrusted loans and entrusted funds

The Bank enters into entrusted loan agreements with a number of customers, whereby the customers provide funding (“entrusted funds”) to the Bank, and the Bank grants loans to third parties (“entrusted loans”) on the instructions of the customers.

Entrusted loans and the corresponding entrusted funds are recorded as off balance sheet items and no provisions are set aside for these entrusted loans. Entrusted funds received but not yet released to borrowers are recorded as deposits from customers.

(s) Financial derivatives

Financial derivatives arise from spot, forward, foreign currency swap, interest rate swap and option transactions undertaken by the Bank in the foreign exchange, interest rate and equity markets. Financial derivatives are recorded at the contract value as off balance sheet items. The Bank recognises gains and losses in the income statement upon the settlement date of the derivative contracts.

(t) Income recognition

When it is probable that the economic benefits will flow to the Bank and the income can be measured reliably, income is recognised in the income statement according to the following methods:

(i) Interest income

— Loan interest income is recognised on an accruals basis with reference to the principal and period outstanding and at the rate applicable. For either the loan principal or interest overdue for more than 90 days (including extension), the accrual of interest is discontinued and is accounted for in the off balance sheet memorandum accounts. Interest receivable is reversed in the income statement and recorded as an off balance sheet item. Amounts received subsequently will first be set off against the loan principal. It is only when the loan principal is fully recovered that any further amounts received can be recognised in the income statement.

— Other interest income is recognised on an accruals basis with reference to the principal and period outstanding and at the rate applicable.

(ii) Commission income

Commission income is recognised when the related services are rendered.

(iii) Other income

Other income is recognised on an accruals basis.

(u) Expense recognition**(i) Interest expenses**

Interest expenses are recognised on an accruals basis with reference to the amount and period outstanding and at the rate applicable.

(ii) Other expenses

Other expenses are recognised on an accruals basis.

(v) Employee benefits

The Bank participates in social insurance programs established by government agencies, including pension plans, medical insurance, housing provident funds and other social insurance. Insurance and provident funds contributions, a proportion of salaries not exceeding the prescribed maximum limit, are paid to the relevant labour and social insurance agencies and recognised as general and administrative expenses when incurred.

(w) Income tax

The Bank uses the tax-effect accounting method to account for income tax. Income tax for the year comprises current tax paid and payable and movements in deferred tax assets and liabilities.

Current income tax is calculated at the applicable tax rate on taxable income.

Deferred tax is provided for using the liability method for the differences between the accounting profits and the taxable profits arising from the timing differences in recognising income, expenses or losses between the accounting and tax regulations. Deferred tax is only recognised to the extent that it is probable that the asset can be utilised in the future. When the tax rate changes or a new type of tax is levied, adjustments are made to the amounts originally recognised for the timing differences under the liability method. The current tax rates are used in arriving at the reversal amounts when the timing differences are reversed.

When it is not probable that the tax benefits of deferred tax assets will be realised, the deferred tax assets are reduced to the extent that the related tax benefits are expected to be realised.

(x) Cash equivalents

Cash equivalents include short-term, highly liquid investments, which are readily convertible into known amounts of cash and are subject to an insignificant risk of changes in value, as well as surplus deposit reserve funds with central banks and deposits and placements with other banks and financial institutions.

(y) Provisions and contingent liability

Provisions are recognised when the Bank has a present obligation as a result of a past event, it is probable that an outflow of economic benefits will be required to settle the obligations and a reliable estimate can be made.

Where it is not probable that the settlement of the above obligation will cause an outflow of economic benefits, or the amount of the outflow cannot be estimated reliably, the obligation is disclosed as a contingent liability.

(z) Profit distributions

Profit distributions are recognised in the income statement and statement of changes in owners' equity upon approval. Cash dividends approved after the balance sheet date, but before the approval of the financial statements, are disclosed on the face of the balance sheet as a separate component under shareholders' equity.

(aa) Related parties

If the Bank has the power, directly or indirectly, to control, jointly control or exercise significant influence over another party, or vice versa, or where the Bank and one or more parties are subject to common control from another party, they are considered to be related parties. Related parties may be individuals or enterprises.

4 Taxes

The Bank's main applicable taxes and tax rates are as follows:

(a) Business tax

Business tax is charged at 5% on operating income, excluding interest income from deposits and placements with banks and other financial institutions and interests recovered for loans already written off included in other operating income, plus penalty income included in non-operating income and postage income and handling charges from customers.

(b) City construction tax

City construction tax is calculated as 1% - 7% of business tax.

(c) Education surcharge

Education surcharge is calculated as 3% of business tax.

(d) Income tax

The Bank's income tax is paid centrally by the head office and the applicable rate is 33%. As taxation on overseas branches is charged at the relevant local rates, when filing the consolidated tax return, tax deductions are allowable according to the relevant income tax laws of the PRC. Tax exemptions are duly recognised upon approval from relevant government departments.