卡森國際控股有限公司

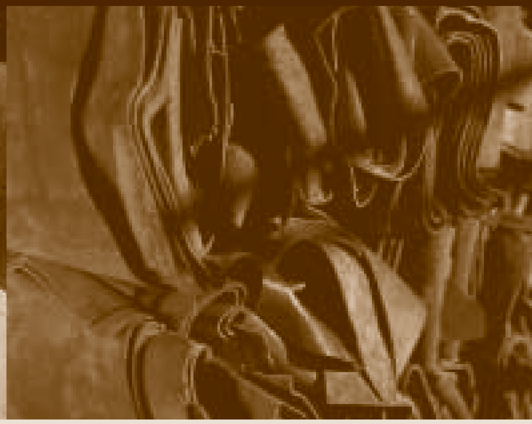
KASEN INTERNATIONAL HOLDINGS LIMITED

(an exempted company incorporated in the Cayman Islands with limited liability)

stock code : 496

Annual Report 2006

Contents



Corporate Information

BOARD OF DIRECTORS

Executive Directors

ZHU Zhangjin, Kasen
(Chairman & Chief Executive Officer)
ZHOU Xiaosong
ZHU Jianqi

Non-Executive Director

LI Hui, David

Independent Non-Executive Directors

LU Yungang, Ken
CHOW Joseph
ZHANG Huaqiao, Joe

COMPANY SECRETARY AND QUALIFIED ACCOUNTANT

YIU Hoi Yan, Kate

STOCK CODE

0496.HK

REGISTERED OFFICE

Cricket Square
Hutchins Drive
P.O. Box 2681
Grand Cayman KY1-1111
Cayman Islands

HEAD OFFICE AND PRINCIPAL PLACE OF BUSINESS

259 Qianjiang Road West
Haining City
Zhejiang Province 314400
China

PLACE OF BUSINESS IN HONG KONG

Room 1605
Tai Tung Building
8 Fleming Road
Wanchai
Hong Kong

PRINCIPAL BANKERS

Industrial and Commercial Bank of China,
Hangzhou Zhijiang Branch
China Construction Bank, Haining Sub branch
Bank of China, Haining Sub branch
Agricultural Bank of China, Haining Sub branch
Communication Bank of China, Haining Sub branch
Guangdong Development Bank, Yuhang Sub branch
China CITIC Bank, Haining Sub branch
China Mingsheng Banking Corporation Ltd,
Yuhang Sub branch
Hongkong and Shanghai Banking Corporation Limited

LEGAL ADVISORS

As to Hong Kong law
Coudert Brothers
In association with Orrick, Herrington & Sutcliffe LLP

As to Cayman Islands law
Conyers Dill & Pearman

PRINCIPAL SHARE REGISTRAR

Butterfield Fund Services (Cayman) Limited
Butterfield House
68 Fort Street
Grand Cayman KY1-1107
Cayman Islands

HONG KONG BRANCH SHARE REGISTRAR

Computershare Hong Kong Investor Services Limited
Shops 1712-16, 17th Floor
Hopewell Centre
183 Queen's Road East
Wanchai
Hong Kong

AUDITORS

Deloitte Touche Tohmatsu

COMPLIANCE ADVISOR

ICEA Capital Limited

AUTHORISED REPRESENTATIVES

ZHU Jianqi
YIU Hoi Yan, Kate

COMPANY WEBSITE

www.kasen.com.cn
www.irasia.com/listco/hk/kasen

Financial Highlights

RESULTS

	For the year ended December 31,				
	2006	2005	2004	2003	2002
	RMB'000	RMB'000	RMB'000	RMB'000	RMB'000
Turnover	**3,916,513**	3,475,457	2,852,391	2,135,498	1,386,805
Profit before taxation	**105,134**	278,665	257,176	281,934	178,668
Profit attributable to equity holders of the Company	**64,143**	265,699	225,701	199,323	108,706

FINANCIAL POSITION

	At December 31,				
	2006	2005	2004	2003	2002
	RMB'000	RMB'000	RMB'000	RMB'000	RMB'000
Cash and cash equivalents	**380,973**	372,278	213,458	410,293	175,111
Total borrowings	**1,257,089**	1,291,738	1,880,251	1,338,681	702,073
Total assets	**4,074,528**	4,441,690	4,036,944	2,634,285	1,344,878
Total liabilities	**1,891,551**	2,143,824	2,835,568	1,917,225	939,492
Equity attributable to equity holders of the Company	**2,108,865**	2,199,560	1,091,104	557,247	373,788

FINANCIAL AND OPERATING RATIOS

	At December 31,				
	2006	2005	2004	2003	2002
Dividend payout ratio (%)[1]	**54.5%**	30%	–	–	–
Debt to equity ratio (%)[2]	**57.6%**	56.2%	156.5%	186.7%	173.2%
Net debt to equity ratio (%)[3]	**40.1%**	40.0%	138.7%	129.5%	130.0%
Trade receivable turnover days[4]	**46**	54	35	38	27
Inventory turnover days[5]	**139**	172	211	134	117
Current ratio[6]	**135.4%**	138.3%	93.7%	101.9%	117.2%
Earnings per share (RMB)					
Basic	**0.06**	0.41	0.47	0.46	0.25
Diluted	**0.06**	0.34	0.35	0.40	N/A

Notes:

1. The dividend per ordinary share divided by the profit attributable to equity holders of the Company per ordinary share.
2. Interest-bearing debt divided by total equity as at the end of the year.
3. Interest-bearing debt minus bank balances and cash divided by the total equity as at the end of each year.
4. Trade receivables as at the end of the year divided by turnover and multiplied by 365 days.
5. Inventories as at the end of the year divided by cost of sales and multiplied by 365 days.
6. Current assets divided by current liabilities as at the end of each year.
7. The adoption of new accounting standards in 2006 has no material impact to the Group.

Directors and Management Profiles

EXECUTIVE DIRECTORS

ZHU Zhangjin, Kasen (朱張金), aged 41, is our founding Chairman and Chief Executive Officer. Before founding our Company in 1995, Mr. Zhu was involved in several business ventures in the areas of textile, leather processing, garment, trading, etc. With over 19 years of experience in the leather manufacturing industry, Mr. Zhu has extensive knowledge in the upholstered furniture industry in the PRC and has been a successful entrepreneur in leather manufacturing related businesses. Mr. Zhu is also the vice chairman of the China Leather Association. In recognition of his contribution to promote the development of the leather manufacturing industry, Mr. Zhu was awarded the "Top Ten Businessmen in Zhejiang" in 2004. In 2006, Mr. Zhu was one of the 10 recipients of the prestigious "National May 4th Youth Award (全國五四青年獎章)".

ZHOU Xiaosong (周小松), aged 51, joined our Company on June 12, 1995 and is an executive Director, vice president, and general manager of our Leather Manufacturing Division. Mr. Zhou has spent more than 17 years in the leather manufacturing industry. He is now the director of our research and development center. Mr. Zhou obtained a diploma in Economics and Management from the Adult College of Hangzhou University in 1999. In 2005, Mr. Zhou was appointed as an arbitrator by the China International Economic and Trade Arbitration Commission (CIETAC).

ZHU Jianqi (祝建其), aged 46, joined our Company on May 1, 1996 and is an executive Director, vice president, and general manager of our Treasury and Finance Departments. Prior to joining our Company, he served as the deputy director and deputy manager of the Qingyun Town Industrial Office. He has more than 21 years of experience in the accounting and financial fields. Mr. Zhu graduated from the business management master program of the Zhejiang University of Technology in 2002. In 2003, he received a diploma in Economics from the China University of Geosciences.

NON-EXECUTIVE DIRECTOR

LI Hui, David (黎輝), aged 38, joined our Company as a non-executive Director on May 30, 2006. Mr. Li is currently a managing director of Warburg Pincus Asia LLC, a leading private equity and venture capital firm. Mr. Li has been with Warburg Pincus since 2002. Before joining Warburg Pincus, Mr. Li was an executive director of the investment banking division of Goldman Sachs (Asia) LLC and a vice president and an associate of Morgan Stanley's investment banking division in Hong Kong and New York. Mr. Li obtained his Bachelor of Science degree in Economics from Renmin University of China and a Master of Business Administration ("MBA") from Yale University's School of Management.

INDEPENDENT NON-EXECUTIVE DIRECTORS

LU Yungang, Ken (陸運剛), aged 44, joined our Company as an independent non-executive Director on June 17, 2005. Mr. Lu is currently founder and managing director of APAC Capital Advisors Limited ("APAC"), a Hong Kong based investment management company that specializes in Greater China equities, as well as a director of AsiaInfo Holdings, Inc. Prior to setting up APAC, Mr. Lu has worked with financial institutions including Credit Suisse First Boston, JP Morgan Securities Asia Inc. and Schroders Asia Limited, holding various posts including Head of China Research when he was with Credit Suisse First Boston. Mr. Lu obtained his Bachelor of Science degree from the Beijing University in July 1985 and his Master of Science degree from the Brigham Young University, Provo, Utah in 1991. He obtained a Ph.D. in Management from the University of California in September 1998.

CHOW Joseph (周凡), aged 44, joined our Company as an independent non-executive Director on July 11, 2005. Mr. Chow is currently a consultant in the fields of finance, accounting and investment, and has held senior managerial positions in various companies, including as Chief Financial Officer of Harbour Networks Limited, Chief Financial Officer with China Netcom (Holdings) Company Limited, director of strategic planning with Bombardier Capital Inc., vice president of international operations with Citigroup and corporate auditor at GE Capital. Mr. Chow obtained a Bachelor of Arts degree in Political Science from Nanjing Institute of International Relations in 1984 and a MBA from the University of Maryland at College Park in 1993.

ZHANG Huaqiao, Joe (張化橋), aged 44, joined our Company as an independent non-executive Director on July 3, 2006. Mr. Zhang is currently an executive Director and Chief Operating Officer at Shenzhen Investment Limited, a company listed on The Stock Exchange of Hong Kong Limited (the "Stock Exchange"). He is also a non-executive Director of Shenzhen International Holdings Limited, a company listed on the Stock Exchange with effect from April 26, 2006. Mr. Zhang holds a Master of Economics degree from the Australian National University, a Master of Economics in Banking and Finance degree from the Graduate School of the People's Bank of China and a Bachelor of Economics (Finance) degree from Hubei Institute of Finance and Economics. Mr. Zhang's most recent position was a managing director and co-head of China Research at UBS Securities Asia Limited where he worked for seven years. In the past 12 years, Mr. Zhang had worked for several investment banks' corporate finance and research departments.

SENIOR MANAGEMENT

LEE Lawrence (李磊), aged 42, joined our Company as vice president and Chief Financial Officer on August 1, 2004. Mr. Lee has over 14 years of experience in corporate finance, financial advisory and management, accounting, and auditing. He is also an associate member of the Association of Chartered Certified Accountants ("ACCA"). Before joining our Company, Mr. Lee served from July 2001 to April 2004 as Chief Financial Officer at Eagle Brand Holdings Limited, a company listed on the Singapore Stock Exchange. He also held financial controllerships at other multinational companies in Korea and the UK. Mr. Lee received a Bachelor degree in Management and Engineering from the Beijing Institute of Technology in 1984. Mr. Lee also obtained a Master degree in Economics from the Renmin University in 1987 and a Master degree in Accounting and Finance from the London School of Economics in 1992.

YU Guanlin (余關林), aged 44, joined our Company in 1995 and has held positions as production manager and deputy general manager. He is currently the general manager for our Cut-and-sew Operations. Before joining our Company, Mr. Yu founded a garment company and was responsible for its design and production. Mr. Yu has extensive knowledge and experience in upholstered furniture manufacturing.

ZHANG Mingfa, Michael (張明發), aged 46, joined our Company on October 1, 1997 as vice president of our Import and Export Division. With more than 26 years of experience in the leather manufacturing industry, Mr. Zhang is currently the Company's Director of Logistics. Mr. Zhang qualifies as an international business engineer based on a qualification certificate approved by the Ministry of Commerce of the PRC in 1995. In 1984, Mr. Zhang obtained a diploma from Chengdu University of Technology. In 1989, Mr. Zhang obtained a diploma in Business Administration from Zhejiang University of Technology.

ZHANG Guming (張顧明), aged 41, joined our Company in 2003 and has held positions as general manager of our sofa manufacturing subsidiaries. He is currently the Director of Human Resources. Before joining our Company, Mr. Zhang was the executive deputy general manager at Haining Dunnu Fashion Co., Ltd from May 2000 to February 2003. Prior to that, Mr. Zhang had been responsible for production management in several local companies that manufactured leather, footwear and textile. Mr. Zhang has extensive knowledge and experience in corporate management and the leather industry.

JIN Xuejiang (金雪江), aged 43, joined our Company in 2001 and has held positions as plant manager and deputy general manager. He is currently the assistant general manager of Sofa Business Division. Before joining our Company, Mr. Jin founded a footwear company and was responsible for its production and sales. Mr. Jin obtained a diploma in Management from Haining Television University in 2005 and has been on a part-time Master of Business Administration course at the Management School of Zhejiang University since September 2005. Mr. Jin has extensive knowledge and experience in upholstered furniture manufacturing.

BO Haigang, Benjamin (卜海剛), aged 39, joined our Company in 2001 and has held positions as sales manager, export manager, and general manager – North America Sales. He is currently the Sales and Marketing Director of our Sofa Business Division. Before joining our Company, Mr. Bo served from 1998 to 2001 as deputy manager for Mannesmann's Demotic Material Handle Co., Ltd. (Shanghai Branch). Mr. Bo also worked from 1994 to 1998 as deputy manager of Shanghai Representative Office for Ssangyong Group, one of the largest conglomerates in Korea. Mr. Bo obtained a Bachelor degree in Industrial and Civil Construction from Tongji University in 1989.

XU Huaihai, Wayne (徐懷海), aged 38, joined our Company as vice president and general manager of our Automotive Leather Division on May 1, 2002. Since 2001, Mr. Xu has been one of the leaders to promote the automotive leather industry in the PRC. Before joining our Company, Mr. Xu worked as a technician specializing in leather manufacturing at the People's Liberation Army. He had also served as a technical and sales supervisor of Ciba-Geigy Shanghai Co., Ltd. and a manager of the Shanghai Representative Office of TFL Gmbh. Mr. Xu graduated from Shanghai Applied Technology Institute in 1989, majoring in leather studies. In 1994, he obtained a Bachelor degree in Applied Chemistry from the East China University of Science and Technology. In 2001, he received a MBA from a joint program organized by the Shanghai University of Finance and Economics and the Webster University of the US.

ORTOLAN Massimiliano, aged 31, joined our Company in September 2006 and is currently the Sales and Marketing Director of our Home Impression brand. Mr. Ortolan has accumulated experiences in sales, marketing and management in the furniture industry. He worked as Associate Sales Director at DeCoro's Chinese head office for 4 years prior to joining Kasen. Before his career in China he lived in London for more than 4 years, where he held various sales and marketing positions in different industries. During his stay in London, he also studied marketing courses at the Guildhal University Business School and MBA courses in Marketing at the Oxford Brookes University.

COMPANY SECRETARY AND QUALIFIED ACCOUNTANT

YIU Hoi Yan, Kate (姚凱欣), aged 34, joined our Company as an accountant on April 29, 2004 and was later promoted to be our Company Secretary and finance and administrative manager. She has over 11 years of experience in auditing and accounting. She is a member of the ACCA and the Hong Kong Institute of Certified Public Accountants. Ms. Yiu obtained a Bachelor of Arts (Honors) in Accountancy from the City University of Hong Kong in 1995.

Chairman's Statement

Dear Shareholders,

On behalf of the Board of Directors ("the Board"), I am pleased to report the annual results of the Company and its subsidiaries ("the Group") for the year ended December 31, 2006.

BUSINESS REVIEW

For the year ended December 31, 2006, the Group's turnover amounted to RMB3,916,513,000, representing an increase of 12.7% as compared to RMB3,475,457,000 for the previous year. Profit attributable to equity holders of the Company was RMB64,143,000, representing a decrease of 75.9% as compared to RMB265,699,000 for the previous year. The Board did not recommend the payment of a final dividend.

2006 has been a tough year for the Group. As a major original equipment manufacturer ("OEM") partner for the US upholstered furniture industry, our sales were adversely impacted by the slow down in the US housing market which had led to a much weaker demand for household furniture. Amid declining retail sales, our major customers in the US cut down their orders in the second half of 2006 in order to clear stocks.

Our profit margin was impacted mainly by a continued hike of raw material prices throughout the year. The prices of raw cowhides, which account for approximately 44% of our cost of sales, went up by approximately 20-30% during the year. This was combined by the soaring prices of other major raw materials such as chemicals, timber and foam. During the year under review, the accelerated appreciation of the Chinese RMB against the US dollar had also led to a further squeeze on our profit margin as most of our revenue is denominated in the US dollars.

I would like to express my gratitude to my fellow management team. With their dedication, hard work and innovation, we have been able to mitigate a substantial amount of these adverse factors through aggressive cost cutting initiatives. We were also able to add some major customers while retaining existing customers during these difficult times.

PROSPECTS

During the year under review, the Chinese government introduced a quota system for duty-free raw cowhide imports in order to regulate and consolidate the leather industry. This will bring stricter controls on new entrants to the leather tanning industry as hide import duties will be levied on new players. As an industry leader, we were allocated the largest duty-free quota, representing more than 15% of the whole nation. We are confident that our leading position in China's leather industry will be maintained and strengthened in years to come.

Over the past five years, leveraging on our success as a leather manufacturer, we have grown into a major OEM partner for the world's upholstered furniture manufacturers. We believe that there are still tremendous potential in this sector as the penetration rate of Chinese made sofas is still relatively low. Therefore, we will continue to explore the outsourcing market in the US and Europe to achieve further growth with more emphasis on profitability.

However, China's huge trade surplus has led to a series of measures being implemented by the government to contain the export industry. It is also clear that the RMB will appreciate further against the other major currencies, in particular the US dollar. Therefore, we have to prepare ourselves for an even more unfavorable macro environment in the future. In addition to continued efficiency improvement and market expansion of our existing core businesses, the Group is planning to establish a presence in the domestic market in order to tap into the growth potential of China's consumption boom.

The Group has carried out an extensive research on the Chinese domestic market for upholstered furniture. In 2007, the Group is planning to open two to three independent flagship furniture stores with a combined floor space of approximately 10,000 square meters. These stores will be located in Shanghai and Hangzhou, two of the largest and richest metropolis in Eastern China all within 90 minutes from our major manufacturing base. As we will not own these premises, the capital expenditure requirement for these stores is expected to be below RMB20 million.

On March 15, 2007, the Group entered into a framework agreement to form a joint venture with Haining Leather Market and another strategic investor to develop leather product shopping malls in major Chinese cities. Haining Leather Market, a well-known and successful developer and operator of large leather product shopping malls, will allow the joint venture to use its trade name "海寧中國皮革城" and to share its management resources and customer base. The Group will take a 51% equity interest in the joint venture which will have a registered capital of RMB360 million. The first project to be developed is expected to be in Changsha, the capital city of Hunan province, where the joint venture has successfully tendered a land of approximately 145,078 square meters. The Changsha project, which will include a flagship store for our own products, is an integral part of our broad domestic retail strategy. It is experimental in nature and we will strive to limit our risk exposures.

The Group is also planning to carry out an asset consolidation process. During 2003/04, the Group acquired large plots of land at relatively cheap prices for factory expansions. Currently our total land area is 2,586,000 square meters, of which 844,137 square meters have not been developed. For the existing production space, our utilization is approximately 50-60%. We plan to sell some of these lands if there are reasonable bids. In addition, we have two fully built factories available for sale as we have relocated their manufacturing to other facilities. Selling these lands and factories will not affect our production capability. The proceeds from these asset sales will be used to finance our leather product shopping mall investments in Haining.

The Board and management remain committed to the prosperity of the Group. Even with the setbacks during this transition period, we are bullish on the Group's long term outlook. We are confident that our position as China's leading leather and furniture producer will be maintained and strengthened, and our domestic retail strategy will enable the Group to benefit from China's growth prospects.

Chairman
ZHU Zhangjin, Kasen

Hong Kong, April 16, 2007

Management Discussion and Analysis

RESULTS OVERVIEW

Year 2006 has been a challenging period for the Group's operations. The sharp increase of raw material prices and other costs, the appreciation of Chinese currency (the RMB) versus the US dollar, and the reduction of tax rebates for export are major adverse factors. In addition, the slowdown of the US housing market and the associated weak demand of quality furniture, and the intense pricing competition resulted from overcapacity of this industry in China aggravate our business.

For the year ended December 31, 2006, the Group's turnover increased by 12.7% to RMB3,916.5 million (2005: RMB3,475.5 million), while its profit for the year decreased by 68.0% to RMB83.4 million (2005: RMB260.4 million). The profit attributable to equity holders of the Company for 2006 was RMB64.1 million, as compared to RMB265.7 million in 2005.

The Group's gross profit margin in 2006 was 10.9%, representing a decrease of 4.9 percentage points as compared to 2005.

The Group's principal raw materials are cowhides and wet blues, which accounted for approximately 44% of the total cost of sales in 2006. Other major raw materials include chemicals, foam, timber, and fabric.

Cost of Sales Breakdown

Item	**2006** **%**	2005 %
Raw cowhides and wet blues	**43.7**	46.5
Chemicals	**10.8**	11.9
Fabric	**8.3**	9.3
Foam	**7.8**	6.8
Timber	**5.3**	4.6
Other raw materials	**9.7**	5.0
Labour	**6.5**	6.9
Depreciation	**2.2**	2.3
Others	**5.7**	6.7

Since the beginning of 2006, the prices of raw cowhides in the global market have increased by approximately 30%. This was the major contributor to the decline of the gross profit margin. In addition, due to the global inflation of commodities prices, costs of chemicals, foam, timber and, to a lesser extent, labor, also increased.

Approximately 84% of the Group's sales are denominated in US dollars. Although the Group has a natural hedge of approximately 50% by importing raw cowhides and chemicals, the appreciation of the RMB against the US dollar still had a significant impact on the Group's gross margin.

The Group's gross margin was also adversely affected by the provision of RMB9.4 million for obsolete inventory of chemicals. This amount was recorded as cost of sales.

OPERATING EXPENSES, TAXATION AND PROFIT ATTRIBUTABLE TO EQUITY HOLDERS

Under the FOB trading terms, the marine freight charges of almost all the exporting business of the Group were borne by the customers. However, the Group's sales of finished upholstered furniture increased by 22.1%, this has led to an increase of RMB20.4 million, or 31.3% in land transportation costs. In addition, the Group incurred an additional RMB14.7 million in credit insurance, commission and customer clearance charges. As a result, the Group's distribution costs for the period increased by 32.4% compared to last year, and the percentage of distribution costs to turnover rose slightly to 2.8% (2005: 2.3%).

The increase of 51.2% in administrative expenses was mainly due to: (1) a charge of RMB15.4 million on the Group's granting of share options to its executives and employees; (2) an increased provision of RMB10.6 million on trade receivables; (3) an increase of RMB6.0 million in travel and entertainment expenses; (4) an increased exchange loss of RMB3.4 million on the Group's trade receivables arising from the RMB appreciation; and (5) an increase of RMB2.5 million on professional fees.

The Group has gradually reduced its bank borrowings and has been successful in negotiating reduced interest rates on these borrowings. As a result, the Group's finance cost reduced by 23.4% compared to the same period of last year.

During the year under review, the Group assessed the recoverable amount of goodwill arising from previous acquisitions, and determined that goodwill associated with the Group's automotive leather operation and a non-operating subsidiary was impaired by an aggregate of RMB23 million (2005: Nil). This impaired amount was recorded as Other Expenses. For details, please refer to Note 14 to the Consolidated Financial Statements.

The overall effective tax rate of the Group increased to 20.6% (2005: 6.6%) because: (1) the provisions for share based payment expenses, goodwill impairments, foreign exchange losses etc. are made at consolidation level while income tax is calculated based on profitability at subsidiary level; (2) tax reliefs for the Group's two major profit making subsidiaries have expired; and (3) the provisions made at subsidiary level for bad debts and inventory are non-deductible expenses for PRC tax computation. As a matter of prudence, deferred tax assets have not been recognized in respect of temporary differences arising from the provisions set out above.

For reasons mentioned above, profit attributable to equity holders of the Company decreased by approximately 75.9% to RMB64.1 million (2005: RMB265.7 million).

SALES ANALYSIS BY PRODUCTS

The table below shows the total turnover by product category for the year under review:

	2006		**2005**		**Y-O-Y Change**
	RMB'Million	**%**	RMB'Million	%	%
Upholstered furniture					
Leather Sofa	**1,841.5**	**47.0%**	1,550.5	44.6%	18.8%
Fabric Sofa	**408.1**	**10.4%**	292.4	8.4%	39.6%
Leather Cut-and-Sew	**626.2**	**16.0%**	542.2	15.6%	15.5%
Fabric Cut-and-Sew	**247.1**	**6.3%**	370.0	10.7%	(33.2%)
Furniture Leather	**615.1**	**15.7%**	593.1	17.0%	3.7%
Automotive Leather	**150.1**	**3.8%**	126.9	3.7%	18.3%
Others	**28.4**	**0.8%**	0.4	0.0%	N.M.
Total	**3,916.5**	**100%**	3,475.5	100%	12.7%

N.M. – Not meaningful.

Upholstered Furniture

The upholstered furniture (including leather and fabric sofas, leather and fabric cut-and-sew) remained the core products of the Group, and its sales accounted for 79.7% of the total turnover in 2006 (2005: 79.3%). The Group's sales of sofa cut-and-sew kits remained largely unchanged as major OEM customers have opted to place more orders on finished sofas. During the year, leather sofa sales increased by 18.8% and fabric sofa sales increased by 39.6%.

Furniture Leather

The Group's priority in furniture leather production is to meet the internal leather requirement of its growing upholstered furniture division. Due to the increase in raw cowhide price and the shortage in cowhide supply pipeline, the Group's external sales of furniture leather only recorded a modest growth of 3.7%.

Automotive Leather

The automotive leather operation, although achieved an 18.3% increase in turnover, continued to be under-performing. Through major US automotive seating companies, such as Intier Automotive and Johnson Controls, we were able to secure supply contract for some major US automotive models. However, due to the reduction in tax rebates for finished leather exports, our price advantage was undermined, which led to less than expected sales volume.

SALES ANALYSIS BY REGIONS

The table below shows the total turnover by geographical market for the year under review:

	2006		**2005**		**Y-O-Y Change**
	RMB'Million	**%**	RMB'Million	%	%
USA	**2,825.8**	**72.2%**	2,383.8	68.6%	18.5%
Europe	**160.3**	**4.1%**	120.3	3.5%	33.3%
Australia	**122.3**	**3.1%**	187.5	5.4%	(34.8%)
PRC, including HK	**736.1**	**18.8%**	727.0	20.9%	1.3%
Others	**72.0**	**1.8%**	56.9	1.6%	26.5%
Total	**3,916.5**	**100.0%**	3,475.5	100.0%	12.7%

The Group continued to expand its markets in the US during the year. In line with the ongoing outsourcing trend of consumption products in the US, the Group's sales increased strongly in this market. After years of efforts, the Group has established long term cooperation with five of the top ten upholstered furniture manufacturers. The Group's sales in the US increased by 18.5% and, as a percentage to the total sales, the turnover in the US accounted for 72.2%.

The Group's expansion into the European market is still at its initial state. The 33.3% increase for this segment is mainly from a one-off sales of finished leather to Russia. As for upholstered furniture, although the total volume remained unchanged, the Group was able to consolidate its customer base by establishing stronger relationships with some major customers.

The Group's strategy of working with retail customers in Australia had caused the termination of supply relationship with a major OEM customer, as a result, the Group's sales to Australia recorded a decrease of 34.8% in 2006.

The Group's sales to the PRC domestic market mainly involved furniture leather and automotive leather, the turnover of which represented 18.8% of its total sales. Business in this segment increased by 1.3% in 2006.

CAPITAL EXPENDITURES

Capital expenditure in 2006 decreased by 53.7% to RMB107.3 million (2005: RMB231.5 million), as most of the expansion for manufacturing facilities was completed prior to 2005. The capital expenditure in 2006 was mainly used in (1) addition of property, plant and machinery for the Higher Point operations; (2) maintenance and replacement of machinery for furniture leather production; and (3) purchase of land. The principal expenditure for these items were approximately RMB44.9 million, RMB28.6 million and RMB33.5 million respectively.

In addition to the above, the Group spent RMB49.9 million in 2006 to acquire the minority interests in two Higher Point subsidiaries.

FINANCIAL RESOURCES AND LIQUIDITY

Net Borrowings

As at December 31, 2006, the Group's net borrowings amounted to RMB1,257.1 million (December 31, 2005: RMB1,291.7 million). The Group's net borrowings primarily comprise of (1) short-term borrowings of RMB1,246.7 million provided by local banks, bearing an interest rate ranging from 4.65% to 8.78% per annum; and (2) government debt of RMB10.4 million, bearing an interest rate of 2.55% per annum. For details, please refer to note 27 to the Consolidated Financial Statements.

Turnover Period, Liquidity and Gearing

The Group's inventory primarily represented raw cowhides and wet blues used for production, accounting for approximately 44.7% of the total inventory of RMB1,326.2 million (2005: RMB1,378.8 million). In 2006, the Group endeavoured to control inventory level and managed to decrease its inventory turnover period to 139 days (2005: 172 days).

In 2006, the Group continued to maintain a strict credit policy, resulting in a decrease in account receivables turnover days to 46 days (2005: 54 days).

The Group attempted to shorten the accounts payable credit term so as to cut the purchase costs. As a result, the accounts payable turnover days decreased to 51 days (2005: 77 days).

As at December 31, 2006, the Group's current ratio and quick ratio decreased slightly to 1.35 (December 31, 2005: 1.38) and 0.65 (December 31, 2005: 0.71), respectively. The Group's cash and cash equivalent balance was RMB381.0 million (December 31, 2005: RMB372.3 million). This represents a gearing ratio of 57.1% (December 31, 2005: 55.8%) and a net debt-to-equity ratio of 39.7% (December 31, 2005: 39.6%). The gearing ratio is based on bank borrowings to shareholders' equity and the net debt-to-equity ratio is based on bank borrowings net of cash and cash equivalent to shareholders' equity.

The Group had drawn down a syndicated loan in aggregate of HK$125,000,000 arranged by CITIC Capital Markets Limited in January 2006. The syndicated loan, with a term of three years, bears interest at 2.00% over 12-month Hong Kong Interbank Offering Rate per annum. In late September 2006, the Group repaid the full amount of loan principal and interest payable to the borrowers of the syndicated loan arrangement.

CONTINGENT LIABILITIES

During the year, the Group has terminated all cross-guarantee arrangements previously entered between the Group and Haining Changhai Packaging and Printing Co., Ltd. ("Haining Changhai"). As of the balance sheet date, the Group has no material contingent liabilities.

PLEDGE OF ASSETS

Certain of the Group's assets have been pledged to secure the borrowings of the Group. For details, please refer to note 34 to the Consolidated Financial Statements.

FOREIGN EXCHANGE EXPOSURE

Starting from July 2005, the Chinese government changed its policy of pegging the value of the RMB to the US dollar. Under the new policy, the RMB has fluctuated within a narrow and managed band against a basket of certain foreign currencies. As a result of this policy change, the RMB appreciated approximately 2.5% and 3.4% against the US dollar in 2005 and 2006, respectively. It is possible that the Chinese government could adopt a more flexible currency policy, which could result in a more significant fluctuation of the RMB against the US dollar.

Considering the limited alternatives of hedging instruments and the restricted currency convertibility of the RMB, the Group neither used any financial instrument for hedging purposes during the year, nor had any hedging instrument outstanding as at December 31, 2006.

The Group's businesses are principally export-related and transactions are primarily denominated in US dollars (approximately 84%). Although a substantial portion of the Group's procurements is denominated in US dollars, management considers that the Group is still exposed to foreign exchange fluctuation risks. Therefore, in the long term our strategies would tend to minimize the mismatch between the US dollar revenue and the RMB costs.

EMPLOYEES AND EMOLUMENTS POLICIES

As at December 31, 2006, the Group employed a total of approximately 14,800 full time employees (2005: 16,000) which included management staff, technicians, salespersons and workers. For the year ended December 31, 2006, the Group's total expenses on the remuneration of employees is RMB286,659,000 (2005: RMB237,063,000) and represents 7.32% (2005: 6.82%) of the operating revenue of the Group. The Group's emolument policies for employees are formulated on the performance of individual employees, which will be reviewed regularly every year. Apart from the provident fund scheme (according to the provisions of the Mandatory Provident Fund Schemes Ordinance for Hong Kong employees) or state-managed retirement pension scheme (for the PRC employees) and medical insurance, discretionary bonuses and employee share options are also awarded to employees according to the assessment of individual performance.

The Group's emolument policies for Directors and other senior management are formulated with reference to their qualification and experience, responsibilities undertaken, contribution to the Group, and the prevailing market level of remuneration for executives of similar position. No Director is involved in deciding his or her own remuneration.

FUTURE PLANS AND PROSPECTS

Looking forward, export-oriented manufacturers for household products in China will continue to face challenges as the RMB is expected to accelerate its appreciation and the Chinese government is under pressure to implement policies to manage the country's massive trade surplus. The Group is of the view that the current macro environment is not favorable to the Group's core businesses.

However, the Group will make every effort to strengthen its position as China's leading manufacturer of leather products and upholstered furniture. The Group aims to achieve its growth with the following initiatives:

Maintaining and strengthening our position as a major OEM partner for the US upholstered furniture industry

The US is currently the largest market for the Group's upholstered furniture products. The slowing down in the US home sales and residential remodeling expenditure has had adverse impact on the sales of residential furniture in 2006. This has in turn affected the Group's sales in the second half of 2006 as its US customers slowed down their orders. However, the Group maintains its view that US brand name furniture companies will continue to outsource their manufacturing to low cost countries.

Compared with other competitors, the Group has a unique advantage in its vertically integrated production and large scale manufacturing capabilities. These advantages were demonstrated by the Group's continued ability for timely delivery of high quality products at competitive prices during difficult times. The Group's reputation as a quality OEM partner and its business relationships with major US customers were strengthened. The Group will maintain its uncompromising commitment to customer value in order to achieve modest growth in both its North America sales and profitability.

Actively exploring market opportunities in Europe and other countries

With the low penetration rate of Chinese made furniture, the European market may offer greater potential to the Group's products. The Group has recently allocated more resources to this market segment by recruiting new personnel and by developing branded products more suited for this market.

Over the past few years, the Group has been able to accumulate product know-how, and design capabilities have improved significantly. The Group's own design accounted for more than 30% of the Group's total sales volume in 2006. The Group's design capabilities will enable the Group to meet the varying demands of the European customers who are operating under even more fragmented markets.

Improving operational efficiency and rationalizing costs

The Group has been expanding its capacities over the last few years, and it is now time to leverage on its economy of scale to improve profitability. The Group recognizes the importance of business process efficiency, and will continuously improve its raw material procurement and its supply chain management. In addition, the Group proposes to implement new incentive schemes to motivate its business units. The Group believes that these initiatives are important to maintain and to strengthen the Group's competitiveness.

The price hike of raw materials is unlikely to diminish in the near term, and as a result, the Group is undertaking actions to develop new products with alternative raw materials to reduce reliance on raw cowhides. Management strongly believes that rationalization of cost base would be able to partially mitigate the adverse effect of raw material price increases.

Establishing domestic presence to tap into China's growth potentials for consumption goods

The upholstery furniture market in China is currently very fragmented. Sofas are mainly being sold by small independent specialty stores within furniture malls. Customers not only have limited choices, but also have to bear additional costs arising from inefficient marketing channels. The Group believes that, with its fast growing economy, China's residential furniture market will be going through major changes in the next few years. The mid to higher end segments are likely to offer better growth potentials, while large players will emerge as stronger competitors in the market. The Group is planning to tap into China's growth potentials for mid to higher end residential furniture by opening large furniture malls in major cities in China. For the year of 2007, two to three flagships stores are to be opened in Shanghai and Hangzhou. These stores will be established through leasing arrangement, so the capital requirement will not exceed RMB20 million.

To further diversify its revenue sources and implement its domestic marketing plans, the Group has formed a joint venture company with Haining Leather Market, a well-known and experienced developer and operator of large leather product shopping malls in China, and Haining Zhengyang Trading. The joint venture company, in which the Group will have a 51% equity interest, will be looking for new sites in major cities to develop large specialized leather product shopping malls. On January 29, 2007, the joint venture partners, through Haining Higher Point, the Group's wholly-owned subsidiary, have successfully tendered a land of approximately 145,078 square meters in Changsha, Hunan province with a consideration of RMB253.75 million. The Group believes that, by leveraging on the Group's strong capabilities as leather product manufacturer and its joint venture partner's extensive knowledge and experience in successfully developing and operating leather product shopping malls, the Group will be able to establish a strong foothold in China's domestic leather product market.

Directors' Report

The directors present their annual report and the audited consolidated financial statements for the year ended December 31, 2006.

The shares of the Company were listed on the Stock Exchange with effect from October 20, 2005.

PRINCIPAL ACTIVITIES

The Company acts as an investment holding company. Its subsidiaries are principally engaged in the processing of raw cowhides and wet blues into finished leather or fully assembled leather products.

RESULTS AND APPROPRIATIONS

The results of the Group for the year ended December 31, 2006 are set out in the consolidated income statement on page 35.

An interim dividend of approximately RMB3.53 cents (equivalent to US0.44 cents or HK3.45 cents) per ordinary share amounting to RMB34.68 million (equivalent to HK$34.16 million) was paid to the shareholders during the year. The directors do not recommend the payment of any final dividend for the year ended December 31, 2006.

DISTRIBUTABLE RESERVES OF THE COMPANY

The amount of the Company's reserves available for distribution to shareholders as at December 31, 2006, calculated in accordance with International Financial Reporting Standards, was approximately RMB840 million.

FINANCIAL SUMMARY

A summary of the results, assets and liabilities of the Group for the past financial periods is set out on page 3.

PROPERTY, PLANT AND EQUIPMENT

During the year, the Group acquired property, plant and equipment of approximately RMB73 million for the purpose of expanding its production capacity.

Details of these and other movements in the property, plant and equipment of the Group during the year are set out in note 15 to the financial statements.

SHARE CAPITAL

Details of the Company's share capital are set out in note 28 to the financial statements.

MAJOR CUSTOMERS AND SUPPLIERS

During the year, the aggregate sales attributable to the Group's five largest customers comprised approximately 39% of the Group's total sales and the sales attributable to the Group's largest customer were approximately 13% of the Group's total sales.

The aggregate purchase during the year attributable to the Group's five largest suppliers was less than 26% of the Group's total purchases.

None of the directors, their associates or any shareholders which, to the knowledge of the directors, owned more than 5% of the Company's issued share capital had any interest in the share capital of any of the five largest customers and suppliers of the Group.

DIRECTORS

The directors of the Company during the year and up to the date of this report are:

Executive directors

ZHU Zhangjin, Kasen *(Chairman)*
ZHOU Xiaosong
ZHU Jianqi

Non-executive director

LI Hui, David	(appointed on May 30, 2006)
SUN Qiang Chang	(resigned on May 30, 2006)

Independent non-executive directors

LU Yungang, Ken	
CHOW Joseph	
ZHANG Huaqiao, Joe	(appointed on July 3, 2006)
SHI Zhengfu	(resigned on July 3, 2006)

In accordance with provision 87 of the Articles, Messrs., Zhu Zhangjin, Zhang Huaqiao, Joe and Lu Yungang, Ken will retire from office of directors by rotation and, being eligible, will offer themselves for re-election at the forthcoming annual general meeting.

None of the directors being proposed for re-election at the forthcoming annual general meeting has a service contract with the Company or any of its subsidiaries which is not determinable by the Group within one year without payment of compensation (other than statutory compensation).

BRIEF DETAILS OF DIRECTORS AND SENIOR MANAGEMENT

Brief details of directors and senior management are set out on pages 4 to 6.

DIRECTORS' AND CHIEF EXECUTIVE'S INTERESTS AND SHORT POSITIONS IN SHARES, UNDERLYING SHARES AND DEBENTURES

As at December 31, 2006, the interests of the directors and chief executives and their associates in the shares of the Company (within the meaning of Part XV of the Securities and Futures Ordinance ("SFO") as recorded in the register required to be kept under Section 352 of the SFO or as otherwise notified to the Company and the Stock Exchange pursuant to the Model Code for Securities Transactions by Directors of Listed Companies (the "Model Code") as contained in Appendix 10 to the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (the "Listing Rules") are as follows:

(1) Long positions in shares of the Company

	Number of shares held, capacity and nature of interest			
Name of Director	**Directly beneficially owned**	**Through controlled corporation**	**Total number of shares interested**	**Percentage of the Company's issued share capital**
Zhu Zhangjin	–	328,867,019 (Note)	328,867,019	33.22%
Zhou Xiaosong	8,173,912	–	8,173,912	0.83%
Zhu Jianqi	7,478,260	–	7,478,260	0.76%

Note: 328,867,019 shares are beneficially owned by Joyview Enterprises Limited, a company wholly-owned by Mr. Zhu Zhangjin

(2) Long positions in underlying shares of the Company

Long positions in underlying shares of the Company are separately disclosed in the section "Share Option Scheme" below.

Save as disclosed herein, none of the Directors nor the chief executives of the Company has any interests or short positions in any shares, underlying shares and debentures of the Company or any of its associated corporations (within the meaning of Part XV of the SFO) as recorded in the register to be kept under Section 352 of the SFO or as otherwise notified to the Company and the Stock Exchange pursuant to the Model Code as at December 31, 2006.

SHARE OPTION SCHEME

Particulars of the Company's share option scheme are set out in note 29 to the financial statements.

A share option scheme was adopted by the Company pursuant to a board resolution passed on September 26, 2005 (the "Scheme") for the primary purpose of providing incentives to Directors and eligible employees. The Scheme became effective on October 20, 2005 and the options issued pursuant to the Scheme will expire no later than 10 years from the date of grant of the option. Under the Scheme, the Board may grant options to any employees of the Company or any of its subsidiaries to subscribe shares of the Company.

For any options granted to directors, chief executives or substantial shareholders of the Company, options to be granted shall be approved by the independent non-executive Directors of the Company (excluding any independent non-executive Director who is the proposed grantee of options).

The total number of shares in respect of which options may be granted under the Scheme is not permitted to exceed 10% of the shares of the Company on October 20, 2005 (representing 101,404,536 shares of the Company) without prior approval from the Company's shareholders. The number of shares issued and to be issued in respect of options granted and may be granted to any individual in any one year is not permitted to exceed 1% of the total shares of the Company in issue at any point in time, without prior approval from the Company's shareholders.

The amount payable on acceptance of an option is HK$1.00. In relation to any options granted under the Scheme, the exercise price is determined by the directors of the Company, and will not be less than the higher of (i) the closing price of the Company's shares on the date of grant, (ii) the average closing price of the shares for the five business days immediately preceding the date of grant; and (iii) the nominal value of the Company's share.

The Scheme does not contain any minimum period(s) for which an option must be held before it can be exercised. However, at the time of granting of the options, the Company may specify any such minimum period(s).

Unless otherwise terminated by the Board or the shareholders of the Company in general meeting in accordance with the terms of the Scheme, the Scheme shall be valid and effective for a period of 10 years from the date on which it becomes unconditional which was October 10, 2005, after which no further options will be granted or offered but the provisions of the Scheme shall remain in full force and effect to the extent necessary to give effect to the exercise of any subsisting options granted prior to the expiry of the 10-years period or otherwise as may be required in accordance with the provisions of the Scheme.

During the year ended December 31, 2006, 30,200,000 share options were granted to eligible Directors and employees of the Group and details are as follows:

Name or category of participant	Exercise price HK$	Number of share options: Outstanding as at January 1, 2006	Granted from January 1, 2006 to December 31, 2006	Cancelled from January 1, 2006 to December 31, 2006	Outstanding as at December 31, 2006	Percentage of total issued share capital	Exercisable period	Notes
Directors								
Zhu Zhangjin	2.38	–	1,000,000	–	1,000,000	0.10%	1/1/2007 to 8/3/2016	1,3,4
	2.38	–	1,000,000	–	1,000,000	0.10%	1/1/2008 to 8/3/2016	2,3,4
Zhou Xiaosong	2.38	–	1,000,000	–	1,000,000	0.10%	1/1/2007 to 8/3/2016	1,3,4
	2.38	–	1,000,000	–	1,000,000	0.10%	1/1/2008 to 8/3/2016	2,3,4
Zhu Jianqi	2.38	–	1,000,000	–	1,000,000	0.10%	1/1/2007 to 8/3/2016	1,3,4
	2.38	–	1,000,000	–	1,000,000	0.10%	1/1/2008 to 8/3/2016	2,3,4
Lu Yungang, Ken	2.38	–	200,000	–	200,000	0.02%	1/1/2007 to 8/3/2016	1,3,4
	2.38	–	200,000	–	200,000	0.02%	1/1/2008 to 8/3/2016	2,3,4
Chow Joseph	2.38	–	200,000	–	200,000	0.02%	1/1/2007 to 8/3/2016	1,3,4
	2.38	–	200,000	–	200,000	0.02%	1/1/2008 to 8/3/2016	2,3,4
Shi Zhengfu	2.38	–	200,000	(200,000)	–	–	1/1/2007 to 8/3/2016	1,3,4
	2.38	–	200,000	(200,000)	–	–	1/1/2008 to 8/3/2016	2,3,4
		–	7,200,000	(400,000)	6,800,000	0.68%		
Other employees in aggregate	2.38	–	11,500,000	–	11,500,000	1.16%	1/1/2007 to 8/3/2016	1,3,4
	2.38	–	11,500,000	–	11,500,000	1.16%	1/1/2008 to 8/3/2016	2,3,4
		–	30,200,000	(400,000)	29,800,000	3.00%		

Directors' Report (cont'd)

Notes:

1. Pursuant to the Scheme adopted by a resolution of the Shareholders on September 24, 2005 and adopted by a resolution of the Board on September 26, 2005, these share options were granted on March 9, 2006 and are exercisable at HK$2.38 per Share from January 1, 2007 to March 8, 2016.

2. These share options were granted pursuant to the Scheme on March 9, 2006 and are exercisable at HK$2.38 per Share from January 1, 2008 to March 8, 2016.

3. These share options represent personal interest held by the relevant participants as beneficial owner.

4. Except the cancelled share option stated above, up to December 31, 2006, none of these share options were exercised nor lapsed.

SUBSTANTIAL SHAREHOLDERS

As at December 31, 2006, the following persons (other than directors or chief executives of the Company stated in "Directors' and Chief Executive's Interests and Short Positions in Shares, Underlying Shares and Debentures") had interests or short positions in the shares and underlying shares of the Company as recorded in the register required to be kept by the Company pursuant to Section 336 of the SFO:

Name of Shareholder	Capacity	Short position	Long position	Number of issued shares held	Percentage of the Company's issued share capital
Joyview Enterprises Limited[2]	Beneficial owner	–	328,867,019	328,867,019	33.22%
Warburg Pincus & Co.[1]	Interest of controlled corporation	–	186,989,966	186,989,966	18.88%
Warburg Pincus Partners LLC[1]	Beneficial owner	–	186,989,966	186,989,966	18.88%
Warburg Pincus Private Equity VIII L.P.[1]	Beneficial owner	–	90,605,988	90,605,988	9.15%
Warburg Pincus International Partners L.P.[1]	Beneficial owner	–	89,616,811	89,616,811	9.05%

Notes:

1. Warburg Pincus International Partners, L.P., and Warburg Pincus Private Equity VIII L.P. are part of the Warburg Pincus Funds. The general partner of the Warburg Pincus Funds is Warburg Pincus Partners LLC, which is a subsidiary of Warburg Pincus & Co. Each of Warburg Pincus Partners LLC and Warburg Pincus & Co. is therefore deemed to be interested in the shares held by the Warburg Pincus Funds, which includes Warburg Pincus International Partners, L.P. and Warburg Pincus Private Equity VIII L.P. as well as four other funds consisted in the Warburg Pincus Funds.

2. Joyview Enterprises Limited is a company beneficially owned as to 100% by Mr. Zhu Zhangjin.

Save as disclosed herein, the Company has not been notified of any other person (other than a director or a chief executive of the Company) who had an interest or a short position in the shares and underlying shares of the Company as recorded in the register required to be kept by the Company pursuant to Section 336 of the SFO as at December 31, 2006.

DIRECTORS' RIGHTS TO ACQUIRE SHARES OR DEBT SECURITIES

Other than the share option scheme disclosed in note 29 to the financial statements, at no time during the year was the Company or any of its subsidiaries a party to any arrangements to enable the directors of the Company to acquire benefits by means of the acquisition of shares in, or debt securities (including debentures) of, the Company or any other body corporate.

CONNECTED TRANSACTIONS

During the year ended December 31, 2006, the Group entered into the following transactions with its connected persons.

(1) Acquisition of further interests in Haining Hainix

On June 1, 2006, Zhejiang Kasen Industrial Co. ,Ltd ("Zhejiang Kasen"), a wholly-owned subsidiary of the Company, entered into an agreement with Haining Zhiyuan Leather Supplementary Material Operation, Haining Zheji Material Operation, and Haining Tianke Sofa Accessories Operation (collectively the "Vendors"), pursuant to which Zhejiang Kasen has agreed to acquire from the Vendors the sale interests, representing 44.55% of the paid up capital of Haining Hainix Sofa Ltd ("Haining Hainix"), a subsidiary of the Company, at the consideration of approximately RMB34.2 million. Details of the acquisition have been set out in the circular dated June 15, 2006.

Prior to the acquisition, Haining Hainix was owned as to 25.5% by Higher Point Investment, 25% by Cardina, 11.6% by Haining Zhiyuan Leather Supplementary Material Operation, 4.95% by Haining Tianke Sofa Accessories Operation, 4.95% by Haining Yushi Commercial & Trading Operation and remaining 28% by Haining Zheji Material Operation. The Company has 50.5% indirect interest in Haining Hainix. Since Haining Zhiyuan Leather Supplementary Operation and Haining Zheji Material Operation hold respectively more than 10% of the equity interests of Haining Hainix, they are therefore connected persons of the Company under the Listing Rules. Thus, the acquisition constitutes a connected transaction for the Company under the Listing Rules.

The Directors believe that the acquisition provides a good opportunity for the Company to take full operation benefits of Haining Hainix. In addition, expected sales and profits of Haining Hainix to be accounted for in the future will be attributed as to 95.05% to the Shareholders. The Directors also noted that Haining Hainix has procured some key customers who are mainly manufacturers of upholstered furniture products located in the United States and Australia and has established a large customer base. Upon completion, the Directors intend to fully capitalize on the growing customer base of Haining Hainix and thereby increasing its sales volume.

On the basis of the consideration of RMB34.2 million payable for the acquisition, the consideration would imply a discount of approximately RMB1.1 million or approximately 3.2%, which was arrived at arm's length negotiation between the relevant parties and on normal commercial terms, and by reference to the net asset value of Haining Hainix as of December 31, 2005 as adjusted by the appreciation amount of the land and buildings of approximately RMB35.7 million valued by the independent valuer, Sallmanns (Far East) Limited in May 2006.

(2) Acquisition of further interests in Haining Hidea

On June 1,2006, Zhejiang Kasen entered into an agreement with Haining Huiteng Garments Material Operation and Haining Liangda Sofa Accessories Operation (collectively the "Vendors"), pursuant to which Zhejiang Kasen has agreed to acquire from the Vendors the sale interests, representing 49.5% of the paid up capital of Haining Hidea Furniture Co. Ltd ("Haining Hidea"), a subsidiary of the Company, at the consideration of approximately RMB15.7 million. Details of the acquisition have been set out in the circular dated June 15, 2006.

Prior to the acquisition, Haining Hidea was owned as to 27% by Haining Huiteng Garments Material Operation, 25.5% by Higher Point Investment, 25% by Cardina and remaining 22.5% by Haining Liangda Sofa Accessories Operation. The Company has 50.5% indirect interest in Haining Hidea. Since Haining Huiteng Garments Material Operation and Haining Liangda Sofa Accessories Operation hold respectively more than 10% of the equity interests of Haining Hidea, they are therefore connected persons of the Company under the Listing Rules. Thus, the acquisition constitutes a connected transaction for the Company under the Listing Rules.

The Directors believe that the acquisition provides a good opportunity for the Company to take full operation benefits of Haining Hidea. In addition, expected sales and profits of Haining Hidea to be accounted for in the future will be attributed as to 100% to the Shareholders. The Directors also considered that the business operation could be managed more efficiently and effectively once the Group obtains a greater control of the board composition. Furthermore, the Group plans to utilize Haining Hidea's production facilities for its expanded customer base.

On the basis of the consideration of RMB15.7 million payable for the acquisition, the consideration would imply a discount of approximately RMB8.1 million or approximately 34.0%, which was arrived at arm's length negotiation between the relevant parties and on normal commercial terms, and by reference to the net asset value of Haining Hidea as of December 31, 2005 as adjusted by the appreciation amount of the land and buildings of approximately RMB26.2 million valued by the independent valuer, Sallmanns (Far East) Limited in May 2006.

CONTINUING CONNECTED TRANSACTIONS

During the year ended December 31, 2006, the Group entered into the following continuing transactions with its connected persons. The transactions are defined by the Listing Rules as "continuing connected transactions". Waivers from strict compliance with the announcement requirements, or the announcement and independent shareholders' approval requirements, had been received from the Stock Exchange. The transactions are subject to the reporting requirements set out in Chapter 14A of the Listing Rules.

(1) Agreement for purchase of sofa fabrics from Wansheng Silk

On January 1, 2005, Haining Wansheng Silk Waving Co., Ltd. ("Wansheng Silk") entered into an agreement with Haining Wansheng Furniture Co., Ltd. ("Wansheng Furniture") and Haining Kasen Leather Co., Ltd. ("Haining Kasen"), a wholly-owned subsidiary of the Company, which will expire on December 31, 2007 and, subject to compliance with Listing Rules requirements regarding connected transactions, automatically renewable for a term of 3 years thereafter. Wansheng Silk is an associate of Mr. Sun Jianxin, an executive director of Wansheng Furniture, and therefore Wansheng Silk is a connected person of the Company. The pricing under this agreement is determined by reference to the prevailing market price. Details of this agreement between Wansheng Silk, Wansheng Furniture and Haining Kasen have been set out in the prospectus of the Company dated October 10, 2005 ("the Prospectus").

Pursuant to this agreement, Wansheng Furniture and Haining Kasen purchase sofa fabrics for use in making upholstered furniture from Wansheng Silk. Wansheng Silk is a manufacturer of silk and other fabrics, suitable for use in sofas. During the year, the aggregate value of the transaction under this agreement was RMB9,541,000, within the estimate of RMB10,000,000 as disclosed in the Prospectus.

(2) Agreement for sale of production wastes to Yujie

On January 1, 2005, Haining Yujie Material Recycling Co., Ltd. ("Yujie") entered into an agreement with Zhejiang Kasen Industrial Co., Ltd. ("Zhejiang Kasen") which will expire on December 31, 2007 and, subject to compliance with Listing Rules requirements regarding connected transactions, automatically renewable for a term of 3 years thereafter. Yujie is an 80% owned subsidiary of Zhejiang Sunbridge Industrial (Group) Co., Ltd. ("Sunbridge") and Sunbridge is a company in which Mr. Zhu Zhangjin indirectly controls more than 30% of the voting power at general meetings. The pricing under this agreement is determined by reference to the prevailing market price. Details of this agreement have been set out in the Prospectus.

Pursuant to this agreement, Yujie will purchase wastes (including reside leather, used tubs, hair and fat) from the Company's subsidiaries (including Zhejiang Kasen, Haining Kasen, Haining Home Impression Furniture Co., Ltd., Haining Schinder Tanning Co., Ltd., Haining Gaosheng Leather Co., Ltd. and Haining Kareno Furniture Co., Ltd.). Yujie is one of the largest recycling companies in Haining and is located near many of the Group's production facilities (all within approximately 10 km). The Company believes that by selling wastes to Yujie, the Group will achieve an efficient management of disposal logistics and an effective supervision of its employees in the sale of wastes. During the year, the aggregate value of the transaction under this agreement was RMB8,975,000, within the estimate of RMB18,000,000 as disclosed in the Prospectus.

(3) Agreement for purchase of wet blues from Kezilesu Xinrong, Yili Horgos and Baiyin Kasen

On January 1, 2005, Kezilesu Xinrong Leather Co., Ltd. ("Kezilesu Xinrong"), Yili Horgos Leather Co., Ltd. ("Yili Horgos") and Baiyin Kasen Leather Co., Ltd. ("Baiyin Kasen") entered into an agreement with Zhejiang Kasen which will expire on December 31, 2007 and, subject to compliance with Listing Rules requirements regarding connected transactions, automatically renewable for a term of 3 years thereafter. Kezilesu Xinrong, Yili Horgos and Baiyin Kasen are each a subsidiary of Sunbridge and Sunbridge is a company in which Mr. Zhu Zhangjin indirectly controls more than 30% of the voting power at general meetings. The pricing under this agreement is determined by reference to the prevailing market price. Details of this agreement have been set out in the Prospectus.

Pursuant to this agreement, the Company will purchase wet blues from Kezilesu Xinrong, Yili Horgos and Baiyin Kasen. Kezilesu Xinrong, Yili Horgos and Baiyin Kasen are the largest importer of raw cowhides in Southern Xinjiang, Northern Xinjiang and Gansu Provinces respectively, and they process such raw cowhides into wet blues. The Group needs to source wet blues externally from time to time and it would also be an advantage in saving transportation and handling costs for the Group if the processing and enhancement of raw cowhides into wet blues were performed near the place of origin of the raw cowhides. During the year, the aggregate value under this agreement for the purchases of wet blues from Kezilesu Xinrong, Yili Horgos and Baiyin Kasen were RMB60,220,000, RMB34,242,000 and RMB68,854,000 respectively. The aggregate of these purchases are within the estimate of RMB510,000,000 as disclosed in the Prospectus.

(4) Agreement for sale of upholstered furniture to Starcorp

On February 22, 2006, Starcorp Corporation Pty. Ltd. ("Starcorp") entered into an agreement with the Group which will expire on December 31, 2008 and, subject to compliance with Listing Rules requirements regarding connected transactions, automatically renewable for a term of 3 years thereafter. Starcorp is a 70% owned subsidiary of Sunbridge and Sunbridge is a company in which Mr. Zhu Zhangjin indirectly controls more than 30% of the voting power at general meetings. The pricing under this agreement is determined by reference to the prevailing market price. Details of this agreement have been set out in the circular dated March 16, 2006. Pursuant to this agreement, the Group will sell upholstered furniture to Starcorp. Starcorp's core business is retail sales of wooden and other upholstered furniture in Australia and the Company considers that this provides a good opportunity for the Group to increase its sales of the upholstered furniture in the Australian market. The annual cap in respect of the continuing transactions for the three years ending December 31, 2008 are RMB110 million, RMB150 million, and RMB180 million respectively. During the year, the aggregate value of the transaction under this agreement was RMB49,209,000, within the estimate of RMB110,000,000 as disclosed in the circular dated March 16, 2006.

(5) Agreement for sales of outdoor leisure products to North Pole

On February 22, 2006, the Group entered into several agreements with North Pole Ltd. and North Pole (China) Ltd. (collectively the "North Pole Agreements"), which will expire on December 31, 2008 and, subject to compliance with Listing Rules requirements regarding connected transactions, automatically renewable for 3 year terms thereafter. North Pole Ltd. and North Pole (China) Ltd. are subsidiaries of a shareholder of the Company for the continuing sales transactions. North Pole Ltd., is owned, among others, as to approximately 46.1% by North Pole Holdings Ltd. and approximately 46.1% by North Pole International Holdings Ltd., both of which are in turn wholly-owned by Warburg Pincus Funds. North Pole (China) Ltd. is a wholly-owned subsidiary of North Pole Ltd. The annual cap in respect of the continuing transactions for the three years ending December 31, 2008 are RMB250 million, RMB500 million, and RMB800 million respectively. The pricing under this agreement is determined by reference to the prevailing market price. Details of this agreement have been set out in the circular dated March 16, 2006.

Pursuant to this agreement, the Company will sell outdoor leisure products to North Pole Ltd. and North Pole (China) Ltd. North Pole Ltd. is a leading manufacturer of outdoor leisure products such as camping tents, furniture and sleeping bags with its sourcing and manufacturing operations mainly located in the PRC whereas its commercial operations are mainly located in the United States. The Company believes that the entering into of the North Pole Agreements will enable the Group to further utilise its existing production capacity to diversify and expand its products mix and revenue base. During the year, the aggregate value of the transaction under this agreement was RMB10,830,000, within the estimate of RMB250,000,000 as disclosed in the circular dated March 16, 2006.

Pursuant to Rule 14A.38 of the Listing Rules, the board of directors engaged the auditors of the Company to perform certain agreed upon procedures in respect of the continuing connected transactions of the Group. The auditors have reported their factual findings on these procedures to the board of directors. Based on the work performed, the auditors of the Company have provided a letter and confirmed that the aforesaid continuing connected transaction (1) have been approved by the board of directors of the Company; (2) are in accordance with the pricing policies of the Group; (3) have been entered into in accordance with the terms of the relevant agreements governing the transaction; and (4) have not exceeded the caps allowed by the Stock Exchange in the previous waiver.

In the opinion of the independent non-executive directors, the continuing connected transactions entered into by the Group were:

(i) in the ordinary and usual course of business of the Group;

(ii) either (a) on normal commercial terms; or (b) where there is no available comparison, on terms that are no less favorable to the Group than terms to or from independent third parties; and

(iii) in accordance with the agreements governing the transactions on terms that are fair and reasonable so far as the shareholders of the Company.

Save as disclosed above, there were no other transactions which need to be disclosed as connected transactions in accordance with the requirements of the Listing Rules during the year ended December 31, 2006.

DIRECTORS' INTEREST IN CONTRACTS

Save as disclosed under the heading "Connected Transactions", there were no contracts of significance to which the Company or any of its subsidiaries was a party and in which a director of the Company had a material interest, whether directly and indirectly, subsisted at the end of the year or at any time during the year.

PURCHASE, SALE OR REDEMPTION OF THE COMPANY'S LISTED SECURITIES

Pursuant to the general mandate granted by the shareholders of the Company, the Board of Directors resolved on July 31, 2006 to repurchase the Company's shares of up to 10% of the issued shares of the Company as at the date of May 30, 2006. During the year, the Company repurchased 23,997,000 ordinary shares on the Stock Exchange at an aggregate consideration of HK$25,165,000. All of the shares were subsequently cancelled. The nominal value of the cancelled shares of RMB29,730 (equivalent to USD3,600) was debited to share capital and the excess of relevant aggregate consideration over nominal value was debited to the Company's share premium. Details of the repurchases are as follows:

Month of the repurchases	Total number of the ordinary shares repurchased	Highest price paid per share	Lowest price paid per share	Aggregate consideration
		HK$	HK$	HK$'000
August 2006	23,997,000	1.0503	0.9986	25,165

The purchases were made for the benefit of the shareholders as a whole as they enhanced the net asset value and/or earnings per share of the Company.

Save as disclosed above, neither the Company nor any of its subsidiaries had purchased, sold or redeemed any of the Company's listed securities during the year.

SUFFICIENCY OF PUBLIC FLOAT

Based on information that is available to the Company and within the knowledge of its directors, the Company has maintained a sufficient public float as required under the Listing Rules throughout the year ended December 31, 2006.

DIRECTOR'S INTERESTS IN COMPETING BUSINESS

None of the Directors hold any interests in any competing business against the Company or any of its jointly-controlled entities and subsidiaries for the year ended December 31, 2006.

PRE-EMPTIVE RIGHTS

There are no provisions for pre-emptive rights under the Company's Article of Association, or the laws of the Caymans Islands, which would oblige the Company to offer new shares on a pro-rata basis to existing shareholders.

INDEPENDENT NON-EXECUTIVE DIRECTORS' CONFIRMATION OF INDEPENDENCE

The Company has received, from each of the independent non-executive directors, Messrs. LU Yungang, Ken, CHOW Joseph, ZHANG Huaqiao, Joe, a confirmation of his independence pursuant to Rule 3.13 of the Listing Rules. The Company considers all of the independent non-executive directors are independent.

POST BALANCE SHEET EVENTS

(1) A tender submitted by Haining Higher Point Investment Development Co., Ltd. ("Haining Higher Point"), a wholly-owned subsidiary of the Company, for the acquisition of a piece of land (the "Land") for an aggregate consideration of RMB253.75 million was accepted on January 29, 2007. The Group, Haining Zhejiang Leather and Garment Market Investment and Development Company Limited ("Haining Leather Market"), and Haining Zhengyang Trading Co., Ltd. ("Haining Zhengyang Trading"), collectively the "Joint Venture Partners", will form a Joint Venture to hold and develop the Land into a leather product retail mall. On February 5, 2007, Haining Higher Point paid the total consideration of RMB203.75 million to Changsha Municipal Bureau of State Land and Resources, 80% of the land price and the total amount of the transaction levy, which was funded from the internal resources of the Group and the remaining 20% of the land price, being RMB50 million, was funded by Haining Leather Market. The cash payments by the Group were from the fund generated from the Group's operating activities.

On March 15, 2007, the Joint Venture Partners, entered into a preliminary joint venture agreement, the total registered capital of which is RMB360 million. The Group will hold 51% interest of the proposed joint venture with an investment amount of approximately RMB184 million.

(2) Pursuant to a board resolution on January 29, 2007, the Company disposed of a subsidiary, Haining Home Craft Furniture Co., Ltd. (海寧家藝家具有限公司) to an independent third party for RMB44.7 million. The net asset value of the subsidiary amounted to RMB41 million as at December 31, 2006.

AUDIT COMMITTEE

An Audit Committee was established by the Company to review and supervise the Company's financial reporting process and internal controls. The Audit Committee comprises the three independent non-executive directors of the Company. Mr. CHOW Joseph is the chairman of the Audit Committee.

The annual results of the Company have been reviewed by the Audit Committee.

REMUNERATION COMMITTEE

A Remuneration Committee was established by the Company to establish policies, review and determine the remuneration of the directors and the senior management. The Remuneration Committee, comprises the two independent non-executive directors and a non-executive director of the Company. Mr. Li Hui, David is the chairman of the Remuneration Committee.

AUDITORS

A resolution will be submitted to the annual general meeting of the Company to re-appoint Messrs. Deloitte Touche Tohmatsu as auditors of the Company.

On behalf of the Board

ZHU Zhangjin, Kasen
Director
Hong Kong, April 16, 2007

Corporate Governance Report

The Board and the Management are committed to maintain a high standard of corporate governance, holding the beliefs of transparency, independence, honesty and accountability. We believe that effective corporate governance is an essential factor to create more value to shareholders. Therefore we continuously review and improve our corporate governance standards to ensure maximum compliance with relevant laws and codes.

The Company has complied with the "Code on Corporate Governance Practices" (the "CG Code") contained in Appendix 14 to the Listing Rules throughout the year ended December 31, 2006, except for the following deviations:

CODE PROVISION A.2.1

Under CG Code Provision A.2.1, the roles of chairman and Chief Executive Officer should be separated and should not be performed by the same individual. The Company does not at present separate the roles of Chairman and Chief Executive Officer. Mr. Zhu Zhangjin is the Chairman and Chief Executive Officer of the Company responsible for overseeing the operations of the Group. The Company is currently considering appointing a new Chief Executive Officer to replace Mr. Zhu if candidate with suitable leadership, knowledge, skills and experience can be identified within or outside the Group. However, due to the nature and extent of the Group's operations, in particular in Mainland China and the in-depth knowledge and experience in the leather and upholstery furniture market required for the position of Chief Executive Officer, it is not possible to determine as to when the appointment of a Chief Executive Officer for the Company can be effected.

CODE PROVISION A.4.1

Under CG Code Provision A.4.1, non-executive directors should be appointed for a specific term, subject to re-election. The current non-executive director of the Company, Mr. Li Hui, David and independent non-executive directors of the Company, Mr. Chow Joseph, on Mr. Lu Yungang, Ken and Mr. Zhang Huaqiao, Joe are not appointed for specific terms, but are subject to retirement by rotation and re-election at the annual general meeting of the Company in accordance with the Company's articles of association. At every annual general meeting, one-third of the directors for the time being or, if their number is not a multiple of three, the number nearest to but not less than one-third, shall retire from office by rotation.

The Board will keep these matters under review. Following sustained development and growth of the Company, we will continue to monitor and revise the Company's governance policies in order to ensure that such policies can meet the general rules and standards required by the Stock Exchange.

The Key corporate governance principles and practices of the Company are summarized as follow:

MODEL CODE FOR SECURITIES TRANSACTIONS BY DIRECTORS

The Company has adopted the Model Code for Securities Transactions by Directors of Listed Issuers (the "Model Code") set out in Appendix 10 to the Listing Rules. Having made specific inquiry with all directors of the Company, the Company ensure that all directors have confirmed their compliance with the required standard set out in the Model Code during the year ended December 31, 2006.

BOARD OF DIRECTORS

The primary responsibilities of the Board are to establish long term strategies, administrate and oversee the operations and financial policies and set up and regularly review the Company's performance. The Board comprises of seven members, including three executive directors, one non-executive director and three independent non-executive directors. The Board members for the year ended December 31, 2006 were:

Executive directors

Mr. Zhu Zhangjin, Kasen *(Chairman)*
Mr. Zhu Jianqi
Mr. Zhou Xiaosong

Non-executive director

Mr. Li Hui, David[1]

Independent non-executive directors

Mr. Chow Joseph
Mr. Lu Yungang, Ken
Mr. Zhang Huaqiao, Joe[2]

Notes:

1. Mr. Li Hui, David has been appointed to fill Mr. Sun Qiang Chang's place, as both non-executive director and chairman of remuneration committee of the Company from May 30, 2006.

2. Mr. Zhang Huaqiao, Joe has been appointed to fill the place of Mr. Shi Zhengfu as independent non-executive director from July 3, 2006.

The Biographical details of all directors and the relationships between them are set out in the "Directors and Management Profiles" section on pages 4 to 6 of this annual report, the Company's website: www.kasen.com.cn, and www.irasia.com/listco/hk/kasen. None of the directors of the Company have any financial, business, family or other material or relevant relationships among members of the Board.

The Company has received an annual confirmation of independence from each of the three independent non-executive directors pursuant to Rule 3.13 of the Listing Rules. Based on the contents of such confirmation, the Company considers that the three independent non-executive directors are independent and that they all meet the specific independence guidelines as set out in Rule 3.13 of the Listing Rules.

The independent non-executive directors bring a wide range of business and financial expertise, experiences and independent judgement to the Board. Through active participation in Board meetings and serving on various Board committees, all independent non-executive directors make various contributions to the effective direction of the Company.

The Company has purchased Directors & Officers Liability and Company Reimbursement Insurance for all directors and some senior management.

CHAIRMAN AND CHIEF EXECUTIVE OFFICER

Mr. Zhu Zhangjin is the Chairman and Chief Executive Officer of the Company responsible for overseeing the operations of the Group. The Board believes that the appointment of Mr. Zhu Zhangjin as the Chairman and Chief Executive Officer of the Company will not impair the balance of power and authority between the Board and the management of the Company, and is most beneficial to the Company's interest at present.

NON-EXECUTIVE DIRECTOR

The current non-executive director of the Company is not appointed for specific terms, but is subject to retirement by rotation and re-election at the annual general meeting of the Company in accordance with the Company's articles of association.

BOARD COMMITTEES

As an integral part of good corporate governance, the following committees have been set up:

Audit Committee

The audit committee comprises three independent non-executive directors of the Company:

Mr. Chow Joseph *(Chairman of the Audit Committee)*
Mr. Lu Yungang, Ken
Mr. Zhang Huaqiao, Joe

The audit committee was set up with written terms of reference prepared based on "A Guide for Effective Audit Committees" published by the Hong Kong Institute of Certified Public Accountants and the CG Code. The primary duties of the audit committee are to review the Company's annual reports and accounts and interim reports and results announcements and to provide advice and comments thereon to the directors. The members meet regularly with the external auditors and the Company's senior management for the review and supervision of the Company's financial reporting and internal control procedures.

During the year ended December 31, 2006, the Audit Committee held two meetings to review the annual and interim results, and to make recommendations to improve the Company's internal control. The chief financial officer, internal audit officer and representatives of the external auditors attended the meetings.

Remuneration Committee

The remuneration committee comprises three members, the majority of which are independent non-executive directors:

Mr. Li Hui, David *(Chairman of the Remuneration Committee)*
Mr. Lu Yungang, Ken
Mr. Zhang Huaqiao, Joe

The remuneration committee has adopted written terms of reference prepared by reference to the suggested terms of reference stated under the CG Code Provision B.1.3.

The remuneration committee has been delegated with the powers and authorities to implement the share option scheme of the Company and to deal with all compensation matters regarding the directors and senior management of the Company in accordance with the terms and conditions of their respective agreement/contract with the relevant member of the Group.

During the year ended December 31, 2006, the Remuneration Committee held one meeting to review the remuneration package of the Board members and the senior management.

NUMBER OF MEETINGS AND DIRECTORS' ATTENDANCE

The individual attendance record of each director at the meetings of the Board, Remuneration Committee and Audit Committee during the year ended December 31, 2006 is set out below:

	Attendance/Number of Meetings		
Name of Directors	**Board**	**Remuneration Committee**	**Audit Committee**
Executive Directors			
Mr. ZHU Zhangjin, Kasen *(Chairman)*	5/5	N/A	N/A
Mr. ZHOU Xiaosong	3/5	N/A	N/A
Mr. ZHU Jianqi	4/5	N/A	N/A
Non-executive Directors			
Mr. LI Hui, David *(Chairman of Remuneration Committee)*	4/5	1/1	N/A
Mr. SUN Qiang Chang* *(Chairman of Remuneration Committee)*	2/5	0/1	N/A
Independent Non-executive Directors			
Mr. CHOW Joseph *(Chairman of Audit Committee)*	4/5	N/A	2/2
Mr. LU Yungang, Ken *(Member of Audit Committee and Remuneration Committee)*	5/5	1/1	2/2
Mr. SHI Zhengfu* *(Member of Audit Committee and Remuneration Committee)*	1/5	0/1	1/2
Mr. ZHANG Huaqiao, Joe *(Member of Audit Committee and Remuneration Committee)*	2/5	0/1	0/2

* These directors resigned during the year.

NOMINATION OF DIRECTORS

The Company believes that it is not necessary to establish a separate Nomination Committee to nominate directors. The task of nominating directors is vested with the Board of the Company. The Board reviews the structure and the composition of the Board regularly, then identifies and nominates qualified individuals to be appointed as new directors of the Company. In 2006, the Board nominated and appointed Mr. Li Hui, David and Mr. Zhang Huaqiao, Joe as non-executive director and independent non-executive director respectively. Before they were nominated, the Board had assessed their independence.

RESPONSIBILITIES IN RESPECT OF THE FINANCIAL STATEMENTS

The Board is responsible for presenting a balanced, clear and understandable assessment of annual and interim reports, price sensitive information announcements and other disclosures required under the Listing Rules and other regulatory requirements.

The directors acknowledge their responsibility for preparing the financial statements of the Company for the year ended December 31, 2006.

The statement of the external auditors of the Company about their reporting responsibilities on the financial statements is set out in the "Independent Auditor's Report".

AUDITORS' REMUNERATION

The remuneration paid to the external auditors of the Company in respect of audit services for the year ended December 31, 2006 amounted to approximately RMB4.6 million.

INTERNAL CONTROL

The Board is responsible for maintaining an adequate internal control system to safeguard shareholder investments and Company assets, and reviewing the effectiveness of such on an annual basis through the Audit Committee. The Audit Committee reports to the Board on any material issues and makes recommendations to the Board.

SHAREHOLDER RIGHTS AND INVESTOR RELATIONS

The rights of shareholders and the procedures for them to demand a poll on resolutions at shareholders' meetings are contained in the Company's Articles of Association. Details of such rights to demand a poll and the poll procedures are included in all circulars to shareholders and will be explained during the proceedings of meetings. Poll results, if any, will be published in newspapers on the business day following the shareholders' meeting and posted on both the website of the Stock Exchange and the website of the Company.

The general meetings of the Company provide a platform to communicate between the shareholders and the Board. The Chairman of the Board as well as chairman of the Remuneration Committee and Audit Committee or, in their absence, other members of the respective committees, and where applicable, the independent Board committee, are available to answer questions at the shareholders' meetings. The Company continues to enhance communications and relationships with its investors. Enquiries from investors are dealt with in an informative and timely manner.

Taking advantages of various resources, the Company keeps communicating with shareholders regularly and properly to ensure that shareholders are adequately aware of any important issues during the course of the Company's operation, and then exercise their rights as shareholders with sufficient knowledge. In addition, the Company regularly meets institutional investors, financial analysts and financial media, and promptly releases information related to any significant progress of the Company, so as to promote the development of the Company through mutual and efficient communications. Investors are welcome to write directly to the Company at its Hong Kong registered office for any inquiries.

Independent Auditor's Report

Deloitte.
德勤

TO THE SHAREHOLDERS OF KASEN INTERNATIONAL HOLDINGS LIMITED
(incorporated in the Cayman Islands with limited liability)

We have audited the consolidated financial statements of Kasen International Holdings Limited (the "Company") and its subsidiaries (collectively referred to as the "Group") set out on pages 35 to 88, which comprise of the consolidated balance sheet as at December 31, 2006, and the consolidated income statement, the consolidated statement of changes in equity and the consolidated cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

DIRECTORS' RESPONSIBILITY FOR THE CONSOLIDATED FINANCIAL STATEMENTS

The directors of the Company are responsible for the preparation and the true and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards issued by the International Accounting Standards Board and the disclosure requirements of the Hong Kong Companies Ordinance. This responsibility includes designing, implementing and maintaining internal control relevant to the preparation and the true and fair presentation of the consolidated financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

AUDITOR'S RESPONSIBILITY

Our responsibility is to express an opinion on these consolidated financial statements based on our audit and to report our opinion solely to you, as a body, and for no other purpose. We do not assume responsibility towards or accept liability to any other person for the contents of this report. We conducted our audit in accordance with Hong Kong Standards on Auditing issued by the Hong Kong Institute of Certified Public Accountants. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance as to whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and true and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Independent Auditor's Report (cont'd)

OPINION

In our opinion, the consolidated financial statements give a true and fair view of the state of affairs of the Group as at December 31, 2006 and of the Group's profit and cash flows for the year then ended in accordance with International Financial Reporting Standards and have been properly prepared in accordance with the disclosure requirements of the Hong Kong Companies Ordinance.

Deloitte Touche Tohmatsu
Certified Public Accountants
Hong Kong
April 16, 2007

Consolidated Income Statement

For the year ended December 31, 2006

	Notes	2006 RMB'000	2005 RMB'000
Turnover	6	**3,916,513**	3,475,457
Cost of sales		**(3,489,136)**	(2,927,194)
Gross profit		**427,377**	548,263
Other income	7	**71,230**	42,675
Distribution costs		**(107,908)**	(81,524)
Administrative expenses		**(171,115)**	(113,180)
Other expenses		**(29,997)**	(4,915)
Share of profit (loss) of associates	19	**937**	(1,114)
Finance costs	8	**(85,390)**	(111,540)
Profit before taxation	9	**105,134**	278,665
Taxation	11	**(21,707)**	(18,311)
Profit for the year		**83,427**	260,354
Attributable to:			
Equity holders of the Company		**64,143**	265,699
Minority interests		**19,284**	(5,345)
		83,427	260,354
Dividend	12	**114,258**	–
Earnings per share	13		
Basic		**6 cents**	41 cents
Diluted		**6 cents**	34 cents

Consolidated Balance Sheet

As at December 31, 2006

	Notes	2006 RMB'000	2005 RMB'000
NON-CURRENT ASSETS			
Goodwill	14	**157,958**	181,006
Property, plant and equipment	15	**1,173,599**	1,281,230
Prepaid lease payment – non-current portion	16	**131,860**	142,812
Investment properties	17	**32,901**	–
Intangible assets	18	**1,485**	1,077
Investments in associates	19	**26,728**	9,127
Investment in a jointly controlled entity	20	**2,614**	811
Available-for-sale investments	21	**310**	310
		1,527,455	1,616,373
CURRENT ASSETS			
Inventories	22	**1,326,216**	1,378,842
Trade and other receivables	23	**633,848**	795,665
Prepaid lease payment – current portion	16	**2,904**	3,543
Amounts due from related companies	24	**36,596**	21,253
Taxes recoverable		**3,315**	13,624
Pledged bank deposits	25	**163,221**	240,112
Bank balances and cash	25	**380,973**	372,278
		2,547,073	2,825,317
TOTAL ASSETS		**4,074,528**	4,441,690
CURRENT LIABILITIES			
Trade, bills and other payables	26	**604,036**	783,992
Amounts due to related companies	24	**19,467**	60,287
Bank and other borrowings – due within one year	27	**1,246,689**	1,191,246
Taxes payable		**10,959**	7,807
		1,881,151	2,043,332
NET CURRENT ASSETS		**665,922**	781,985
TOTAL ASSETS LESS CURRENT LIABILITIES		**2,193,377**	2,398,358
NON-CURRENT LIABILITIES			
Bank and other borrowings – due after one year	27	**10,400**	100,492
		10,400	100,492
NET ASSETS		**2,182,977**	2,297,866

Consolidated Balance Sheet (cont'd)

As at December 31, 2006

	Note	2006 RMB'000	2005 RMB'000
CAPITAL AND RESERVES			
Share capital	28	**1,227**	1,256
Reserves		**2,107,638**	2,198,304
Equity attributable to equity holders of the Company		**2,108,865**	2,199,560
Minority interests		**74,112**	98,306
Total equity		**2,182,977**	2,297,866

The consolidated financial statements on pages 35 to 88 were approved and authorized for issue by the Board of Directors on April 16, 2007 and are signed on its behalf by:

Zhu Zhangjin, Kasen
Director

Zhu Jianqi
Director

Consolidated Statement of Changes in Equity

For the year ended December 31, 2006

	Attributable to equity holders of the Company											
	Share capital RMB'000	Share premium RMB'000	Equity reserve RMB'000	Exchange reserve RMB'000	Statutory reserve RMB'000 (Note 30)	Special reserve RMB'000 (Note 30)	Share option reserve RMB'000 (Note 29)	Reserve on acquisition RMB'000	Retained earnings RMB'000	Sub-total RMB'000	Minority interests RMB'000	Total equity RMB'000
At January 1, 2005	689	308,191	1,291	(662)	141,831	168,659	–	–	475,500	1,095,499	110,272	1,205,771
Exchange differences arising on translation of foreign operations recognized directly in equity	–	–	–	(131)	–	–	–	–	–	(131)	–	(131)
Profit for the year	–	–	–	–	–	–	–	–	265,699	265,699	(5,345)	260,354
Total recognized income and expense for the year	–	–	–	(131)	–	–	–	–	265,699	265,568	(5,345)	260,223
Issue of new shares	246	539,000	–	–	–	–	–	–	–	539,246	–	539,246
Transaction costs attribute to issue of new shares	–	(38,511)	–	–	–	–	–	–	–	(38,511)	–	(38,511)
Conversion of convertible loan notes	321	338,728	(1,291)	–	–	–	–	–	–	337,758	–	337,758
Acquisition of additional interests in subsidiaries	–	–	–	–	–	–	–	–	–	–	(6,621)	(6,621)
Appropriation of statutory reserve	–	–	–	–	27,431	–	–	–	(27,431)	–	–	–
At December 31, 2005	1,256	1,147,408	–	(793)	169,262	168,659	–	–	713,768	2,199,560	98,306	2,297,866
Reversal of exchange differences recognized in previous year	–	–	–	793	–	–	–	–	–	793	–	793
Profit for the year	–	–	–	–	–	–	–	–	64,143	64,143	19,284	83,427
Total recognized income and expense for the year	–	–	–	793	–	–	–	–	64,143	64,936	19,284	84,220
Share repurchases	(29)	(25,862)	–	–	–	–	–	–	–	(25,891)	–	(25,891)
Capital contribution from minority shareholder	–	–	–	–	–	–	–	–	–	–	5,600	5,600
Share based payment expense	–	–	–	–	–	–	15,486	–	–	15,486	–	15,486
Acquisition of additional interests in subsidiaries from minority shareholders (Note 31)	–	–	–	–	–	–	–	(30,968)	–	(30,968)	(29,188)	(60,156)
Disposal of subsidiaries (Note 32)	–	–	–	–	–	–	–	–	–	–	(19,230)	(19,230)
Dividend paid	–	–	–	–	–	–	–	–	(114,258)	(114,258)	(660)	(114,918)
Appropriation of statutory reserve	–	–	–	–	10,742	–	–	–	(10,742)	–	–	–
At December 31, 2006	**1,227**	**1,121,546**	**–**	**–**	**180,004**	**168,659**	**15,486**	**(30,968)**	**652,911**	**2,108,865**	**74,112**	**2,182,977**

Consolidated Cash Flow Statement

For the year ended December 31, 2006

	Notes	2006 RMB'000	2005 RMB'000
OPERATING ACTIVITIES			
Profit before taxation		**105,134**	278,665
Adjustments for:			
Impairment loss recognized in respect of trade and other receivables		**17,626**	5,630
Allowances for inventories		**11,404**	3,532
Amortization of intangible assets		**350**	225
Amortisation of prepaid lease payment		**3,277**	3,436
Depreciation of property, plant and equipment		**95,858**	87,474
Loss (gain) on disposal of property, plant and equipment		**2,161**	(26)
Interest expenses		**85,390**	111,540
Interest income		**(8,905)**	(7,487)
Share based payment expense		**15,486**	–
Adjustment of exchange reserve recognized in previous years		**793**	–
(Gain) loss on disposals of subsidiaries	32	**(8,838)**	1,380
Gain on disposals of available-for-sale investments		**–**	(305)
Goodwill impairment		**23,048**	–
Share of (profit) loss of associates		**(937)**	1,114
Discounts on acquisition of an additional interest in a subsidiary	31	**(10,279)**	(5,300)
Operating cash flows before movements in working capital		**331,568**	479,878
(Increase) decrease in inventories		**(9,097)**	10,364
Decrease (increase) in trade and other receivables		**68,604**	(273,209)
(Increase) decrease in amounts due from related companies		**(15,993)**	152,542
Decrease in trade, bills and other payables		**(98,713)**	(108,310)
(Decrease) increase in amounts due to related companies		**(35,225)**	22,908
Cash generated from operations		**241,144**	284,173
Income taxes paid		**(27,277)**	(31,774)
Income taxes refunded		**19,031**	8,549
NET CASH FROM OPERATING ACTIVITIES		**232,898**	260,948

Consolidated Cash Flow Statement (cont'd)

For the year ended December 31, 2006

	Notes	**2006 RMB'000**	2005 RMB'000
INVESTING ACTIVITIES			
Purchase of property, plant and equipment		**(41,123)**	(194,462)
Increase in prepaid lease payment		**(614)**	(5,554)
Increase in investment properties		**(32,901)**	–
Investment in a jointly controlled entity		**(1,803)**	(811)
Investment in associates		**(13,664)**	(5,068)
Payment for acquisition of additional interests in subsidiaries	31	**(49,877)**	(1,321)
Decrease (increase) in pledged bank deposits		**76,891**	(927)
Purchase of intangible assets		**(891)**	(397)
Proceeds from disposals of property, plant and equipment		**250**	9,305
Interest received		**8,905**	7,487
Proceeds from sales of available-for-sales investments		**–**	2,405
Proceeds from sales of held for trading investments		**–**	3,505
Purchase of investments in securities		**–**	–
Disposal of subsidiaries	32	**(5,672)**	–
NET CASH USED IN INVESTING ACTIVITIES		**(60,499)**	(185,838)
FINANCING ACTIVITIES			
Bank and other borrowings raised		**2,301,375**	3,068,370
Issue of shares		**–**	539,246
Repurchase of shares		**(25,891)**	–
Advances from related companies		**8,000**	41,311
Repayment of bank and other borrowings		**(2,250,224)**	(3,351,949)
Interest paid		**(85,646)**	(96,536)
Repayment to related companies		**(2,000)**	(78,221)
Transaction costs attributable to issue of new shares		**–**	(38,511)
Dividends paid to equity shareholders		**(114,258)**	–
Dividends paid to minority shareholders		**(660)**	–
Capital contribution from minority shareholders		**5,600**	–
NET CASH (USED IN) FROM FINANCING ACTIVITIES		**(163,704)**	83,710
NET INCREASE IN CASH AND CASH EQUIVALENTS		**8,695**	158,820
CASH AND CASH EQUIVALENTS AT BEGINNING OF THE YEAR		**372,278**	213,458
CASH AND CASH EQUIVALENTS AT END OF THE YEAR, represented by bank balances and cash		**380,973**	372,278

Notes to the Consolidated Financial Statements

For the year ended December 31, 2006

1. GENERAL

The Company is a public limited company incorporated in the Cayman Islands and its shares are listed on the Stock Exchange of Hong Kong Limited ("Stock Exchange") since October 20, 2005. The addresses of the registered office and principal place of business of the Company are disclosed in the corporate information to the annual report.

The Company acts as an investment holding company. Its subsidiaries are principally engaged in the processing of raw cowhides and wet blues into finished leather or fully assembled leather products.

2. APPLICATION OF NEW AND REVISED INTERNATIONAL FINANCIAL REPORTING STANDARDS

In the current year, the Group has applied, for the first time, a number of new standard, amendments and interpretations issued by the International Accounting Standards Board (the "IASB") and the International Financial Reporting Interpretations Committee (the "IFRIC") of the IASB that are either effective for annual accounting periods beginning on or after December 1, 2005 or January 1, 2006. The adoption of the new standards, amendment and interpretations had no material effect on the results and financial position for the current or prior accounting periods have been prepared and presented. Accordingly, no prior period adjustment has been required.

At the date of authorization of these consolidated financial statements, the following new standards, amendment and interpretations were in issue but not yet effective:

IAS 1 (Amendment)	Capital Disclosures[1]
IFRS 7	Financial Instruments: Disclosures[1]
IFRS 8	Operating Segments[2]
IFRIC 7	Applying the Restatement Approach under IAS 29 Financial Reporting in Hyperinflationary Economies[3]
IFRIC 8	Scope of IFRS 2[4]
IFRIC 9	Reassessment of Embedded Derivatives[5]
IFRIC 10	Interim Financial Reporting and Impairment[6]
IFRIC 11	IFRS 2: Group and Treasury Share Transactions[7]
IFRIC 12	Service Concession Arrangements[8]

[1] Effective for annual periods beginning on or after January 1, 2007.
[2] Effective for annual periods beginning on or after January 1, 2009.
[3] Effective for annual periods beginning on or after March 1, 2006.
[4] Effective for annual periods beginning on or after May 1, 2006.
[5] Effective for annual periods beginning on or after June 1, 2006.
[6] Effective for annual periods beginning on or after November 1, 2006.
[7] Effective for annual periods beginning on or after March 1, 2007.
[8] Effective for annual periods beginning on or after January 1, 2008.

The directors anticipate that the adoption of these new standards, amendment and interpretations in future periods will have no material financial impact on the results and the financial position of the Group.

3. PRINCIPAL ACCOUNTING POLICIES

The consolidated financial statements have been prepared in accordance with International Financial Reporting Standards. In addition, the consolidated financial statements include applicable disclosures required by the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited and by the Hong Kong Companies Ordinance.

The consolidated financial statements have been prepared on the historical cost basis.

Basis of consolidation

The consolidated financial statements incorporate the financial statements of the Company and entities controlled by the Company and its subsidiaries. Control is achieved where the Company has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

The results of subsidiaries acquired or disposed of during the year are included in the consolidated income statement from the effective date of acquisition or up to the effective date of disposal, as appropriate.

Where necessary, adjustments are made to the financial statements of the subsidiaries to bring the accounting policies used in line with those used by other members of the Group.

All intra-group transactions, balances, income and expenses are eliminated on consolidation.

Minority interests in the net assets of consolidated subsidiaries are presented separately from the Group's equity therein. Minority interests in the net assets consist of the amount of those interests at the date of the original business combination and the minority's share of changes in equity since the date of the consolidation. Losses applicable to the minority in excess of the minority's interest in the subsidiary's equity are allocated against the interests of the Group except to the extent that the minority has a binding obligation and is able to make an additional investment to cover the losses.

3. PRINCIPAL ACCOUNTING POLICIES *(Continued)*

Business combinations

The acquisition of subsidiaries is accounted for using the purchase method. The cost of the acquisition is measured at the aggregate of the fair values, at the date of exchange, of assets given, liabilities incurred or assumed by the Group in exchange for control of the acquiree, plus any costs directly attributable to the business combination. The acquiree's identifiable assets, liabilities and contingent liabilities that meet the conditions for recognition under IFRS 3 Business Combinations are recognized at their fair values at the acquisition date.

Goodwill arising on acquisition is recognised as assets and measured at cost, being the excess of the cost of the business combination over the Group's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities. If, after reassessment, the Group's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities exceeds the cost of the business combination, the excess is recognised immediately in the profit or loss.

The interest of minority shareholders in the acquiree is initially measured at the minority's proportion of the net fair values of the assets, liabilities and contingent liabilities recognized.

Acquisition of additional interests in subsidiaries

On acquisition of additional interest in a subsidiary, the difference between the consideration paid and the aggregate of the goodwill (or discount on acquisition) and the carrying values of the underlying assets and liabilities attributable to the additional interests in a subsidiary acquired is debited to reserve on acquisition.

Goodwill

Goodwill arising on acquisition on or after March 31, 2004.

Goodwill arising on the acquisition of a subsidiary represents the excess of the cost of acquisition over the Group's interest in the net fair values of the identifiable assets, liabilities and contingent liabilities of the subsidiary recognized at the date of acquisition. Goodwill is initially recognized as assets at cost and is subsequently measured at cost less any accumulated impairment losses.

For the purpose of impairment testing, goodwill is allocated to each of the Group's cash-generating units expected to benefit from the synergies of the combination. Cash-generating units to which goodwill has been allocated are tested for impairment annually, or more frequently when there is an indication that the unit may be impaired. For goodwill arising on an acquisition in a financial year, the cash-generating unit to which goodwill has been allocated is tested for impairment before the end of that financial year. If the recoverable amount of the cash-generating unit is less than the carrying amount of the unit, the impairment loss is allocated first to reduce the carrying amount of any goodwill allocated to the unit and then to the other assets of the unit pro-rata on the basis of the carrying amount of each asset in the unit. An impairment loss recognized for goodwill is not reversed in a subsequent period.

On disposal of a subsidiary, the attributable amount of goodwill is included in the determination of the profit or loss on disposal.

3. PRINCIPAL ACCOUNTING POLICIES *(Continued)*

Investments in associates

An associate is an entity over which the Group has significant influence and that is neither a subsidiary nor an interest in a joint venture. Significant influence is the power to participate in the financial and operating policy decisions of the investee but is not control or joint control over those policies.

The results and assets and liabilities of associates are incorporated in the consolidated financial statements using the equity method of accounting. Under the equity method, investments in associates are carried in the consolidated balance sheet at cost as adjusted by post-acquisition changes in the Group's share of net assets of the associate, less any identified impairment loss. When the Group's share of losses of an associate equals or exceeds its interest in that associate, the Group discontinues recognizing its share of further losses. An additional share of losses is provided for and a liability is recognized only to the extent that the Group has incurred legal or constructive obligations or made payments on behalf of that associate.

Any excess of the Group's share of the net fair value of the identifiable assets, liabilities and contingent liabilities over the cost of acquisition, after reassessment, is recognized immediately in profit or loss.

Where a group entity transacts with an associate of the Group, profits and losses are eliminated to the extent of the Group's interests in the relevant associate.

Jointly controlled entities

Joint venture arrangements that involve the establishment of a separate entity in which venturers have joint control over the economic activity of the entity are referred to as jointly controlled entities.

The results and assets and liabilities of jointly controlled entities are incorporated in the consolidated financial statements using the equity method of accounting. Under the equity method, investments in jointly controlled entities are carried in the consolidated balance sheet at cost as adjusted by post-acquisition changes in the Group's share of net assets of the jointly controlled entities, less any identified impairment loss. When the Group's share of losses of a jointly controlled entity equals or exceeds its interest in that jointly controlled entity, the Group discontinues recognizing its share of further losses. An additional share of losses is provided for and a liability is recognized only to the extent that the Group has incurred legal or constructive obligations or made payments on behalf of that jointly controlled entity.

When a group entity transacts with a jointly controlled entity of the Group, unrealized profits or losses are eliminated to the extent of the Group's interest in the jointly controlled entity, except to the extent that unrealised losses provide evidence of an impairment of the assets transferred, in which case, the full amount of losses is recognised.

3. PRINCIPAL ACCOUNTING POLICIES *(Continued)*

Revenue recognition

Revenue is measured at the fair values of the consideration received or receivable and represents amounts receivable for goods sold in the normal course of business, net of sales related taxes.

Sales of goods are recognised when goods are delivered and title has passed.

Interest revenue is accrued on a timely basis, by reference to the principal outstanding and at the effective interest rate applicable, which is the rate that exactly discounts estimated future cash receipts through the expected life of the financial asset to that asset's net carrying amount.

Property, plant and equipment

Property, plant and equipment other than construction in progress are stated at cost less subsequent accumulated depreciation and accumulated impairment losses.

Depreciation is charged so as to write off the cost of assets, other than construction in progress, over their estimated useful lives and after taking into account of the estimated residual value, using the straight-line method. The estimated useful lives, residual values and depreciation method are reviewed at each year end, with the effect of any changes in estimate accounted for on a prospective basis.

Construction in progress represents property, plant and equipment in the course of construction for production or for its own use purposes. Construction in progress is carried at cost less any recognised impairment loss. Construction in progress is classified to the appropriate category of property, plant and equipment when completed and ready for intended use. Depreciation of these assets, on the same basis as other property assets, commences when the assets are ready for their intended use.

An item of property, plant and equipment is derecognised upon disposal or when no future economic benefits are expected to arise from the continued use of the asset. Any gain or loss arising on derecognition of the assets is included in the consolidated income statement in the year in which the item is derecognised.

Investment property

On initial recognition, investment properties are measured at cost, including any directly attributable expenditure. Subsequent to initial recognition, investment properties are measured using the fair value model. Gains or losses arising from changes in the fair value of investment property are included in profit or loss for the period in which they arise.

An investment property is derecognised upon disposal or when the investment property is permanently withdrawn from use or no future economic benefits are expected from its disposals. Any gain or loss arising on derecognition of the assets is included in the consolidated income statement in the year in which the item is derecognized.

3. PRINCIPAL ACCOUNTING POLICIES *(Continued)*

Leasing

Leases are classified as finance leases whenever the terms of the lease transfer substantially all the risks and rewards of ownership to the lessee. All other leases are classified as operating leases.

Operating lease payments are recognised as an expense on a straight-line basis over the lease term.

Rental income from operating leases is recognised in the consolidated income statements on a straight-line basis over the term of the relevant leases.

Foreign currencies

The individual financial statements of each group entity are presented in the currency of the primary economic environment in which the entity operates its functional currency. For the purpose of the consolidated financial statements, the results and financial position of each entity are expressed in RMB, which are the functional currency of the Company and the presentation currency for the consolidated financial statements.

In preparing the financial statements of the individual entities, transactions in currencies other than the entities' functional currency ("foreign currencies") are recorded at the rates of exchanges prevailing at the dates of the transactions. At each balance sheet date, monetary items denominated in foreign currencies are retranslated at the rates prevailing at the balance sheet date. Non-monetary items that are measured in terms of historical cost in a foreign currency are not retranslated.

Exchange differences arising on the settlement of monetary items, and on the translation of monetary items are recognized in profit or loss in the period which they arise .

3. PRINCIPAL ACCOUNTING POLICIES *(Continued)*

Borrowing costs

Borrowing costs directly attributable to the acquisition, construction or production of qualifying assets that necessarily take a substantial period of time to get ready for their intended use or sale, are added to the cost of those assets, until such time as the assets are substantially ready for their intended use or sale. Investment income earned on the temporary investment of specific borrowings pending their expenditure on qualifying assets is deducted from the borrowing costs eligible for capitalisation.

All other borrowing costs are recognized in profit or loss in the period in which they are incurred.

Government grants

Government grants are recognised as income over the periods necessary to match them with the related costs. Grants related to expense items are recognised in the same period as those expenses are charged in the consolidated income statement and are reported separately as 'other income'.

Retirement benefits costs

Payments to defined contribution retirement benefits schemes and state-managed retirement benefit schemes are charged as an expense when employees have rendered service entitling them to the contributions.

Share-based payments

Equity-settled share-based payments to employees are measured at fair value of the equity instrument at the grant date. Fair value is measured by using a binomial model. The expected life used in the model has been adjusted, based on management's best estimate, for the effects of non-transferability, exercise restrictions and behavioral considerations.

The fair value determined at the grant date of the equity-settled share-based payments is expensed on a straight-line basis over the vesting period, based on the Group's estimate of share options that will eventually vest.

Taxation

Income tax expense represents the sum of the tax currently payable and deferred tax.

3. PRINCIPAL ACCOUNTING POLICIES *(Continued)*

The tax currently payable is based on taxable profit for the year. Taxable profit differs from profit as reported in the consolidated income statement because it excludes items of income or expense that are taxable or deductible in other years and it further excludes items that are never taxable or deductible. The Group's liability for current tax is calculated using tax rates that have been enacted or substantively enacted by the balance sheet date.

Deferred tax is recognized on differences between the carrying amounts of assets and liabilities in the consolidated financial statements and the corresponding tax bases used in the computation of taxable profit, and are accounted for using the balance sheet liability method. Deferred tax liabilities are generally recognized for all taxable temporary differences and deferred tax assets are generally recognised for all deductible temporary differences to the extent that it is probable that taxable profits will be available against which deductible temporary differences can be utilized. Such assets and liabilities are not recognized if the temporary difference arises from goodwill or from the initial recognition (other than in a business combination) of other assets and liabilities in a transaction that affects neither the taxable profit nor the accounting profit.

The carrying amount of deferred tax assets is reviewed at each balance sheet date and reduced to the extent that it is no longer probable that sufficient taxable profits will be available to allow all or part of the asset to be recovered.

Deferred tax assets and liabilities are measured at the tax rates that are expected to apply in the period when the liability is settled or the asset is realized, based on tax rates that have been enacted on substantively enacted by the balance sheet date. The measurement of deferred tax liabilities and assets reflects the tax consequences that would follow from the manner in which the Group expects, at the reporting date, to recover or settle the carrying amount of its assets and liabilities.

Deferred tax assets and liabilities are offset when there is legally enforceable right to set off current tax assets against current tax liabilities and when they relate to income taxes levied by the same taxation authority and the Group intends to settle its current tax assets and liabilities on a net basis.

3. PRINCIPAL ACCOUNTING POLICIES *(Continued)*

Intangible assets

Intangible assets acquired separately

Intangible assets acquired separately and with finite useful lives are carried at cost less accumulated amortisation and accumulated impairment losses. Amortisation is charged on a straight-line basis over their estimated useful lives. The estimated useful life and amortisation method are reviewed at the end of each annual reporting period, with the effect of any changes in estimate being accounted for on a prospective basis.

Gains or losses arising from derecognizing of an intangible asset are measured at the difference between the net disposal proceeds and the carrying amount of the assets and are recognized in the consolidated income statement when the asset is derecognized.

Impairment of tangible and intangible assets excluding goodwill

At each balance sheet date, the Group reviews the carrying amounts of its tangible and intangible assets to determine whether there is any indication that those assets have suffered an impairment loss. If any such indication exists, the recoverable amount of the asset is estimated in order to determine the extent of the impairment loss exists. Where it is not possible to estimate the recoverable amount of an individual asset, the Group estimates the recoverable amount of the cash-generating unit to which the asset belongs.

Recoverable amount is the higher of fair value less costs to sell and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset for which the estimates of future cash flows have not been adjusted. An impairment is recognised as an expense immediately.

When an impairment loss subsequently reverses, the carrying amount of the asset is increased to the revised estimate of its recoverable amount, but so that the increased carrying amount does not exceed the carrying amount that would have been determined had no impairment loss been recognised for the asset in prior years. A reversal of an impairment loss is recognised immediately in profit or loss.

Inventories

Inventories are stated at the lower of cost and net realizable value. Costs are determined on the weighted average cost method. Net realisable value represents the estimated selling price for inventories less all estimated costs of completion and costs necessary to make the sale.

3. PRINCIPAL ACCOUNTING POLICIES *(Continued)*

Financial instruments

Financial assets and financial liabilities are recognised on the Group's balance sheet when the Group becomes a party to the contractual provisions of the instrument.

Financial assets

Financial assets are classified into loans and receivables or available for sale investments. All regular way purchases or sales are purchases or sales of financial assets that require delivery of assets within the time frame estimated by regulation or convention in the marketplace and is recognized and derecognized on a trade date basis. The accounting policies adopted in respect of each category of financial assets are set out below.

Amounts due from related parties, trade and other receivables and bank balances and pledged bank deposits

These financial assets have fixed or determinable payments that are not quoted in an active market and are classified as loans and receivables.

Loans and receivables are measured at initial recognition at fair value, and are subsequently measured at amortized cost using the effective interest method. Appropriate allowances for estimated irrecoverable amounts are recognised in profit or loss when there is objective evidence that the asset is impaired. The allowance recognised is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the effective interest rate computed at initial recognition.

Investments

Available-for-sale investment in equity investments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured are carried at cost less impairment. Impairment losses recognised in profit or loss for equity investments classified as available-for-sale are not subsequently reversed through profit or loss.

Financial liabilities and equity

Financial liabilities and equity instruments issued by a group entity are classified according to the substance of the contractual arrangements entered into and the definitions of a financial liability and an equity instrument.

An equity instrument is any contract that evidences a residual interest in the assets of the Group after deducting all of its liabilities. The accounting policies adopted for financial liabilities and equity instruments are set out below.

3. PRINCIPAL ACCOUNTING POLICIES *(Continued)*

Financial instruments *(Continued)*

Bank and other borrowings

Borrowings are initially measured at fair value, and are subsequently measured at amortised cost, using the effective interest method. Any difference between the proceeds (net of transaction costs) and the settlement or redemption of borrowings is recognised over the term of the borrowings.

Trade, bills and other payables and amounts due to related companies

The above financial liabilities are initially measured at fair value, and are subsequently measured at amortised cost, using the effective interest method.

Equity instruments

Equity instruments issued by the Company are recorded at the proceeds received, net of direct issue costs.

Derecognition

Financial assets are derecognised when the rights to receive cash flows from the assets expire or, the financial assets are transferred and the Group has transferred substantially all the risks and rewards of ownership of the financial assets. On derecognition of a financial asset, the difference between the asset's carrying amount and the sum of the consideration received and receivable and the cumulative gain or loss that had been recognised directly in equity is recognised in profit or loss.

Financial liabilities are derecognised when the obligation specified in the relevant contract is discharged, cancelled or expired. The difference between the carrying amount of the financial liability derecognised and the consideration paid and payable is recognised in profit or loss.

4. KEY SOURCES OF ESTIMATION UNCERTAINTY

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

Impairment of goodwill

Determining whether goodwill is impaired requires an estimation of the value in use of the cash-generating units to which goodwill has been allocated. The value in use calculation requires the Group to estimate the future cash flows expected to arise from the cash-generating unit and a suitable discount rate in order to calculate the present value.

The carrying amount of goodwill at the balance sheet date was RMB158 million after an impairment loss of RMB23 million was recognized during 2006. Details of the impairment loss calculation are provided in note 14.

5. FINANCIAL RISK MANAGEMENT OBJECTIVES AND POLICIES

The Group's major financial instruments include borrowings, trade receivables, trade payables and bank balances and cash. Details of these financial instruments are disclosed in respective notes. The risks associated with these financial instruments and the policies on how to mitigate these risks are set out below. The management manages and monitors these exposures to ensure appropriate measures are implemented on a timely and effective manner.

Market risk

Interest rate risk

The Group's exposure to fair value interest rate risk relates primarily to the fixed rate bank and other borrowings (see Note 27 for detail of these borrowings). The Group has not entered into any interest rate hedging contracts. The directors monitor the Group's exposure on continuing basis and will consider hedging interest rate risk should the need arise.

Foreign currency risk

The Group's exposure to foreign currency risk related primarily to the sales and purchase transactions denominated in US dollars and such related receivables and payables arising from time to time. In addition, the Group has short term borrowings denominated in US dollars. The Group has not entered into any forward contracts to hedge the exposures. The directors monitor the Group's exposure on continuing basis and will consider hedging the currency risk should the need arise. Balances denominated in foreign currency in the consolidated balance sheet mainly represented trade receivables, bank balances and cash, trade payables and bank borrowings.

Credit risk

As at December 31, 2006, the Group's maximum exposure to credit risk which will cause a financial loss to the Group due to failure to perform an obligation by the counterparties is arising from the carrying amount of the respective recognised financial assets as stated in the consolidated balance sheet.

The Group's credit risk is primarily attributable to its trade receivables. The amounts presented in the consolidated balance sheet are net of impairment loss on trade receivables, estimated by the Group's management based on prior experience and their assessment of the current economic environment.

The Group trades only with recognized creditworthy third parties. It is Group's policy that all customers who wish to trade on credit terms are subject to credit verification procedures. In addition, receivable balances are monitored on an ongoing basis with the result that the Group's exposure to bad debts is not significant.

During the year, the Group maintained export credit insurance to protect the Group against the risk that the overseas customers may default settlement.

The Group has no significant concentration of credit risk, with exposure spread over a number of counterparties and customers.

The credit risk on bank deposits is limited because the counterparties are banks with high credit-ratings assigned by international credit-rating agencies.

5. FINANCIAL RISK MANAGEMENT OBJECTIVES AND POLICIES *(Continued)*

Liquidity risk

In the management of the liquidity risk, the Group monitors and maintains a level of cash and cash equivalents deemed adequate by the management to finance the Group's operations and monitors the level of borrowings on a continuing basis.

6. BUSINESS AND GEOGRAPHICAL SEGMENTS

For management purposes, the Group is currently organized into five operating divisions. These divisions are the basis on which the Group reports its primary segment information.

Business segment

During the year, the Group has presented its business by the following segments:

– Upholstered furniture, comprising leather and fabric upholstered furniture and furniture covers;

– Furniture leather;

– Automotive leather;

– Leather garments (Note); and

– Others (including sale of wooden frame and others)

Note: There was no transaction for leather garments segment in both years.

Segment information about these businesses is presented below:

6. BUSINESS AND GEOGRAPHICAL SEGMENTS *(Continued)*

Consolidated Income Statement

	Upholstered furniture RMB'000	Furniture leather RMB'000	Automotive leather RMB'000	Others RMB'000	Eliminations RMB'000	Total RMB'000
2006						
Turnover						
External sales	**3,122,953**	**615,104**	**150,141**	**28,315**	**–**	**3,916,513**
Inter-segment sales	**603,005**	**2,249,976**	**–**	**126,818**	**(2,979,799)**	**–**
2005						
Turnover						
External sales	2,755,003	593,121	126,907	426	–	3,475,457
Inter-segment sales	640,091	1,599,461	–	98,347	(2,337,899)	–

Inter-segment sales are charged at prevailing market prices.

	Year ended December 31, **2006** **RMB'000**	2005 RMB'000
Result		
Segment result		
- Upholstered furniture	**195,956**	321,955
- Furniture leather	**(17,748)**	44,585
- Automotive leather	**(9,391)**	10,946
- Others	**(246)**	(575)
	168,571	376,911
Unallocated income	**31,361**	18,746
Unallocated expenses	**(10,345)**	(4,338)
Share of profit (loss) of an associate	**937**	(1,114)
Finance costs	**(85,390)**	(111,540)
Profit before taxation	**105,134**	278,665
Taxation	**(21,707)**	(18,311)
Profit for the year	**83,427**	260,354

6. BUSINESS AND GEOGRAPHICAL SEGMENTS *(Continued)*

Other Information

	Year ended December 31, 2006 RMB'000	2005 RMB'000
Impairment loss recognized in respect of trade and other receivables		
– Upholstered furniture	**5,747**	2,152
– Furniture leather	**10,398**	1,718
– Automotive leather	**1,392**	1,343
– Others	**89**	417
	17,626	5,630
Allowances for inventories		
– Upholstered furniture	**1,480**	306
– Furniture leather	**9,924**	3,226
	11,404	3,532
Capital additions		
– Upholstered furniture	**52,518**	124,801
– Furniture leather	**15,102**	66,600
– Automotive leather	**493**	23,339
– Others	**5,653**	16,728
	73,766	231,468
Depreciation and amortization		
– Upholstered furniture	**47,545**	38,043
– Furniture leather	**43,200**	45,540
– Automotive leather	**3,825**	1,857
– Others	**4,915**	5,695
	99,485	91,135
Goodwill impairment		
– Upholstered furniture	**10,138**	–
– Automotive leather	**12,910**	–
	23,048	–

6. BUSINESS AND GEOGRAPHICAL SEGMENTS *(Continued)*

Balance Sheets

	As at December 31,	
	2006	2005
	RMB'000	RMB'000
ASSETS		
Segment assets		
– Upholstered furniture	**1,656,269**	1,909,643
– Furniture leather	**1,475,264**	1,600,250
– Automotive leather	**200,962**	190,614
– Others	**128,275**	82,598
Subtotal	**3,460,770**	3,783,105
Investments in associates	**26,728**	9,127
Investment in a jointly controlled entity	**2,614**	811
Unallocated corporate assets	**584,416**	648,647
	4,074,528	4,441,690
LIABILITIES		
Segment liabilities		
– Upholstered furniture	**437,400**	525,898
– Furniture leather	**119,390**	206,128
– Automotive leather	**7,410**	12,204
– Others	**39,836**	39,762
Subtotal	**604,036**	783,992
Unallocated corporate liabilities	**1,287,515**	1,359,832
	1,891,551	2,143,824

Geographical segment

Segment assets are substantively located in the People's Republic of China ("PRC").

The following table provides an analysis of the Group's sales by geographical market:

	2006	2005
	RMB'000	RMB'000
United States	**2,825,773**	2,383,797
PRC, including Hong Kong	**736,138**	727,001
Europe	**160,326**	120,272
Australia	**122,253**	187,543
Others	**72,023**	56,844
	3,916,513	3,475,457

7. OTHER INCOME

Details of other income are as follows:

	2006 **RMB'000**	2005 RMB'000
Government grants		
Grants for technology development	**2,830**	180
Grants for export sales	**18,362**	6,786
Incentive for business development	**4,274**	4,500
Other grants	**3,456**	928
	28,922	12,394
Net gain from sale of raw materials	**10,947**	11,535
Interest income	**8,905**	7,487
Discounts on acquisition of an additional interest in a subsidiary	**10,279**	5,300
Gain (loss) on disposals of subsidiaries (Note 32)	**8,838**	(1,380)
Others	**3,339**	7,339
	71,230	42,675

8. FINANCE COSTS

	2006 **RMB'000**	2005 RMB'000
Interest on:		
Bank borrowings wholly repayable within five years	**84,611**	94,245
Other borrowings wholly repayable within five years	**269**	3,536
Other borrowings not wholly repayable within five years	**510**	510
Convertible loan notes	**–**	13,249
	85,390	111,540

9. PROFIT BEFORE TAXATION

Profit before taxation has been arrived at after charging (crediting):

	2006 RMB'000	2005 RMB'000
Amortization of intangible assets (included in administrative expenses)	**350**	225
Amortization of prepaid lease payments	**3,277**	3,436
Depreciation of property, plant and equipment	**95,858**	87,474
Total depreciation and amortization	**99,485**	91,135
Auditors' remuneration	**4,619**	3,620
Cost of inventories recognised as expense	**3,477,732**	2,923,662
Impairment loss recognized in respect of trade and other receivables	**17,626**	5,630
Impairment of goodwill	**23,048**	–
Loss (gain) on disposal of property, plant and equipment	**2,161**	(26)
Operating lease rentals in respect of land and buildings	**1,892**	1,878
Net foreign exchange losses	**17,836**	15,263
Expenses of sampling and products upgrading	**8,048**	26,399
Allowances for inventories	**11,404**	3,532
Total employee benefit expenses	**286,659**	237,063

10. DIRECTORS AND EMPLOYEES' REMUNERATION

The emoluments paid or payable to the directors were as follows:

2006

	Zhu Zhangjin ("Mr. Zhu") RMB'000	Zhou Xiaosong RMB'000	Zhu Jianqi RMB'000	Li Hui RMB'000	Lu Yungang RMB'000	Chow Joseph RMB'000	Zhang Huaqiao RMB'000	Shi Zhengfu RMB'000	Sun Qiang Chang RMB'000	Total RMB'000
Fees	–	–	–	–	–	–	–	–	–	–
Other emoluments										
Salaries and other benefits	340	238	238	–	150	150	75	75	–	1,266
Contributions to retirement benefits schemes	2	2	2	–	–	–	–	–	–	6
Share based payment expense	1,039	1,039	1,039	–	208	208	–	–	–	3,533
Total emoluments	1,381	1,279	1,279	–	358	358	75	75	–	4,805

2005

	Mr. Zhu RMB'000	Zhou Xiaosong RMB'000	Zhu Jianqi RMB'000	Li Hui RMB'000	Lu Yungang RMB'000	Chow Joseph RMB'000	Zhang Huaqiao RMB'000	Shi Zhengfu RMB'000	Jiang Jianzhong RMB'000	Total RMB'000
Fees	–	–	–	–	–	–	–	–	–	–
Other emoluments										
Salaries and other benefits	220	196	196	–	–	–	–	–	95	707
Contributions to retirement benefits schemes	2	2	2	–	–	–	–	–	11	17
Total emoluments	222	198	198	–	–	–	–	–	106	724

Notes:

(1) Mr. Li Hui, David was appointed as non-executive director and Mr. Sun Qiang Chang resigned as non-executive director on May 30, 2006.

(2) Mr. Zhang Huaqiao, Joe was appointed as independent non-executive director and Mr. Shi Zhengfu resigned as independent non-executive director on July 3, 2006.

10. DIRECTORS AND EMPLOYEES' REMUNERATION *(Continued)*

Of the five individuals with the highest emoluments in the Group, three (2005: three) were directors of the Company whose emoluments are included in the disclosures as above. The emoluments of the remaining two (2005: two) individuals was as follows:

	2006 **RMB'000**	2005 RMB'000
Basic salaries and other benefits	**854**	650
Contributions to retirement benefits schemes	**14**	14
Share based payment expense	**1,247**	–
	2,115	664

The emoluments of the two individuals with the highest emoluments are within the following bands:

HK$	**2006** **Number of individuals**	2005 Number of individuals
1,000,000 or below	**1**	2
1,000,001-1,500,000	**1**	-

During the year, no emoluments were paid by the Group to the directors and the five highest paid individuals as an inducement to join or upon joining the Group or as compensation for loss of office. None of the directors has waived any emoluments during the year.

11. TAXATION

	2006 **RMB'000**	2005 RMB'000
Hong Kong Profits Tax		
– current year	**1,027**	718
– underprovision in previous year	**58**	425
PRC enterprise income tax		
– current year	**18,717**	19,504
– under(over)provision of income tax	**1,905**	(2,336)
	21,707	18,311

Hong Kong Profits Tax is calculated at 17.5% of estimated assessable profit for the year.

PRC enterprise income tax is calculated at the applicable rates to the PRC subsidiaries. Certain subsidiaries of the Company operating in the PRC are eligible for certain tax holidays and concessions and were exempted from PRC income taxes for the years of 2006 and 2005 ("Tax Holidays"). The maximal of Tax Holiday is 5 years from the first taxable profit year.

11. TAXATION *(Continued)*

The taxation for the year can be reconciled to the profit before taxation per the consolidated income statement as follows:

	2006 RMB'000	2005 RMB'000
Profit before taxation	**105,134**	278,665
Tax rate applicable to the major operation of the Group	**26.4%**	26.4%
Tax at the applicable rate	**27,755**	73,568
Tax effect of income not taxable for tax purpose	**(1,210)**	(1,460)
Tax effect of expenses/losses not deductible for tax purpose	**6,052**	3,129
Tax effect of deferred tax assets not recognized	**1,693**	147
Tax effect of tax losses not recognized	**9,519**	6,406
Tax effect of share of result of associates	**(247)**	294
Utilization of tax loss previously not recognized	**–**	(1,464)
Tax effect of Tax Holidays and concessions	**(27,988)**	(61,184)
Tax effect of different tax rates of subsidiaries operating with different tax regulations in the PRC and in Hong Kong	**4,170**	786
Overprovision in previous years	**–**	(2,336)
Underprovision in previous years	**1,963**	425
Taxation for the year	**21,707**	18,311

At December 31, 2006, the Group has unused tax losses of approximately RMB43,761,000 (2005: RMB32,041,000) available to offset against future profits, of which losses of RMB5,527,000 (2005: RMB32,041,000) will expire in year 2010, losses of RMB38,234,000 (2005: Nil) will expire in year 2011. No deferred tax asset has been recognized in respect of unused tax losses due to the unpredictability of future profit streams.

12. DIVIDEND

Dividends recognised as distributions during the year:

	2006 RMB'000	2005 RMB'000
Final 2005, HK7.59 cents per share	**79,575**	–
Interim 2006, HK3.45 cents per share	**34,683**	–
	114,258	–

13. EARNINGS PER SHARE

The calculation of the basic and diluted earnings per share attributable to the equity holders of the Company is based on the following data:

Earnings

	2006 **RMB'000**	2005 RMB'000
Earnings for the purposes of basic earnings per share, being profit attributable to equity holders of the Company	**64,143**	265,699
Effect of dilutive potential ordinary shares:		
Interest on convertible loan notes	–	13,249
Earnings for the purposes of diluted earnings per share	**64,143**	278,948

Number of shares

	2006	2005
Weighted average number of ordinary shares for the purposes of basic earnings per share	**1,004,410,969**	645,419,597
Effect of dilutive potential ordinary shares:		
Convertible loan notes	–	179,512,056
Weighted average number of ordinary shares for the purposes of diluted earnings per share	**1,004,410,969**	824,931,653

The share options granted to the employees of the Group has no effect to the diluted earnings per share because the exercise price of the Company's share options was higher than average market price for shares during the share option outstanding period.

14. GOODWILL

	2006 RMB'000	2005 RMB'000
COST		
At January 1 and December 31	**181,006**	181,006
ACCUMULATED IMPAIRMENT LOSSES		
At January 1	–	–
Impairment losses recognized in the year	**23,048**	–
At December 31	**23,048**	–
CARRYING AMOUNTS		
At December 31	**157,958**	181,006

Goodwill arose from the Group's acquisition of the subsidiaries through SFT International Pty. Ltd. ("SFT") in September 2004. Goodwill acquired in a business combination is allocated, at acquisition, to the cash generating units (CGUs) that are expected to benefit from that business combination.

During the financial year of 2006, the Group assessed the recoverable amount of goodwill, and determined that goodwill associated with the Group's upholstered furniture operation and automotive leather operation was impaired by RMB23 million. The recoverable amount of the upholstered furniture operation and automotive leather operation was assessed by reference to value in use model.

The main factor contributing to the impairment of the cash-generating units was the failure of generating sufficient cash as previously expected. In 2006, the Group lost some orders from customers, thus leading to less cash generated as expected. No write-down of the carrying amounts of other assets in the cash-generating unit was necessary.

Allocation of goodwill to cash-generating units

Before recognition of impairment losses, the carrying amount of goodwill allocated to cash-generating units that are significant individually or in aggregate is as follows:

	2006 RMB'000	2005 RMB'000
Haining Kareno Furniture Co., Ltd. ("Kareno")	**60,287**	60,287
Haining Kasen Leather Co., Ltd. ("Haining Kasen")	**97,671**	97,671
Haining Schinder Tanning Co., Ltd.	**12,910**	12,910
Haining Home Direct Furniture Co., Ltd. ("Home Direct")	**10,138**	10,138
	181,006	181,006

14. GOODWILL *(Continued)*

IMPAIRMENT TESTING ON GOODWILL

Goodwill has been allocated to the following cash-generating units (CGUs). The carrying amount of goodwill (net of accumulated impairment losses) as at December 31, 2006 is allocated as follows:

	2006	2005
	RMB'000	RMB'000
Upholstered furniture operation		
– Kareno	**60,287**	60,287
– Home Direct	**–**	10,138
– Haining Kasen	**97,671**	97,671
Automotive leather operation		
Haining Schinder Tanning Co., Ltd.	**–**	12,910
	157,958	181,006

The recoverable amount of the CGUs is determined based on a value in use calculation which uses cash flow projections based on financial budgets approved by management covering a five-year period, and a discount rate of 11.78% per annum (2005: 5% per annum). The cash flows beyond that five year period have been extrapolated using a steady 3% per annum growth rate.

The key assumptions used in the value in use calculations for the above operations are as follows:

Budgeted sales growth rate — The values assigned to the assumptions reflect the past experiences, overall industry situation in PRC, as well as the marketing staff's best estimate for the sales in the next five years. The growth factor is consistent with management development strategies. Management believes that the planned sales growth per year for the next five years is reasonably achievable.

Budgeted gross margin — The average gross margins achieved in the three years immediately before the budget period, normalized with the effect of increased raw material prices and the sudden currency appreciation. This reflects past experience, with Management expects that the company can fully absorb the adverse effects of increased raw material prices and the risk from the appreciation of RMB against US dollars.

Raw materials price inflation — The forecast takes into account of major raw materials' prices during the budget period for the countries from which raw materials are purchased. The values assigned to the key assumption are consistent with external sources of information.

15. PROPERTY, PLANT AND EQUIPMENT

	Buildings RMB'000	Plant and equipment RMB'000	Motor vehicles RMB'000	Furniture, fixtures and equipment RMB'000	Construction in progress RMB'000	Total RMB'000
COST						
At January 1, 2005	691,457	380,441	22,590	33,560	158,227	1,286,275
Additions	12,923	77,539	4,076	14,187	122,346	231,071
Disposals	(11,262)	(8)	–	–	–	(11,270)
Reclassification	190,571	17,186	162	18	(207,937)	–
At January 1, 2006	883,689	475,158	26,828	47,765	72,636	1,506,076
Additions	5,224	28,941	5,808	5,168	27,734	72,875
Disposals of subsidiaries	(72,242)	(8,839)	(1,672)	(2,568)	(4,029)	(89,350)
Disposals	–	(545)	(133)	(501)	(1,617)	(2,796)
Reclassification	74,970	1,439	1,006	329	(77,744)	–
At December 31, 2006	**891,641**	**496,154**	**31,837**	**50,193**	**16,980**	**1,486,805**
DEPRECIATION						
At January 1, 2005	42,102	78,166	9,489	9,606	–	139,363
Provided for the year	38,133	37,751	3,838	7,752	–	87,474
Eliminated on disposals	(1,991)	–	–	–	–	(1,991)
At January 1, 2006	78,244	115,917	13,327	17,358	–	224,846
Provided for the year	42,085	41,773	3,990	8,010	–	95,858
Elimination on disposals of subsidiaries	(4,937)	(1,241)	(406)	(529)	–	(7,113)
Elimination on disposals	–	(149)	(44)	(192)	–	(385)
At December 31, 2006	**115,392**	**156,300**	**16,867**	**24,647**	**–**	**313,206**
CARRYING AMOUNTS						
At December 31, 2006	**776,249**	**339,854**	**14,970**	**25,546**	**16,980**	**1,173,599**
At December 31, 2005	805,445	359,241	13,501	30,407	72,636	1,281,230

The buildings are located on the land leased under medium-term land use rights in the PRC.

The above items are depreciated on a straight line basis after consideration of residual value at the following rates per annum:

Buildings	shorter of the lease term or useful life
Plant and machinery	10 – 15 years
Motor vehicles	5 years
Furniture, fixtures and equipment	5 – 10 years

The Group has pledged its buildings with a carrying amount of approximately RMB469 million (2005: RMB487 million) to secure general banking facilities granted to the Group.

As at December 31, 2006, the title deeds of the buildings in amount of RMB45 million (2005: RMB49 million) has not been obtained. The directors believe that the relevant title deeds will be granted in the due course and the absence of official certificate does not impair the value of the relevant properties of the Group.

16. PREPAID LEASE PAYMENTS

The prepaid lease payments made by the Group are interest in land use rights under medium-term lease in the PRC. An amount of approximately RMB82,125,000 (2005: RMB87,144,000) had been pledged to banks to secure the borrowings of the Group granted by the banks.

	2006 **RMB'000**	2005 RMB'000
Analyzed for reporting purposes as:		
Non-current asset	**131,860**	142,812
Current asset	**2,904**	3,543
	134,764	146,355

	2006 **RMB'000**	2005 RMB'000
Without title deeds	**23,189**	17,911
With temporary title deeds	**–**	9,500
With formal title deeds	**111,575**	118,944
	134,764	146,355

The directors believe that the relevant title deeds will be granted to the Group in due course.

17. INVESTMENT PROPERTIES

	2006 **RMB'000**	2005 RMB'000
Carrying amount		
– Land in PRC	**32,901**	–

The fair value of the Group's investment properties at December 31, 2006 was arrived at by reference to a valuation carried out by Sallmanns (Far East) Limited, an independent qualified professional valuers not connected with the Group. Sallmanns (Far East) Limited are qualified valuers and have appropriate qualifications and recent experiences in the valuation of similar properties in the relevant locations. The valuation was arrived at by reference to market evidence of transaction prices for similar properties.

The land held is for capital appreciation purpose under medium-term lease in the PRC.

18. INTANGIBLE ASSETS

	RMB'000
COST	
At January 1, 2005	1,077
Additions	397
At January 1, 2006	1,474
Additions	891
Disposals of subsidiaries	(147)
At December 31, 2006	**2,218**
ACCUMULATED AMORTIZATION	
At January 1, 2005	172
Provided for the year	225
At January 1, 2006	397
Provided for the year	350
Elimination on disposals of subsidiaries	(14)
At December 31, 2006	**733**
CARRYING AMOUNT	
At December 31, 2006	**1,485**
At December 31, 2005	1,077

Intangible assets represent expenditure incurred for development of computer software and are amortized over five years.

19. INVESTMENTS IN ASSOCIATES

The interests in associates represents a 25% interest in 海寧美景海綿有限公司 (Future Foam Asia, Inc.) ("Future Foam"), an equity joint venture established in the PRC in 2004, and a 30% interest in 海寧市斜橋森博水務有限公司 (Haining Xieqiao Senbo Water Co., Ltd.) ("Senbo Water"), an associate changed from a subsidiary through additional capital injection by minority shareholders, and a 35% interest in Sichuan Longteng Leather Co., Ltd. ("Longteng"), an equity joint venture established in the PRC in 2006.

	2006 **RMB'000**	2005 RMB'000
Cost of unlisted investment in associates	**26,905**	10,241
Share of post-acquisition losses	**(177)**	(1,114)
	26,728	9,127

	2006 **RMB'000**	2005 RMB'000
Summarised financial information relating to the associates		
Total assets	**130,734**	59,664
Total liabilities	**(52,275)**	(23,156)
Net assets	**78,459**	36,508
Group's share of net assets of associates	**26,728**	9,127
Revenue	**96,309**	6,639
Profit (loss) for the year	**4,048**	(4,456)
Group's share of associates' profit (loss) for the year	**937**	(1,114)

20. INVESTMENT IN A JOINTLY CONTROLLED ENTITY

The interest in a jointly controlled entity represents a 50% interest in 海寧市卡森－美如可思皮革有限公司 (Haining Kasen-Melx Leather Co., Ltd.) ("Kasen-Melx"), an equity joint venture established in the PRC which commenced business in August 2005. The jointly controlled entity was established for the principal purpose of trading in leather and other furniture products.

Jointly controlled entity is accounted for using the equity method of accounting:

	2006 **RMB'000**	2005 RMB'000
Cost of unlisted investment in jointly controlled entity	**2,614**	811
The summarized financial information in respect of the Group's jointly controlled entities which are accounted for using the equity method is set out below:		
Total assets	**8,131**	1,672
Total liabilities	**(2,778)**	(91)
Net assets	**5,353**	1,581
Group's share of net assets of jointly controlled entity	**2,614**	811
Revenue	**2,103**	–
Profit (loss) for the year	**164**	(40)
Group's share of jointly controlled entity's profit (loss) for the year	**–**	–

21. AVAILABLE-FOR-SALE INVESTMENTS

The amount represents investments in unlisted equity securities issued by private entities incorporated in the PRC. As the range of fair value estimates vary significantly, the directors of the Company are of the opinion that it may not be meaningful to disclose the fair values.

22. INVENTORIES

	2006 **RMB'000**	2005 RMB'000
Raw materials	**348,878**	389,974
Work in progress	**806,913**	823,296
Finished goods	**170,425**	165,572
	1,326,216	1,378,842

23. TRADE AND OTHER RECEIVABLES

	2006 RMB'000	2005 RMB'000
Trade receivables	535,961	549,341
Less: allowance for doubtful debts	(45,494)	(34,908)
	490,467	514,433
Prepayments	64,917	154,247
Other receivables	92,890	136,490
Less: allowance for doubtful debts	(14,426)	(9,505)
	633,848	795,665

Movement in the allowance for doubtful debts

	2006 RMB'000	2005 RMB'000
Balance at beginning of the year	44,413	38,783
Amounts written off during the year	(496)	–
Amount relating to disposal of subsidiaries	(1,623)	–
Increase in allowance recognised in profit or loss	17,626	5,630
Balance at end of the year	59,920	44,413

The Group grants a credit period ranging from 30 days to 90 days to their trade customers. The aging analysis of trade receivables is as follows:

	2006 RMB'000	2005 RMB'000
Aged:		
Within 60 days	345,725	355,407
61 – 90 days	53,892	51,342
91 – 180 days	47,468	63,429
181 – 365 days	35,546	43,139
1 – 2 years	7,836	1,116
	490,467	514,433

The directors consider that the carrying amount of trade and other receivables at December 31, 2006 approximates their fair value.

24. AMOUNTS DUE FROM (TO) RELATED COMPANIES

Details of the amounts due from (to) related companies are as follows:

Name of related companies	Notes	2006 RMB'000	2005 RMB'000
(a) Operating in nature			
海寧宇潔物資回收有限公司 Haining Yujie Material Recycling Co., Ltd. ("Yujie")	(i), (ii)	**3,783**	2,705
伊犁霍爾果斯皮革有限公司 Yili Horgos Leather Co., Ltd. ("Yili Horgos")	(i), (ii)	**(29)**	(47,219)
白銀卡森皮革有限公司 Baiyin Kasen Leather Co., Ltd. ("Baiyin Kasen")	(i), (ii)	**–**	(2,130)
克孜勒蘇新蓉皮革有限公司 Kezilesu Xinrong Leather Co., Ltd. ("Kezilesu Xinrong")	(i), (ii)	**–**	(848)
Starcorp Corporation Pty. Ltd. ("Starcorp")	(i), (ii)	**28,496**	17,963
海寧萬盛絲綢噴織有限公司 Haining Wansheng Silk Weaving Co., Ltd. ("Wansheng Silk")	(ii), (v)	**–**	(5,960)
海寧美景海綿有限公司 Future Foam	(ii), (viii)	**(13,438)**	(3,532)
Kasen-Melx	(ii), (ix)	**3,080**	(339)
上海思達傢俱有限公司 Shanghai Star Furniture Co., Ltd.	(i), (ii)	**–**	(259)
North Pole Ltd.	(ii), (vii)	**313**	–
澳林家具(上海)有限公司 AoLin Furniture (Shanghai) Co., Ltd.	(i), (ii)	**196**	–
海寧長虹進出口有限公司 Haining Changhong Import and Export Co., Ltd. ("Changhong I&E")	(ii), (v)	**193**	–
海派皮業有限公司 Haining Haipai Leather Industry Co., Ltd.	(ii), (v)	**29**	–
(b) Non-operating in nature			
周慧敏	(iv), (vi)	**–**	59
孫時良	(iv), (vi)	**–**	526
海寧市斜橋森博水務有限公司 Haining Senbo Water Co., Ltd. ("Senbo Water")	(iii), (vi)	**506**	–
海寧獵馬皮革服裝有限公司 Haining Liema Leather Garments Co., Ltd.	(v), (x)	**(6,000)**	–
		17,129	(39,034)
Represented by:			
Amounts due from related companies, included in current assets		**36,596**	21,253
Amounts due to related companies, included in current liabilities		**(19,467)**	(60,287)
		17,129	(39,034)

24. AMOUNTS DUE FROM (TO) RELATED COMPANIES *(Continued)*

(c) Aging of amounts due from (to) related companies in operating nature is as follows:

	2006		2005	
	Amounts due from related companies RMB'000	**Amounts due to related companies RMB'000**	Amounts due from related companies RMB'000	Amounts due to related companies RMB'000
Aging:				
Within 60 days	**10,421**	**(12,621)**	4,588	(14,484)
60 – 90 days	**5,619**	**(6,105)**	3,900	(544)
91 – 180 days	**12,067**	**(706)**	12,100	(45,259)
181 – 365 days	**6,303**	**(35)**	665	–
1 – 2 years	**2,186**	**–**	–	–
	36,596	**(19,467)**	21,253	(60,287)

Details of the operating transactions with the related parties are set out in note 37.

Notes:

(i) Mr. Zhu has influence and beneficial interests in these companies through Sunbridge Industrial Group Co., Ltd.

(ii) The amounts are unsecured, interest-free and repayable according to the credit terms.

(iii) Senbo Water ceased to be subsidiary and became associate of the Group since May 2006.

(iv) The individuals ceased to be directors of the non-wholly owned subsidiaries of the Company since October 24, 2006.

(v) A director of a non-wholly owned subsidiary has influence and beneficial interests in the company.

(vi) The amounts are unsecured, interest-free and recoverable within one year.

(vii) The company is the subsidiary of one major shareholder of the Company.

(viii) Associate of the Company.

(ix) Jointly controlled entity of the Company.

(x) The amounts are unsecured, carried annual interest rate of 6.696% and repayable on demand.

The directors consider that the carrying amount of amounts due from (to) related companies at December 31, 2006 approximates their fair value.

25. BANK BALANCES AND CASH

(a) Pledged bank deposits

The amount mainly represents deposits pledged to banks to secure the bills payable issued by the Group and the bank facilities granted to the Group.

The deposits carry an average interest rate of 0.72% (2005: 0.72%). The pledged bank deposits will be released upon the settlement of relevant bill payables and bank borrowings. The fair value of the pledged bank deposits at December 31, 2006 approximates the carrying amount.

(b) Bank balances and cash

Bank balances and cash comprised of bank deposits with short maturity at market interest rate and cash on hand.

The fair value of the bank balances and cash at December 31, 2006 approximates the carrying amount.

26. TRADE, BILLS AND OTHER PAYABLES

The aging analysis of trade payables is as follows:

	2006 RMB'000	2005 RMB'000
Aging:		
Within 60 days	**286,950**	321,512
60 – 90 days	**20,807**	33,685
91 – 180 days	**13,080**	49,869
181 – 365 days	**10,907**	15,974
1 – 2 years	**8,719**	6,643
Over 2 years	**6,445**	3,206
Total trade payables	**346,908**	430,889
Bills payables (Note)	**142,479**	183,403
Other payables and accrued liabilities	**114,649**	169,700
	604,036	783,992

26. TRADE, BILLS AND OTHER PAYABLES *(Continued)*

Note:

The aging analysis of bills payable is follows:

	2006 **RMB'000**	2005 RMB'000
Aging:		
Within 60 days	**61,156**	81,026
60 – 90 days	**26,937**	58,959
91 – 180 days	**54,386**	43,418
	142,479	183,403

During the year of 2003, the local government paid approximately RMB53 million to the Group for the construction of certain infrastructure and public facilities on local government's behalf in a location which is under-developed. The Group applied the amount received from the government to the construction of such facilities and entered into various construction contracts. Up to December 31, 2006, the Group recorded a balance of approximately RMB14 million which had not been utilized in the constructions and was included in other payables and accrued liabilities. Details of the capital commitments of the Group relating to the construction contracts at the balance sheet dates are set out in note 36.

The directors consider that the carrying amount of trade, bills and other payables at December 31, 2006 approximates their fair value.

27. BANK AND OTHER BORROWINGS

	2006 RMB'000	2005 RMB'000
Bank borrowings	**1,246,689**	1,281,338
Other borrowings	**10,400**	10,400
Total	**1,257,089**	1,291,738
Analysed as:		
Secured	**475,936**	502,038
Unsecured	**781,153**	789,700
	1,257,089	1,291,738
Denominated in United States Dollars (foreign currency)	**124,998**	94,246
Denominated in Renminbi (functional currency)	**1,132,091**	1,197,492
	1,257,089	1,291,738
The bank and other borrowings are repayable as follows:		
Within one year or on demand	**1,246,689**	1,191,246
In the one to second year	**–**	90,092
After five years	**10,400**	10,400
	1,257,089	1,291,738
Less: Amount due within one year shown under current liabilities	**(1,246,689)**	(1,191,246)
Amount due after one year	**10,400**	100,492

Bank borrowings are substantively fixed-rate borrowings and carry interests ranging from 4.65% to 8.78% (2005: from 4.00% to 8.35%) per annum.

Other borrowings represent loans advanced by independent third parties and carry at a fixed interest rate of 2.55% (2005: 2.55%) per annum.

Parts of borrowings were guaranteed by group companies, related parties and independent third parties and were also secured by the assets owned by the Group. Details of the assets pledged by the Group and the corporate guarantees given by related parties in favour of the Group's borrowings are set in notes 34 and 37(d).

The directors consider that the carrying amount of bank and other borrowings at December 31, 2006 approximates their fair value.

28. SHARE CAPITAL

	Number of ordinary shares	Number of series A preferred shares	Number of series B preferred shares	
				US$'000
Authorized share capital of the Company				
At January 1, 2005	399,682,608,696	217,391,304	100,000,000	40,000
Shares consolidation	(133,227,536,232)	–	–	–
Shares re-designation and reclassification	211,594,202	(217,391,304)	(100,000,000)	–
At December 31, 2005 & December 31, 2006	266,666,666,666	–	–	40,000

	Number of ordinary shares	Number of series A preferred shares	Number of series B preferred shares		Equivalent to
				US$	**RMB'000**
Issued and fully paid ordinary shares of the Company					
At January 1, 2005	829,894,730	–	–	82,990	689
Share consolidation	(276,631,577)	–	–	–	–
Issued upon conversion of convertible loan notes	–	176,693,933	81,279,209	38,696	321
Conversion of preference shares to ordinary shares	257,973,142	(176,693,933)	(81,279,209)	–	–
Issued on public floatation	202,809,074	–	–	30,421	246
At December 31, 2005	1,014,045,369	–	–	152,107	1,256
Share repurchase	(23,997,000)	–	–	(4)	(29)
At December 31, 2006	**990,048,369**	**–**	**–**	**152,103**	**1,227**

Pursuant to the general mandate granted by the shareholders of the Company, the Board of Directors resolved on July 31, 2006 to repurchase the Company's shares of up to 10% of the issued shares of the Company as at the date of May 30, 2006. The repurchase was made at the discretion of the Board. Up to December 31, 2006, 23,997,000 shares were repurchased.

28. SHARE CAPITAL *(Continued)*

During the year, the Company repurchased its own shares through the Stock Exchange of Hong Kong Limited as follows:

Month of repurchase	No. of ordinary share	Price per share Highest	Price per share Lowest	Aggregate consideration paid
	'000	**HK$**	**HK$**	**RMB'000**
August 2006	23,997	1.05	0.99	25,891

The above shares were cancelled upon repurchase. None of the Company's subsidiaries repurchased, sold or redeemed any of the Company's listed shares during the year.

29. SHARE OPTION

A share option scheme was adopted by the Company pursuant to a resolution passed on September 26, 2005 (the ''Scheme'') for the primary purpose of providing incentives to directors and eligible employees. The Scheme became effective on October 20, 2005 and the option issued pursuant to the Scheme will expire with no later than 10 years from the date of grant of the option. Under the Scheme, the board of directors of the Company may grant options to any employees of the Company or any of its subsidiaries to subscribe shares of the Company.

The Company granted a total of 29,800,000 share options to the directors and other eligible employees on March 9, 2006. The exercise price of the options is fixed at HK$2.38 (the share price immediately before grant date was HK$2.24). The fair value of the options determined at the date of grant using the Binomial Model was approximately RMB21 million and the Company recorded a share based payment expense of RMB15,486,000 in the year ended December 31, 2006 (2005: Nil).

The following assumptions were used in the Binomial model:

	2006 Options to Employees
Average risk-free rate of return	**4.44%**
Weighted average expected option life	**7.58 years**
Volatility rate	**49%**
Dividend yield	**5.95%**
Average share price at the grant date	**HK$2.35**

29. SHARE OPTION *(Continued)*

Expected volatility was determined by using the historical volatility of the price return of the ordinary shares of the Company over the period starting from its listing date on October 20, 2005 to March 9, 2006.

The Binomial Model has been used to estimate the fair value of the options. The variables and assumptions used in computing the fair value of the share options are based on the director's best estimate. The value of an option varies with different variables of certain subjective assumptions.

The share options could be exercised during the following periods:

Date	**Percentage of share options**
From January 1, 2007 to March 8, 2016	50%
From January 1, 2008 to March 8, 2016	50%

Details of the share options outstanding during the current year are as follows:

	Number of share options
Granted on March 9, 2006 and outstanding as at December 31, 2006	29,800,000

No share option has been exercised during the year.

30. RESERVES

(a) The statutory reserve represents amounts appropriated from the profits after tax of certain subsidiaries of the Company established in the PRC to comply with the PRC laws and regulations.

(b) The special reserve represents the difference between the nominal value of the share capital issued by the Company and the nominal value of the share capital of Zhejiang Kasen acquired pursuant to the reorganization completed in 2004.

(c) The Company suffered loss of RMB53,104,000 for the year ended December 31, 2006 (2005: loss of RMB281,732,000).

31. ACQUISITION OF ADDITIONAL INTERESTS IN SUBSIDIARIES

In June 2006, the Group acquired 44.55% and 49.5% additional interests in its subsidiaries, Haining Hainix Sofa Co., Ltd. ("Hainix Sofa") and Haining Hidea Furniture Co., Ltd. ("Hidea Furniture"), respectively, from their minority shareholders.

In April 2005, the Group acquired 4.416% additional interest in its subsidiary, Haining Kareno Furniture Co., Ltd. ("Kareno") from its minority shareholder.

The acquisition prices were agreed through negotiation between the Group and the minority shareholders.

	2006			
	Hainix Sofa RMB'000	**Hidea Furniture RMB'000**	**Total carrying amount RMB'000**	2005 Carrying amount RMB'000
Net assets acquired	**17,251**	**11,937**	**29,188**	6,621
Reserve on acquisition (Note)	**16,935**	**14,033**	**30,968**	–
Discounts on acquisition of an additional interest in a subsidiary	**–**	**(10,279)**	**(10,279)**	(5,300)
	34,186	**15,691**	**49,877**	1,321
Satisfied by:				
Cash consideration	**34,186**	**15,691**	**49,877**	1,321

Note: This represents the portion of the revaluation difference that arose since the original acquisition date that is attributable to the increase of the Group's interests.

32. DISPOSAL OF SUBSIDIARIES

During the year, the Group entered into an agreement to dispose of an non-wholly owned subsidiary, 海寧萬盛沙發有限公司 ("Haining Wansheng Furniture Co., Ltd.") ("Wansheng Furniture"), which carried out upholstered furniture manufacturing operations. The disposal was completed on June 29, 2006, on which date the control of Wansheng Furniture passed to the acquirer.

Senbo Water ceased to be a subsidiary of the Group from May 2006 due to the additional capital injections of its minority shareholder.

During the year of 2005, the Group disposed of its interests in SFT.

The net assets of the disposed subsidiaries at the date of disposal were as follows:

	2006			
	Wansheng Furniture RMB'000	Senbo Water RMB'000	Total RMB'000	2005 RMB'000
Property, plant and equipment	70,727	11,510	82,237	–
Prepaid lease payment	8,928	–	8,928	–
Amounts due from related companies	650	–	650	–
Inventories	50,319	–	50,319	–
Trade and other receivables	75,582	5	75,587	1,381
Intangible assets	133	–	133	–
Bank balances and cash	21,421	5,562	26,983	–
Trade and other payables	(106,690)	(6,049)	(112,739)	–
Amount due to related companies	(11,345)	(250)	(11,595)	–
Bank borrowings	(85,000)	(800)	(85,800)	–
	24,725	9,978	34,703	1,381
Minority interests	(12,237)	(6,993)	(19,230)	–
Gain (loss) on disposal	8,823	15	8,838	(1,380)
	21,311	3,000	24,311	1
Satisfied by:				
Cash consideration received	21,311	–	21,311	1
Transferred to interests in associates	–	3,000	3,000	–
Net cash outflow arising on disposal of subsidiaries:				
Cash consideration	21,311	–	21,311	–
Cash and cash equivalents disposed of	(21,421)	(5,562)	(26,983)	–
	(110)	(5,562)	(5,672)	–

Wansheng Furniture and Senbo Water did not make any significant contributions to the results and cash flows of the Group during the current year.

33. RETIREMENT BENEFITS PLAN

The Group contributes to a local municipal government retirement scheme for all qualifying employees in the PRC. The employer and its employees are each required to make contributions to the scheme at the rates specified in the scheme's rules. The only obligation of the Group with respect to the retirement scheme is to make the required contributions under the scheme.

In addition, the Group operates a Mandatory Provident Fund ("MPF") Scheme for its qualifying employees in Hong Kong. The assets of the MPF Scheme are held separately from those of the Group, in funds under the control of trustees. The Group contributes at the lower of HK$1,000 or 5% of relevant payroll costs monthly to the MPF Scheme, which contribution is matched by employees.

The total cost charged to the consolidated income statement of approximately RMB8,844,000 (2005: RMB8,273,000) represents contributions payable to the above schemes by the Group in respect of the current accounting period. As at December 31, 2006, contributions of approximately RMB2,589,000 (2005: RMB7,873,000) due in respect of the reporting period had not been paid to the above schemes.

34. PLEDGE OF ASSETS

At the balance sheet date, certain of the Group's assets have been pledged to secure the borrowings of the Group. The aggregate carrying amount of the assets of the Group at the balance sheet date is as follows:

	2006 **RMB'000**	2005 RMB'000
Buildings (note 15)	**468,517**	486,878
Prepaid lease payments (note 16)	**82,125**	87,144
Bank deposits (note 25)	**163,221**	240,112
	713,863	814,134

35. LEASE ARRANGEMENTS

As lessee

At the balance sheet date, the Group had outstanding commitments for future minimum lease payments under non-cancelable operating leases, which fall due as follows:

	2006	2005
	RMB'000	RMB'000
Within one year	**1,502**	1,543
In the second to fourth year inclusive	**3,169**	1,440
	4,671	2,983

The lease payments represent rentals payable by the Group for certain of its office properties. Leases are negotiated for an average term of three years and rentals are fixed for an average of three years.

36. CAPITAL COMMITMENTS

At the balance sheet date, the Group had capital commitments as follows:

	2006	2005
	RMB'000	RMB'000
Capital expenditure contracted for but not provided in the consolidated financial statements in respect of acquisition of property, plant and equipment	**1,464**	6,656
Capital expenditure contracted for but not provided in the consolidated financial statements in respect of construction of certain infrastructure and public facilities in the PRC on behalf of the government (note 26)	**14,135**	20,991
	15,599	27,647

37. CONNECTED AND RELATED PARTY DISCLOSURES

Transactions between group companies have been eliminated on consolidation and are not disclosed in this note. Details of transactions between the Group and other related parties are disclosed below.

(a) The Group had the following significant transactions with the connected and related parties during the year:

	Nature of transactions	Notes	**2006 RMB'000**	2005 RMB'000
Connected and related parties				
Yili Horgos	Purchase by the Group		**34,242**	108,522
白銀白利斯皮革有限公司 Baiyin Palace Leather Co., Ltd. ("Baiyin Palace")	Sales by the Group		**–**	10,273
	Sales of production wastes by the Group	(i)	**–**	151
Yujie	Sales of production wastes by the Group		**8,975**	11,369
Baiyin Kasen	Purchase by the Group		**68,854**	148,680
	Sales of production wastes by the Group		**–**	2,259
Kezilesu Xinrong	Purchase by the Group		**60,220**	35,981
Wansheng Silk	Purchase by the Group		**9,541**	9,895
	Interest expense charged to the Group		**–**	282
Starcorp	Sales by the Group		**49,209**	57,443
North Pole Ltd.	Sales by the Group		**10,830**	–
Related parties				
上海森橋皮業有限公司 Shanghai Sunbridge Leather Industry Co., Ltd. ("Sunbridge Leather")	Sales by the Group	(i)	**–**	2,531
海寧長虹皮件有限公司 Haining Changhong Leather Co., Ltd. ("Changhong Leather")	Interest expense charged to the Group	(ii)	**–**	436
	Sales by the Group		**–**	269

37. CONNECTED AND RELATED PARTY DISCLOSURES *(Continued)*

(a) The Group had the following significant transactions with the related parties during the year: *(Continued)*

	Nature of transactions	Notes	2006 RMB'000	2005 RMB'000
Related parties *(Continued)*				
Changhong I&E	Sales by the Group		**259**	–
	Interest expense charged to the Group		**–**	299
海寧富華皮件有限公司 Haining Fuhua Leather Co., Ltd. ("Haining Fuhua")	Interest expense charged to the Group	(ii)	**–**	420
浙江森橋實業(集團)有限公司 Zhejiang Sunbridge Industrial (Group) Co., Ltd. ("Sunbridge")	Disposal of property, plant and equipment	(iii)	**–**	4,255
Future Foam	Purchase by the Group		**81,374**	4,946
Kasen-Melx	Sales by the Group		**3,759**	–
	Expense charged to the Group		**–**	403
	Rental income charged by the Group		**–**	6
Shanghai Star Furniture Co., Ltd.	Purchase by the Group		**–**	852
Haining Liema Leather Garments Co., Ltd.	Interest expense charged to the Group		**115**	–
Haining Haipai Leather Industry Co., Ltd.	Sales by the Group		**74**	–
Senbo Water	Provision sewage treatment service to the Group		**22**	–
AoLin Furniture (Shanghai) Co., Ltd.	Sales by the group		**196**	–

Notes:

(i) Mr. Zhu has influence and beneficial interests in the company through Sunbridge.

(ii) A director of a non-wholly owned subsidiary has significant influence and beneficial interests in the company.

(iii) Mr. Zhu has influence and beneficial interests in the company.

37. CONNECTED AND RELATED PARTY DISCLOSURES *(Continued)*

(b) Share options granted to the directors

	2006	2005
Number of share options granted to the directors	**6,800,000**	–

(c) In April 2005, the Group acquired 4.416% additional interest in its subsidiary of Kareno from Ausen International Pty. Ltd. In June 2006, the Group acquired 44.55% and 49.5% additional interests in its subsidiaries of Hainix Sofa and Hidea Furniture, respectively, from following minority shareholders (see note 31).

(d) Corporate guarantees given by the related companies in favor of the Group's borrowings:

	2006 **RMB'000**	2005 RMB'000
Wansheng Silk	–	8,000
孫建新(Note)	–	30,000
	–	38,000

Note: 孫建新 is a director of a non-wholly owned subsidiary of the Group.

(e) Details of the balances with the related parties are set out in note 24.

(f) Key management of the Group are all directors whose remunerations were disclosed in Note 10.

38. CONTINGENT LIABILITIES

At the balance sheet date, the Group had the following contingent liabilities:

	2006 **RMB'000**	2005 RMB'000
Guarantees given to banks in respect of banking facilities extended to – Independent third parties	–	67,897

Notes to the Consolidated Financial Statements (cont'd)

For the year ended December 31, 2006

39. PRINCIPAL SUBSIDIARIES

The following table lists major subsidiaries of the Company as at December 31, 2006 which, in the opinion of the directors, principally affected the results or net assets of the Group. To give details of other subsidiaries would, in the opinion of the directors, result in particulars of excessive length.

Name of the company	Country of incorporation/ establishment and operations	Issued and fully paid share capital/ registered capital	Attributable equity interest of the Company Direct %	Attributable equity interest of the Company Indirect %	Principal activities
Haining Gaosheng Leather Co., Ltd. 海寧高盛皮革有限公司 (Note a)	PRC	RMB60,000,000	–	89	Production and processing of leather and tailored products
Haining Hainix Sofa Co., Ltd. 海寧漢林沙發有限公司 (Notes b)	PRC	US$6,000,000	–	95.05	Production and sale of sofas, dining chairs and other furniture products
Haining Hengsen Furniture Co., Ltd. 海寧恒森傢俱有限公司 (Note a)	PRC	RMB30,000,000	–	100	Production of furniture and glass fiber reinforced plastic products; wood processing
Haining Hidea Furniture Co., Ltd. 海寧慧達傢俱有限公司 (Note b)	PRC	US$5,000,000	–	100	Production and sale of sofas, dining chairs and other furniture products
Haining Higher Point Investment Development Co., Ltd. 海寧高點投資發展有限公司 (Note a)	PRC	RMB100,000,000	–	100	Investment holding
Haining Home Impression Furniture Co., Ltd. 海寧家美傢俱有限公司 (Note b)	PRC	US$2,000,000	–	100	Production and sale of upholstered furniture
Haining Home Point Furniture Co., Ltd. 海寧家典傢俱有限公司 (Note b)	PRC	US$5,000,000	–	100	Production and sale of upholstered furniture
Haining Kareno Furniture Co., Ltd. 海寧卡雷諾傢俬有限公司 (Note b)	PRC	US$3,600,000	–	100	Production and sale of upholstered furniture

39. PRINCIPAL SUBSIDIARIES *(Continued)*

Name of the company	Country of incorporation/ establishment and operations	Issued and fully paid share capital/ registered capital	Attributable equity interest of the Company Direct %	Indirect %	Principal activities
Haining Kasen Leather Co., Ltd. 海寧卡森皮革有限公司 (Note b)	PRC	US$3,000,000	–	100	Production and sale of upholstered furniture
Haining Oyi May Sofa Co., Ltd. 海寧歐意美沙發有限公司 (Note b)	PRC	US$5,000,000	–	50.5	Production and sale of upholstered furniture
Haining Schinder Tanning Co., Ltd. 海寧森德皮革有限公司 (Note b)	PRC	US$1,000,000	–	100	Production and sale of automotive leather
Richmond International Trading Limited 富華國際貿易有限公司 (Note a)	Hong Kong	HK$100	–	100	Trading of leather and other furniture products
Shanghai La Kassa Furniture Co., Ltd. 上海禾美傢俱有限公司 (Note b)	PRC	US$4,000,000	–	100	Production and sale of upholstered furniture
Zhejiang Kasen Industrial Co., Limited 浙江卡森實業有限公司 (Note c)	PRC	RMB896,240,000	–	100	Research, development, production and sales of furniture leather
Zhejiang Liema Furniture Co., Ltd. 浙江獵馬傢俬有限公司 (Note b)	PRC	US$7,000,000	–	50.5	Production and sale of upholstered furniture

Notes:

(a) The companies are limited liability companies.

(b) The companies are Sino-foreign owned enterprises.

(c) The company is wholly foreign owned enterprise.

None of the subsidiaries had issued any debt securities at the end of the year.

40. POST BALANCE SHEET EVENTS

(1) A tender submitted by Haining Higher Point Investment Development Co., Ltd. ("Haining Higher Point"), a wholly-owned subsidiary of the Company for the acquisition of a piece of land (the "Land") for an aggregate consideration of RMB253.75 million was accepted on January 29, 2007. The Group, Haining Zhejiang Leather and Garment Market Investment and Development Company Limited ("Haining Leather Market"), and Haining Zhengyang Trading Co., Ltd. ("Haining Zhengyang Trading"), collectively the "Joint Venture Partners", will form a Joint Venture to hold and develop the Land into a leather product retail mall. On February 5, 2007, Haining Higher Point paid the total consideration of RMB203.75 million to Changsha Municipal Bureau of State Land and Resources, 80% of the land price and the total amount of the transaction levy, which was funded from the internal resources of the Group and the remaining 20% of the land price, being RMB50 million, was funded by Haining Leather Market. The cash payments by the Group were from the fund generated from the Group's operating activities.

On March 15, 2007, the Joint Venture Partners, entered into a preliminary joint venture agreement, the total registered capital of which is RMB360 million. The Group will hold 51% interest of the proposed joint venture with an investment amount of approximately RMB184 million.

(2) Pursuant to a board resolution on January 29, 2007, the Company disposed of a subsidiary, Haining Home Craft Furniture Co., Ltd. (海寧家藝家具有限公司) to an independent third party for RMB44.7 million. The net asset value of the subsidiary amounted to RMB41 million as at December 31, 2006.