Notes to the Financial Statements

(Prepared in accordance with International Financial Reporting Standards)
(Expressed in Renminbi)

1 BASIS OF PRESENTATION

China Southern Airlines Company Limited (the "Company") and its subsidiaries (the "Group") are principally engaged in the provision of domestic, Hong Kong and Macau and international passenger, cargo and mail airline services.

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

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

2 PRINCIPAL ACCOUNTING POLICIES

(a) Statement of compliance

These financial statements have been prepared in accordance with all applicable International Financial Reporting Standards ("IFRSs"), which collective term includes all applicable individual International Financial Reporting Standards, International Accounting Standards ("IASs") and Interpretations promulgated by the International Accounting Standards Board (the "IASB"). These financial statements also comply with the applicable disclosure requirements of the Hong Kong Companies Ordinance and the applicable disclosure provisions of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited.

The IASB has issued certain new and revised IFRSs that are first effective or available for early adoption for the current accounting period of the Group and the Company. The adoption of these new and revised IFRSs did not result in substantial changes in the Group's accounting policies applied in these financial statements for the two years presented.

The Group has not applied any new standards or interpretations that are not yet effective for the current accounting period (Note 50).

(b) Basis of preparation of the financial statements

At 31 December 2006, the Group's current liabilities exceeded its current assets by RMB32,180 million, which includes bank and other loans repayable within one year of RMB23,822 million. In preparing the financial statements, the directors have considered the Group's sources of liquidity and believe that adequate funding is available to fulfil the Group's short term obligations and capital expenditure requirements. Accordingly, the financial statements have been prepared on a basis that the Group will be able to continue as a going concern. Further details are set out in Note 44.

The consolidated financial statements for the year ended 31 December 2006 comprise the Company and its subsidiaries and the Group's interest in associates and jointly controlled entities.

The measurement basis used in the preparation of the financial statements is the historical cost basis except that the following assets and liabilities are stated at their fair value as explained in the accounting policies set out below:

– Certain property, plant and equipment (Note 2(h));

– Certain assets held under finance leases (Note 2(j)); and

– Derivative financial instruments (Note 2(g)).

Notes to the Financial Statements (Cont'd)

(Prepared in accordance with International Financial Reporting Standards)
(Expressed in Renminbi)

2 PRINCIPAL ACCOUNTING POLICIES (cont'd)

(b) Basis of preparation of the financial statements (cont'd)

The preparation of financial statements in conformity with IFRSs requires management to make judgements, estimates and assumptions that affect the application of policies and reported amounts of assets and liabilities, income and expenses. The estimates and associated assumptions are based on historical experience and various other factors that are believed to be reasonable under the circumstances, the results of which form the basis of making the judgements about carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

The estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised if the revision affects only that period, or in the period of the revision and future periods if the revision affects both current and future periods.

Judgements made by management in the application of IFRSs that have significant effect on the financial statements and estimates with a significant risk of material adjustment in the next year are discussed in Note 50.

(c) Subsidiaries and minority interests

Subsidiaries are entities controlled by the Group. Control exists when the Group has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. In assessing control, potential voting rights that presently are exercisable are taken into account.

An investment in a subsidiary is consolidated into the consolidated financial statements from the date that control commences until the date that control ceases. Intra-group balances and transactions and any unrealised profits arising from intra-group transactions are eliminated in full in preparing the consolidated financial statements. Unrealised losses resulting from intra-group transactions are eliminated in the same way as unrealised gains but only to the extent that there is no evidence of impairment.

Minority interests represent the portion of the net assets of subsidiaries attributable to interests that are not owned by the Company, whether directly or indirectly through subsidiaries, and in respect of which the Group has not agreed any additional terms with the holders of those interests which would result in the Group as a whole having a contractual obligation in respect of those interests that meets the definition of a financial liability. Minority interests are presented in the consolidated balance sheet within equity, separately from equity attributable to the equity shareholders of the Company. Minority interests in the results of the Group are presented on the face of the consolidated income statement as an allocation of the total profit or loss for the year between minority interests and the equity shareholders of the Company.

Where losses applicable to the minority exceed the minority's interest in the equity of a subsidiary, the excess, and any further losses applicable to the minority, are charged against the Group's interest except to the extent that the minority has a binding obligation to, and is able to, make additional investment to cover the losses. If the subsidiary subsequently reports profits, the Group's interest is allocated all such profits until the minority's share of losses previously absorbed by the Group has been recovered.

Loans from holders of minority interests and other contractual obligations towards these holders are presented as financial liabilities in the consolidated balance sheet in accordance with Notes 2(o) or (p) depending on the nature of the liability.

In the Company's balance sheet, an investment in a subsidiary is stated at cost less impairment losses (Note 2(l)).

Notes to the Financial Statements (Cont'd)

(Prepared in accordance with International Financial Reporting Standards)
(Expressed in Renminbi)

2 PRINCIPAL ACCOUNTING POLICIES (cont'd)

(d) Associates and jointly controlled entities

An associate is an entity in which the Group or the Company has significant influence, but not control or joint control, over its management, including participation in the financial and operating policies.

A jointly controlled entity is an entity which operates under a contractual arrangement between the Group or Company and other parties, where the contractual arrangement establishes that the Group or Company and one or more of the other parties share joint control over the economic activities of the entity.

An investment in an associate or a jointly controlled entity is accounted for in the consolidated financial statements under the equity method and is initially recorded at cost and adjusted thereafter for the post acquisition change in the Group's share of the associate's or the jointly controlled entity's net assets. The consolidated income statement includes the Group's share of the post-acquisition, post-tax results of the associates and jointly controlled entities for the year, including any impairment loss on goodwill relating to the investment in associates and jointly controlled entities recognised for the year (Notes 2(e) and (l)).

When the Group's share of losses exceeds its interest in the associate or the jointly controlled entity, the Group's interest is reduced to nil and recognition of further losses is discontinued except to the extent that the Group has incurred legal or constructive obligations or made payments on behalf of the associate or the jointly controlled entity. For this purpose, the Group's interest in the associate or the jointly controlled entity is the carrying amount of the investment under the equity method together with the Group's long-term interests that in substance form part of the Group's net investment in the associate or the jointly controlled entity.

Unrealised profits and losses arising from transactions between the Group and its associates and jointly controlled entities are eliminated to the extent of the Group's interest in the associate or jointly controlled entity, except where unrealised losses provide evidence of an impairment of the asset transferred, in which case they are recognised immediately in profit or loss.

In the Company's balance sheet, its investments in associates and jointly controlled entities are stated at cost less impairment losses (Note 2(l)).

(e) Goodwill

Goodwill represents the excess of the cost of a business combination or an investment in an associate or a jointly controlled entity over the Group's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities.

Goodwill is stated at cost less accumulated impairment losses. Goodwill is allocated to cash-generating units and is tested annually for impairment (Note 2(l)). In respect of associates or jointly controlled entities, the carrying amount of goodwill is included in the carrying amount of the interest in the associate or jointly controlled entity.

Any excess of the Group's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities over the cost of a business combination or an investment in an associate or a jointly controlled entity is recognised immediately in profit or loss.

On disposal of a cash generating unit, an associate or a jointly controlled entity during the year, any attributable amount of purchased goodwill is included in the calculation of the profit or loss on disposal.

Notes to the Financial Statements (Cont'd)

(Prepared in accordance with International Financial Reporting Standards)
(Expressed in Renminbi)

2 PRINCIPAL ACCOUNTING POLICIES (cont'd)

(f) Other investments in equity securities

The Group's and the Company's policies for investments in equity securities, other than investments in subsidiaries, associates and jointly controlled entities, are as follows:

Investments in equity securities are initially stated at cost, which is their transaction price unless fair value can be more reliably estimated using valuation techniques whose variables include only data from observable markets. Cost includes attributable transaction costs.

The Group's other investments in equity securities represent unlisted equity securities of companies established in the PRC. They do not have a quoted market price in an active market and whose fair value cannot be reliably measured. Accordingly, they are recognised in the balance sheet at cost less impairment losses (Note 2(l)).

Investments are recognised/derecognised on the date the Group commits to purchase/sell the investments or they expire.

(g) Derivative financial instruments

Derivative financial instruments are recognised at fair value. At each balance sheet date the fair value is remeasured. The gain or loss on remeasurement to fair value is charged immediately to profit or loss.

(h) Property, plant and equipment

Items of property, plant and equipment are initially stated at cost, less accumulated depreciation and impairment losses (Note 2(l)). The cost of an item of property, plant and equipment comprises its purchase price and any directly attributable costs of bringing the asset to working condition and location for its intended use and the initial estimate, where relevant, of the costs of dismantling and removing the items and restoring the site on which they are located.

Subsequent to the revaluation of the Group's property, plant and equipment as at 31 December 1996 (Note 18(d)), which was based on depreciated replacement costs, certain of the Group's property, plant and equipment are carried at revalued amount, being the fair value at the date of the revaluation less any subsequent accumulated depreciation.

Revaluations are performed with sufficient regularity to ensure that the carrying amount of these assets does not differ materially from that which would be determined using fair value at the balance sheet date.

Changes arising on the revaluation of property, plant and equipment are generally dealt with in reserves. The only exceptions are as follows:

– When a deficit arises on revaluation, it will be charged to profit or loss to the extent that it exceeds the amount held in the reserve in respect of that same asset immediately prior to the revaluation; and

– When a surplus arises on revaluation, it will be credited to profit or loss to the extent that a deficit on revaluation in respect of that same asset had previously been charged to profit or loss.

The cost of self-constructed items of property, plant and equipment includes the cost of materials, the initial estimate, where relevant, of the costs of dismantling and removing the items and restoring the site on which they are located, and an appropriate proportion of production overheads and borrowing costs (see note 2(y)).

Notes to the Financial Statements (Cont'd)

(Prepared in accordance with International Financial Reporting Standards)
(Expressed in Renminbi)

2 PRINCIPAL ACCOUNTING POLICIES (cont'd)

(h) Property, plant and equipment (cont'd)

Gains or losses arising from the retirement or disposal of an item of property, plant and equipment are determined as the difference between the net disposal proceeds and the carrying amount of the item and are recognised in profit or loss on the date of retirement or disposal. Any related revaluation surplus is transferred from the revaluation reserve to retained profits.

Depreciation is calculated to write off the cost or valuation of items of property, plant and equipment, less their estimated residual value, if any, using the straight line method over their estimated useful lives as follows:

Buildings	15 to 40 years
Owned and leased aircraft	15 to 20 years
Other flight equipment	
Jet engines	15 to 20 years
Others, including rotable spares	8 to 15 years
Machinery and equipment	5 to 10 years
Vehicles	6 years

Where parts of an item of property, plant and equipment have different useful lives, the cost or valuation of the item is allocated on a reasonable basis between the parts and each part is depreciated separately. Both the useful life of an asset and its residual value, if any, are reviewed annually.

(i) Construction in progress

Construction in progress represents office buildings, various infrastructure projects under construction and equipment pending installation, and is stated at cost less impairment losses (Note 2(l)). Capitalisation of these costs ceases and the construction in progress is transferred to property, plant and equipment when the asset is substantially ready for its intended use, notwithstanding any delay in the issue of the relevant commissioning certificates by the relevant PRC authorities.

No depreciation is provided in respect of construction in progress.

(j) Leased assets

An arrangement, comprising a transaction or a series of transactions, is or contains a lease if the Group determines that the arrangement conveys a right to use a specific asset or assets for an agreed period of time in return for a payment or a series of payments. Such a determination is made based on an evaluation of the substance of the arrangement and is regardless of whether the arrangement takes the legal form of a lease.

(i) Classification of assets leased to the Group

Assets that are held by the Group under leases which transfer to the Group substantially all the risks and rewards of ownership are classified as being held under finance leases. Leases which do not transfer substantially all the risks and rewards of ownership to the Group are classified as operating leases, except for land held for own use under an operating lease, the fair value of which cannot be measured separately from the fair value of a building situated thereon at the inception of the lease, is accounted for as being under a finance lease, unless the building is also clearly held under an operating lease. For these purposes, the inception of the lease is the time that the lease was first entered into by the Group, or taken over from the previous lessee.

Notes to the Financial Statements (Cont'd)

(Prepared in accordance with International Financial Reporting Standards)
(Expressed in Renminbi)

2 PRINCIPAL ACCOUNTING POLICIES (cont'd)

(j) Leased assets (cont'd)

(ii) Assets acquired under finance leases

Where the Group acquires the use of assets under finance leases, the amounts representing the fair value of the leased asset, or, if lower, the present value of the minimum lease payments, of such assets are included in property, plant and equipment and the corresponding liabilities, net of finance charges, are recorded as obligations under finance leases. Depreciation is provided at rates which write off the cost or valuation of the assets over the term of the relevant lease or, where it is likely the Group will obtain ownership of the asset, the life of the asset, as set out in Note 2(h). Impairment losses are accounted for in accordance with the accounting policy as set out in Note 2(l). Finance charges implicit in the lease payments are charged to profit or loss over the period of the leases so as to produce an approximately constant periodic rate of charge on the remaining balance of the obligations for each accounting period.

(iii) Operating lease charges

Where the Group has the use of assets held under operating leases, payments made under the leases are charged to profit or loss in equal instalments over the accounting periods covered by the lease term, except where an alternative basis is more representative of the pattern of benefits to be derived from the leased asset. Lease incentives received are recognised in profit or loss as an integral part of the aggregate net lease payments made.

The cost of acquiring land held under operating lease is amortised on a straight-line basis over the respective periods of lease terms which ranged from 30 to 70 years.

(iv) Sale and leaseback transactions

Gains or losses on sale and leaseback transactions which result in finance leases are deferred and amortised over the terms of the related leases. Gains or losses on other aircraft sale and leaseback transactions which result in operating leases are recognised immediately if the transactions are established at fair value. Any difference between the sales price and the fair value is deferred and amortised over the period the assets are expected to be used.

(k) Deferred expenditure

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

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

Deferred expenditure is stated at cost less impairment losses (Note 2(l)).

(l) Impairment of assets

(i) Impairment of investments in equity securities and other receivables

Investments in equity securities and other current and non-current receivables that are stated at cost or amortised cost are reviewed at each balance sheet date to determine whether there is objective evidence of impairment. If any such evidence exists, any impairment loss is determined and recognised as follows:

– For unquoted equity securities carried at cost, the impairment loss is measured as the difference between the carrying amount of the financial asset and the estimated future cash flows, discounted at the current market rate of return for a similar financial asset where the effect of discounting is material. Impairment losses for equity securities are not reversed.

Notes to the Financial Statements (Cont'd)

(Prepared in accordance with International Financial Reporting Standards)
(Expressed in Renminbi)

2 PRINCIPAL ACCOUNTING POLICIES (cont'd)

(l) Impairment of assets (cont'd)

(i) Impairment of investments in equity securities and other receivables (cont'd)

– For trade and other current receivables and other financial assets carried at amortised cost, the impairment loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows, discounted at the financial asset's original effective interest rate (i.e. the effective interest rate computed at initial recognition of these assets), where the effect of discounting is material.

If in a subsequent period the amount of an impairment loss decreases and the decrease can be linked objectively to an event occurring after the impairment loss was recognised, the impairment loss is reversed through profit or loss. A reversal of an impairment loss shall not result in the asset's carrying amount exceeding that which would have been determined had no impairment loss been recognised in prior years.

(ii) Impairment of other assets

Internal and external sources of information are reviewed at each balance sheet date to identify indications that the following assets may be impaired or, except in the case of goodwill, an impairment loss previously recognised no longer exists or may have decreased:

– Property, plant and equipment carried at cost less accumulated depreciation;
– Construction in progress;
– Lease and equipment deposits;
– Lease prepayments;
– Deferred expenditure;
– Investments in subsidiaries, associates and jointly controlled entities; and
– Goodwill.

If any such indication exists, the asset's recoverable amount is estimated. For goodwill, the recoverable amount is estimated annually whether or not there is any indication of impairment.

– Calculation of recoverable amount

The recoverable amount of an asset is the greater of its net selling price and the 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 time value of money and the risks specific to the asset. Where an asset does not generate cash inflows largely independent of those from other assets, the recoverable amount is determined for the smallest group of assets that generates cash inflows independently (i.e. a cash-generating unit).

Notes to the Financial Statements (Cont'd)

(Prepared in accordance with International Financial Reporting Standards)
(Expressed in Renminbi)

2 PRINCIPAL ACCOUNTING POLICIES (cont'd)

(l) Impairment of assets (cont'd)

(ii) Impairment of other assets (cont'd)

– Recognition of impairment losses

An impairment loss is recognised in profit or loss whenever the carrying amount of an asset, or the cash-generating unit to which it belongs, exceeds its recoverable amount. Impairment losses recognised in respect of cash-generating units are allocated first to reduce the carrying amount of any goodwill allocated to the cash-generating unit (or group of units) and then, to reduce the carrying amount of the other assets in the unit (or group of units) on a pro rata basis, except that the carrying value of an asset will not be reduced below its individual fair value less costs to sell, or value in use, if determinable.

– Reversals of impairment losses

In respect of assets other than goodwill, an impairment loss is reversed if there has been a favourable change in the estimates used to determine the recoverable amount. An impairment loss in respect of goodwill is not reversed.

A reversal of an impairment loss is limited to the asset's carrying amount that would have been determined had no impairment loss been recognised in prior years. Reversals of impairment losses are credited to profit or loss in the year in which the reversals are recognised.

(m) Inventories

Inventories, which consist primarily of expendable spare parts and supplies, are stated at cost less any applicable provision for obsolescence, and are charged to profit or loss when used in operations. Cost represents the average unit cost.

Inventories held for disposal are carried at the lower of cost and net realisable value. Net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

(n) Trade and other receivables

Trade and other receivables are initially recognised at fair value and thereafter stated at amortised cost less impairment losses for bad and doubtful debts (Note 2(l)), except where the effect of discounting would be immaterial. In such cases, the receivables are stated at cost less impairment losses for bad and doubtful debts (Note 2(l)).

(o) Interest-bearing borrowings

Interest-bearing borrowings are recognised initially at fair value less attributable transaction costs. Subsequent to initial recognition, interest-bearing borrowings are stated at amortised cost with any difference between the amount initially recognised and redemption value being recognised in profit or loss over the period of the borrowings, together with any interest and fees payable, using the effective interest method.

(p) Trade and other payables

Trade and other payables are initially recognised at fair value and thereafter stated at amortised cost unless the effect of discounting would be immaterial, in which case they are stated at cost.

Notes to the Financial Statements (Cont'd)

(Prepared in accordance with International Financial Reporting Standards)
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2 PRINCIPAL ACCOUNTING POLICIES (cont'd)

(q) Cash and cash equivalents

Cash and cash equivalents comprise cash at bank and on hand, demand deposits with banks and other financial institutions having been within three months of maturity at acquisition. Bank overdrafts that are repayable on demand and form an integral part of the Group's cash management are also included as a component of cash and cash equivalents for the purpose of the consolidated cash flow statement.

(r) Financial guarantees issued, provisions and contingent liabilities

(i) Financial guarantees issued

Financial guarantees are contracts that require the issuer (i.e. the guarantor) to make specified payments to reimburse the beneficiary of the guarantee (the "holder") for a loss the holder incurs because a specified debtor fails to make payment when due in accordance with the terms of a debt instrument.

Where the Group issues a financial guarantee, the fair value of the guarantee (being the transaction price, unless the fair value can otherwise be reliably estimated) is initially recognised as deferred income within trade and other payables. Where consideration is received or receivable for the issuance of the guarantee, the consideration is recognised in accordance with the Group's policies applicable to that category of asset. Where no such consideration is received or receivable, an immediate expense is recognised in profit or loss on initial recognition of any deferred income.

The amount of the guarantee initially recognised as deferred income is amortised in profit or loss over the term of the guarantee as income from financial guarantees issued. In addition, provisions are recognised in accordance with note 2(r)(ii) if and when (i) it becomes probable that the holder of the guarantee will call upon the Group under the guarantee, and (ii) the amount of that claim on the Group is expected to exceed the amount currently carried in trade and other payables in respect of that guarantee i.e. the amount initially recognised, less accumulated amortisation.

(ii) Provisions and contingent liabilities

Provisions are recognised for liabilities of uncertain timing or amount when the Group or the Company has a present legal or constructive obligation as a result of a past event, and it is probable that an outflow of economic benefits will be required to settle the obligations and a reliable estimate can be made. Where the time value of money is material, provisions are stated at the present value of the expenditures expected to settle the obligation.

Where it is not probable that an outflow of economic benefits will be required, or the amount cannot be estimated reliably, the obligation is disclosed as a contingent liability, unless the probability of outflow of economic benefits is remote. Possible obligations, whose existence will only be confirmed by the occurrence or non-occurrence of one or more future events are also disclosed as contingent liabilities unless the probability of outflow of economic benefits is remote.

(s) Defeasance of long-term liabilities

Where long-term liabilities have been defeased by the placement of security deposits, those liabilities and deposits (and income and charge arising therefrom) are netted off in order to reflect the overall commercial effect of the arrangements. Such netting off has been effected where a right is held by the Group to insist on net settlement of the liability and deposit including in all situations of default and where that right is assured beyond doubt.

(t) Deferred credits

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

2 PRINCIPAL ACCOUNTING POLICIES (cont'd)

(u) Income tax

Income tax for the year comprises current and movements in deferred tax assets and liabilities. Current tax and movements in deferred tax assets and liabilities are recognised in profit or loss except to the extent that they relate to items recognised directly in equity, in which case they are recognised in equity.

Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantively enacted at the balance sheet date, and any adjustment to tax payable in respect of previous years.

Deferred tax assets and liabilities arise from deductible and taxable temporary differences respectively, being the differences between the carrying amounts of assets and liabilities for financial reporting purposes and their tax bases. Deferred tax assets also arise from unused tax losses and unused tax credits.

Apart from certain limited exceptions, all deferred tax liabilities, and all deferred tax assets to the extent that it is probable that future taxable profits will be available against which the asset can be utilised, are recognised. Future taxable profits that may support the recognition of deferred tax assets arising from deductible temporary differences include those that will arise from the reversal of existing taxable temporary differences, provided those differences relate to the same taxation authority and the same taxable entity, and are expected to reverse either in the same period as the expected reversal of the deductible temporary difference or in periods into which a tax loss arising from the deferred tax asset can be carried back or forward. The same criteria are adopted when determining whether existing taxable temporary differences support the recognition of deferred tax assets arising from unused tax losses and credits, that is, those differences are taken into account if they relate to the same taxation authority and the same taxable entity, and are expected to reverse in a period, or periods, in which the tax loss or credit can be utilised.

The limited exception to the recognition of deferred tax assets and liabilities are those temporary differences arising from goodwill not deductible for tax purposes, the initial recognition of assets or liabilities that affect neither accounting nor taxable profit (provided they are not part of a business combination), and temporary differences relating to investments in subsidiaries to the extent that, in the case of taxable differences, the Group controls the timing of the reversal and it is probable that the differences will not reverse in the foreseeable future, or in the case of deductible differences, unless it is probable that they will reverse in the future.

The amount of deferred tax recognised is measured based on the expected manner of realisation or settlement of the carrying amount of the assets and liabilities, using tax rates enacted or substantively enacted at the balance sheet date. Deferred tax assets and liabilities are not discounted.

The carrying amount of a deferred tax asset is reviewed at each balance sheet date and is reduced to the extent that it is no longer probable that sufficient taxable profits will be available to allow the related tax benefit to be utilised. Any such reduction is reversed to the extent that it becomes probable that sufficient taxable profits will be available.

Current tax balances and deferred tax balances, and movements therein, are presented separately from each other and are not offset. Current tax assets are offset against current tax liabilities, and deferred tax assets against deferred tax liabilities, if the Company or the Group has the legally enforceable right to set off current tax assets against current tax liabilities and the following additional conditions are met:

– in the case of current tax assets and liabilities, the Company or the Group intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously; or

Notes to the Financial Statements (Cont'd)

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2 PRINCIPAL ACCOUNTING POLICIES (cont'd)

(u) Income tax (cont'd)

– in the case of deferred tax assets and liabilities, if they relate to income taxes levied by the same taxation authority on either:

  – the same taxable entity; or

  – different taxable entities, which, in each future period in which significant amounts of deferred tax liabilities or assets are expected to be settled or recovered, intend to realise the current tax assets and settle the current tax liabilities on a net basis or realise and settle simultaneously.

(v) Revenue recognition

Provided it is probable that the economic benefits will flow to the Group and the revenue and costs, if applicable, can be measured reliably, revenue is recognised in profit or loss as follows:

(i) Passenger, cargo and mail revenues are recognised when the transportation is provided. Ticket sales for transportation not yet provided are included in current liabilities as sales in advance of carriage. Revenues from airline-related business are recognised when services are rendered. Revenue is stated net of sales tax.

(ii) Rental income receivable under operating leases is recognised in profit or loss in equal instalments over the periods covered by the lease term, except where an alternative basis is more representative of the pattern of benefits to be derived from the use of the leased asset. Lease incentives granted are recognised in profit or loss as an integral part of the aggregate net lease payments receivables.

(iii) Dividend income is recognised when the shareholder's right to receive payment is established.

(iv) Government grants are recognised in the balance sheet initially when there is reasonable assurance that they will be received and that the Group will comply with the conditions attaching to them. Grants that compensate the Group for expenses incurred are recognised as revenue in profit or loss on a systematic basis in the same periods in which the expenses are incurred. Grants that compensate the Group for the cost of an asset are deducted in arriving at the carrying amount of the asset and consequently are recognised in profit or loss over the useful life of the asset.

(v) Interest income is recognised as it accrues using the effective interest method.

(w) Traffic commissions

Traffic commissions are expensed in profit or loss when the transportation is provided and the related revenue is recognised. Traffic commissions for transportation not yet provided are recorded on the balance sheet as a prepaid expense.

(x) Maintenance and overhaul costs

Routine maintenance, repairs and overhauls are charged to profit or loss as and when incurred.

In respect of owned and finance leased aircraft, components within the aircraft subject to replacement during major overhauls are depreciated over the average expected life between major overhauls. When each major overhaul is performed, its cost is recognised in the carrying amount of property, plant and equipment and is depreciated over the estimated period between major overhauls. Any remaining carrying amount of cost of previous major overhaul is derecognised and charged to profit or loss.

Notes to the Financial Statements (Cont'd)

(Prepared in accordance with International Financial Reporting Standards)
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2 PRINCIPAL ACCOUNTING POLICIES (cont'd)

(x) Maintenance and overhaul costs (cont'd)

In respect of aircraft held under operating leases, the Group has responsibility to fulfil certain return conditions under relevant lease agreements. In order to fulfil these return conditions, major overhauls are required to be conducted on a regular basis. Accordingly, estimated costs of major overhauls are accrued and charged to profit or loss over the estimated period between overhauls. After the aircraft has completed its last overhaul cycle prior to being returned, expected cost of overhaul to be incurred at the end of the lease is estimated and accrued over the remaining period of the lease. Differences between the estimated costs and the actual costs of overhauls are charged to profit or loss in the period when the overhaul is performed.

(y) Borrowing costs

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

The capitalisation of borrowing costs as part of the cost of a qualifying asset commences when expenditure for the asset is being incurred, borrowing costs are being incurred and activities that are necessary to prepare the asset for its intended use are in progress. Capitalisation of borrowing costs is suspended or ceases when substantially all the activities necessary to prepare the qualifying asset for its intended use are interrupted or complete.

(z) Short term employee benefits and contributions to defined contribution retirement schemes

Salaries, annual bonuses and contributions to defined contribution retirement schemes are accrued in the year in which the associated services are rendered by employees. Where payment or settlement is deferred and the effect would be material, these amounts are stated at their present values.

(aa) Termination benefits

Termination benefits are recognised when, and only when, the Group demonstrably commits itself to terminate employment or to provide benefits as a result of voluntary redundancy by having a detailed formal plan which is without realistic possibility of withdrawal.

(bb) Frequent flyer award programmes

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

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

(cc) Translation of foreign currencies

Foreign currencies transactions during the year are translated into Renminbi at the applicable rates of exchange quoted by the People's Bank of China ("PBOC") prevailing on the transaction dates. Monetary assets and liabilities denominated in foreign currencies are translated into Renminbi at the PBOC exchange rates prevailing on the balance sheet date. Exchange gains and losses are recognised in profit or loss.

Non-monetary assets and liabilities that are measured in terms of historical cost in a foreign currency are translated into Renminbi at the PBOC exchange rates prevailing on the transaction dates. Non-monetary assets and liabilities denominated in foreign currencies that are stated at fair value are translated into Renminbi at the PBOC exchange rates prevailing on the dates the fair value was determined.

Notes to the Financial Statements (Cont'd)

(Prepared in accordance with International Financial Reporting Standards)
(Expressed in Renminbi)

2 PRINCIPAL ACCOUNTING POLICIES (cont'd)

(dd) Related parties

For the purposes of these financial statements, a party is considered to be related to the Group if:

(i) the party has the ability, directly or indirectly through one or more intermediaries, to control the Group or exercise significant influence over the Group in making financial and operating policy decisions, or has joint control over the Group;

(ii) the Group and the party are subject to common control;

(iii) the party is an associate of the Group or a joint venture in which the Group is a venturer;

(iv) the party is a member of key management personnel of the Group or the Group's parent, or a close family member of such an individual, or is an entity under the control, joint control or significant influence of such individuals;

(v) the party is a close family member of a party referred in (i) or is an entity under the control, joint control or significant influence of such individuals; or

(vi) the party is a post-employment benefit plan which is for the benefit of employees of the Group or of any entity that is a related party of the Group.

Close family members of an individual are those family members who may be expected to influence, or be influenced by, that individual in their dealings with the entity.

(ee) Segmental reporting

A segment is a distinguishable component of the Group that is engaged either in providing products or services (business segment), or in providing products or services within a particular economic environment (geographical segment), which is subject to risks and rewards that are different from those of other segments.

In accordance with the Group's internal financial reporting system, the Group has chosen business segment information as the primary reporting format and geographical segment information as the secondary reporting format for the purposes of these financial statements.

Notes to the Financial Statements (Cont'd)

(Prepared in accordance with International Financial Reporting Standards)
(Expressed in Renminbi)

3 TURNOVER

Turnover comprises revenues from airline and airline-related business and is stated net of sales tax. An analysis of turnover is as follows:

	2006 RMB million	2005 RMB million
Traffic revenue		
Passenger	**41,549**	34,328
Cargo and mail	**3,538**	3,091
	45,087	37,419
Other operating revenue		
Commission income	**238**	237
General aviation income	**91**	77
Ground services income	**184**	195
Air catering income	**50**	25
Rental income	**107**	69
Aircraft lease income	**–**	1
Others	**462**	270
	1,132	874
	46,219	38,293

Pursuant to various sales tax rules and regulations, the Group is required to pay sales tax to national and local tax authorities at the rate of approximately 3% of the traffic revenue in respect of domestic flights and outbound international, Hong Kong and Macau flights. Sales tax incurred by the Group during the year ended 31 December 2006, netted off against revenue, amounted to RMB1,300 million (2005: RMB1,111 million).

4 FLIGHT OPERATIONS EXPENSES

	2006 RMB million	2005 RMB million
Jet fuel costs	**16,193**	11,929
Operating lease charges		
– Aircraft and flight equipment	**3,027**	2,497
– Land and buildings	**260**	302
Air catering expenses	**1,244**	1,196
Aircraft insurance	**274**	283
Flight personnel payroll and welfare	**1,714**	1,619
Training expenses	**419**	373
CAAC Infrastructure Development Fund contributions	**1,127**	978
Others	**409**	217
	24,667	19,394

Notes to the Financial Statements (Cont'd)

(Prepared in accordance with International Financial Reporting Standards)
(Expressed in Renminbi)

5 MAINTENANCE EXPENSES

	2006 **RMB million**	2005 RMB million
Repairing and maintenance charges	**3,585**	4,153
Maintenance materials	**414**	436
	3,999	4,589

6 AIRCRAFT AND TRAFFIC SERVICING EXPENSES

	2006 **RMB million**	2005 RMB million
Landing and navigation fees	**5,220**	4,891
Ground service charges	**999**	868
	6,219	5,759

7 PROMOTION AND SALES EXPENSES

	2006 **RMB million**	2005 RMB million
Sales commissions	**1,489**	1,503
Ticket office expenses	**689**	659
Computer reservation services	**439**	417
Advertising and promotion	**43**	32
Others	**151**	169
	2,811	2,780

8 GENERAL AND ADMINISTRATIVE EXPENSES

	2006 **RMB million**	2005 RMB million
General corporate expenses	**3,098**	2,408
Auditors' remuneration	**13**	12
Other taxes and levies	**29**	37
	3,140	2,457

Notes to the Financial Statements (Cont'd)

(Prepared in accordance with International Financial Reporting Standards)
(Expressed in Renminbi)

9 DEPRECIATION AND AMORTISATION

	2006 **RMB million**	2005 RMB million
Depreciation		
– Owned assets	**3,678**	3,292
– Assets acquired under finance leases	**1,321**	1,128
Amortisation of deferred credits	**(61)**	(20)
Other amortisation	**33**	40
	4,971	4,440

10 STAFF COSTS

	2006 **RMB million**	2005 RMB million
Salaries, wages and welfare	**3,854**	3,515
Retirement scheme contributions	**584**	472
Early retirement benefits (Note 37)	**392**	–
	4,830	3,987

Staff costs relating to flight operations, maintenance, aircraft and traffic servicing, promotion and sales and general and administrative expenses are also included in the respective total amounts disclosed separately in Notes 4 to 8 above.

11 INTEREST EXPENSE

	2006 **RMB million**	2005 RMB million
Interest on bank and other loans wholly repayable within five years	**1,675**	995
Interest on other loans	**138**	93
Finance charges on obligations under finance leases	**716**	626
Less: borrowing costs capitalised	**(459)**	(98)
	2,070	1,616

The borrowing costs have been capitalised at rates ranging from 5.29% to 5.61% per annum in 2006 (2005: 4.14% to 5.27% per annum).

Notes to the Financial Statements (Cont'd)

(Prepared in accordance with International Financial Reporting Standards)
(Expressed in Renminbi)

12 GAIN/(LOSS) ON SALE OF PROPERTY, PLANT AND EQUIPMENT, NET

	2006 RMB million	2005 RMB million
Aircraft and spare engines	**329**	–
Other property, plant and equipment	**6**	(32)
	335	(32)

During the year, the Group recognised a gain on disposal of property, plant and equipment of RMB329 million on selling of three Boeing 757-200 aircraft to independent third parties, being the excess of the sale proceeds which approximated fair values of these assets on the respective date of disposal, over the carrying amounts of the assets and related disposal costs.

13 EMOLUMENTS OF DIRECTORS, SUPERVISORS AND SENIOR MANAGEMENT

(a) Directors' and supervisors' emoluments

Details of directors' and supervisors' emoluments for the year ended 31 December 2006 are set out below:

Name	**Directors' fees RMB'000**	**Salaries, allowances and benefits in kind RMB'000**	**Discretionary bonuses RMB'000**	**Retirement scheme contributions RMB'000**	**Total RMB'000**
Executive directors					
Liu Shao Yong (Note (i))	**–**	**472**	**–**	**14**	**486**
Li Wen Xin	**–**	**87**	**–**	**3**	**90**
Wang Quan Hua	**–**	**374**	**–**	**14**	**388**
Zhao Liu An (Note (i))	**–**	**374**	**–**	**14**	**388**
Si Xian Min	**–**	**442**	**–**	**13**	**455**
Tan Wan Geng	**–**	**271**	**–**	**11**	**282**
Xu Jie Bo	**–**	**357**	**–**	**13**	**370**
Chen Zhen You	**–**	**253**	**–**	**13**	**266**
Zhou Yong Qian	**–**	**146**	**–**	**3**	**149**
Supervisors					
Sun Xiao Yi	**–**	**374**	**–**	**14**	**388**
Yang Guang Hua	**–**	**374**	**50**	**13**	**437**
Yang Yi Hua	**–**	**220**	**–**	**13**	**233**
Independent non-executive directors					
Peter Lok	**102**	**–**	**–**	**–**	**102**
Wei Ming Hai	**100**	**–**	**–**	**–**	**100**
Wang Zhi	**100**	**–**	**–**	**–**	**100**
Sui Guang Jun	**100**	**–**	**–**	**–**	**100**
	402	**3,744**	**50**	**138**	**4,334**

Notes to the Financial Statements (Cont'd)

(Prepared in accordance with International Financial Reporting Standards)
(Expressed in Renminbi)

13 EMOLUMENTS OF DIRECTORS, SUPERVISORS AND SENIOR MANAGEMENT (cont'd)

(a) Directors' and supervisors' emoluments (cont'd)

Details of directors' and supervisors' emoluments for the year ended 31 December 2005 are set out below:

Name	Directors' fees RMB'000	Salaries, allowances and benefits in kind RMB'000	Discretionary bonuses RMB'000	Retirement scheme contributions RMB'000	Total RMB'000
Executive directors					
Liu Shao Yong (Note (i))	–	299	–	12	311
Liu Ming Qi	–	242	–	10	252
Peng An Fa	–	101	–	6	107
Wang Quan Hua	–	237	–	12	249
Zhao Liu An (Note (i))	–	237	–	12	249
Zhou Yong Qian	–	237	–	12	249
Si Xian Min	–	281	–	12	293
Zhou Yong Jin	–	127	–	2	129
Xu Jie Bo	–	226	–	12	238
Wu Rong Nan	–	368	162	7	537
Supervisors					
Sun Xiao Yi	–	237	–	12	249
Yang Guang Hua	–	225	–	12	237
Yang Yi Hua	–	48	70	11	129
Independent non-executive directors					
Simon To (Note (ii))	–	–	–	–	–
Peter Lok	58	–	–	–	58
Wei Ming Hai	58	–	–	–	58
Wang Zhi	58	–	–	–	58
Sui Guang Jun	58	–	–	–	58
	232	2,865	232	132	3,461

Notes:

(i) The above amounts included salaries paid to these directors as pilots of the Company.

(ii) Simon To received director's fee of RMB1 during the year ended 31 December 2005.

Notes to the Financial Statements (Cont'd)

(Prepared in accordance with International Financial Reporting Standards)
(Expressed in Renminbi)

13 EMOLUMENTS OF DIRECTORS, SUPERVISORS AND SENIOR MANAGEMENT (cont'd)

(b) Individuals with highest emoluments

Of the five individuals with the highest emoluments, one was director of the Company during 2005 whose emolument was disclosed in Note 13 (a) above. In 2006, none of the five individuals with the highest emoluments is a director. The aggregate of the emoluments in respect of five (2005: four) individuals during the year are as follows:

	2006 RMB'000	2005 RMB'000
Salaries, allowances and benefits in kind	**2,680**	1,931
Retirement scheme contributions	**58**	39
	2,738	1,970

The emoluments of the five (2005: four) individuals with the highest emoluments are within the following band:

	2006 Number of individuals	2005 Number of individuals
Nil to HK$1,000,000 (RMB1,025,000 equivalent (2005: RMB1,052,000 equivalent))	**5**	4

14 INCOME TAX EXPENSE/(BENEFIT)

(a) Income tax expense/(benefit) in the consolidated income statement

	2006 RMB'000	2005 RMB'000
PRC income tax		
Provision for the year	**160**	12
Over-provision in prior year	**(16)**	–
	144	12
Deferred tax (Note 24)	**9**	(19)
Income tax expense/(benefit)	**153**	(7)

The statutory income tax rate in the PRC is 33%. The Company is taxed at a preferential rate of 18% (2005: 15%), except for certain branches which are taxed at rates ranging from 15% to 33% (2005: 15% to 33%). The subsidiaries of the Group are taxed at rates ranging from 15% to 33% (2005: 15% to 33%).

Notes to the Financial Statements (Cont'd)

(Prepared in accordance with International Financial Reporting Standards)
(Expressed in Renminbi)

14 INCOME TAX EXPENSE/(BENEFIT) (cont'd)

(a) Income tax expense/(benefit) in the consolidated income statement (cont'd)

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

(b) Reconciliation between tax expense/(benefit) and accounting profit/(loss) at applicable tax rates

	2006 **RMB'000**	2005 RMB'000
Profit/(loss) before tax	**357**	(1,853)
Tax on profit/(loss) before tax, calculated at the rates applicable to profit/(loss) in the tax jurisdiction concerned	**50**	(271)
Adjustments for tax effect of:		
Non-deductible expenses	**127**	82
Non-taxable income	**–**	(8)
Change in tax rate of the Company and its certain branches from 15% to 18%	**(21)**	–
Share of results of associates and jointly controlled entities	**(22)**	37
Tax effect of unused tax losses not recognised	**39**	135
Over-provision in prior year	**(16)**	–
Others	**(4)**	18
Actual tax expense/(benefit)	**153**	(7)

15 PROFIT/(LOSS) ATTRIBUTABLE TO EQUITY SHAREHOLDERS OF THE COMPANY

The profit/(loss) attributable to equity shareholders of the Company for the year ended 31 December 2006 includes a loss of RMB3 million (2005: loss of RMB1,743 million) which has been dealt with in the financial statements of the Company.

16 DIVIDENDS

No interim dividend was paid during both the current and prior years.

The board of directors of the Company does not recommend the payment of a final dividend in respect of the year ended 31 December 2006. No final dividend was paid in respect of the year ended 31 December 2005.

17 EARNINGS/(LOSS) PER SHARE

The calculation of basic earnings/(loss) per share for the year ended 31 December 2006 is based on the profit attributable to equity shareholders of the Company of RMB188 million (2005: loss of RMB1,848 million) and the weighted average number of shares in issue during the year of 4,374 million (2005: 4,374 million).

The amounts of diluted earnings/(loss) per share are the same as basic earnings/(loss) per share as there were no dilutive potential ordinary shares in existence for both the current and prior years.

Notes to the Financial Statements (Cont'd)

(Prepared in accordance with International Financial Reporting Standards)
(Expressed in Renminbi)

18 PROPERTY, PLANT AND EQUIPMENT, NET

(a) The Group

		Aircraft				
	Buildings	Owned	Acquired under finance leases	Other flight equipment, including rotables	Machinery, equipment and vehicles	Total
	RMB million	RMB million	RMB million	RMB million	RMB million	RMB million
Cost or valuation:						
At 1 January 2005	6,988	27,134	14,529	9,044	2,599	60,294
Exchange adjustments	(6)	–	–	–	(14)	(20)
Additions	64	1,827	8,146	1,336	307	11,680
Transfer from construction in progress	513	–	–	–	56	569
Transfer to inventories	–	–	–	(126)	–	(126)
Disposals	(256)	–	–	(207)	(81)	(544)
At 31 December 2005	7,303	28,961	22,675	10,047	2,867	71,853
Representing:						
Cost	6,948	22,732	18,335	7,873	2,383	58,271
Valuation – 1996 (Note (d))	355	6,229	4,340	2,174	484	13,582
	7,303	28,961	22,675	10,047	2,867	71,853
At 1 January 2006	7,303	28,961	22,675	10,047	2,867	71,853
Additions	–	1,520	4,521	769	339	7,149
Transfer from construction in progress	516	–	96	12	46	670
Through the acquisition of CSAHC Hainan (Note 43(b))	34	39	–	41	17	131
Reclassification on exercise of purchase option	–	3,273	(3,273)	–	–	–
Reclassification	(172)	–	–	–	172	–
Disposals	(780)	(580)	(204)	(575)	(133)	(2,272)
At 31 December 2006	**6,901**	**33,213**	**23,815**	**10,294**	**3,308**	**77,531**
Representing:						
Cost	6,546	27,420	19,475	8,120	2,824	64,385
Valuation – 1996 (Note (d))	355	5,793	4,340	2,174	484	13,146
	6,901	**33,213**	**23,815**	**10,294**	**3,308**	**77,531**

Notes to the Financial Statements (Cont'd)

(Prepared in accordance with International Financial Reporting Standards)
(Expressed in Renminbi)

18 PROPERTY, PLANT AND EQUIPMENT, NET (cont'd)

(a) The Group (cont'd)

	Buildings	Aircraft Owned	Aircraft Acquired under finance leases	Other flight equipment, including rotables	Machinery, equipment and vehicles	Total
	RMB million	RMB million	RMB million	RMB million	RMB million	RMB million
Accumulated depreciation:						
At 1 January 2005	757	4,331	2,894	4,137	1,334	13,453
Exchange adjustments	(1)	–	–	–	(11)	(12)
Charge for the year	227	1,546	1,108	1,121	418	4,420
Disposals	(74)	–	–	(145)	(55)	(274)
At 31 December 2005	909	5,877	4,002	5,113	1,686	17,587
At 1 January 2006	909	5,877	4,002	5,113	1,686	17,587
Charge for the year	248	1,984	1,321	995	451	4,999
Reclassification on exercise of purchase option	–	1,034	(1,034)	–	–	–
Reclassification	(41)	–	–	–	41	–
Disposals	(56)	(510)	(204)	(513)	(119)	(1,402)
At 31 December 2006	**1,060**	**8,385**	**4,085**	**5,595**	**2,059**	**21,184**
Net book value:						
At 31 December 2006	**5,841**	**24,828**	**19,730**	**4,699**	**1,249**	**56,347**
At 31 December 2005	6,394	23,084	18,673	4,934	1,181	54,266

Notes to the Financial Statements (Cont'd)

(Prepared in accordance with International Financial Reporting Standards)
(Expressed in Renminbi)

18 PROPERTY, PLANT AND EQUIPMENT, NET (cont'd)

(b) The Company

		Aircraft				
	Buildings	**Owned**	**Acquired under finance leases**	**Other flight equipment, including rotables**	**Machinery, equipment and vehicles**	**Total**
	RMB million	RMB million	RMB million	RMB million	RMB million	RMB million
Cost or valuation:						
At 1 January 2005	4,026	22,133	14,529	7,467	1,876	50,031
Additions	29	128	8,146	1,181	65	9,549
Transfer from construction in progress	77	–	–	–	56	133
Transfer to inventories	–	–	–	(126)	–	(126)
Disposals	(78)	–	–	(202)	(29)	(309)
At 31 December 2005	4,054	22,261	22,675	8,320	1,968	59,278
Representing:						
Cost	3,860	17,648	18,335	6,495	1,704	48,042
Valuation – 1996 (Note (d))	194	4,613	4,340	1,825	264	11,236
	4,054	22,261	22,675	8,320	1,968	59,278
At 1 January 2006	4,054	22,261	22,675	8,320	1,968	59,278
Additions	–	218	4,521	751	236	5,726
Transfer from construction in progress	394	–	96	12	45	547
Through the acquisition of CSAHC Hainan (Note 43(b))	34	39	–	41	17	131
Transfer from Guangxi Airlines (Note 51(d))	147	–	–	177	63	387
Reclassification on exercise of purchase option	–	3,273	(3,273)	–	–	–
Reclassification	(172)	–	–	–	172	–
Disposals	(685)	(580)	(204)	(420)	(93)	(1,982)
At 31 December 2006	**3,772**	**25,211**	**23,815**	**8,881**	**2,408**	**64,087**
Representing:						
Cost	3,578	21,034	19,475	7,056	2,144	53,287
Valuation – 1996 (Note (d))	194	4,177	4,340	1,825	264	10,800
	3,772	**25,211**	**23,815**	**8,881**	**2,408**	**64,087**

Notes to the Financial Statements (Cont'd)

(Prepared in accordance with International Financial Reporting Standards)
(Expressed in Renminbi)

18 PROPERTY, PLANT AND EQUIPMENT, NET (cont'd)

(b) The Company (cont'd)

	Buildings	Aircraft Owned	Aircraft Acquired under finance leases	Other flight equipment, including rotables	Machinery, equipment and vehicles	Total
	RMB million	RMB million	RMB million	RMB million	RMB million	RMB million
Accumulated depreciation:						
At 1 January 2005	425	3,158	2,894	3,491	809	10,777
Charge for the year	138	1,255	1,108	786	336	3,623
Disposals	(61)	–	–	(100)	(15)	(176)
At 31 December 2005	502	4,413	4,002	4,177	1,130	14,224
At 1 January 2006	502	4,413	4,002	4,177	1,130	14,224
Charge for the year	145	1,618	1,321	732	340	4,156
Transfer from Guangxi Airlines (Note 51(d))	42	–	–	97	48	187
Reclassification on exercise of purchase option	–	1,034	(1,034)	–	–	–
Reclassification	(41)	–	–	–	41	–
Disposals	(39)	(510)	(204)	(300)	(77)	(1,130)
At 31 December 2006	**609**	**6,555**	**4,085**	**4,706**	**1,482**	**17,437**
Net book value:						
At 31 December 2006	**3,163**	**18,656**	**19,730**	**4,175**	**926**	**46,650**
At 31 December 2005	3,552	17,848	18,673	4,143	838	45,054

(c) Substantially all of the Group's buildings are located in the PRC. The Group was formally granted the rights to use the twenty one parcels of land in Guangzhou, Shenzhen, Zhuhai, Beihai, Changsha, Shantou, Haikou, Zhengzhou, Guiyang and Wuhan by the relevant PRC authorities for periods of 30 to 70 years, which expire between 2020 and 2068. For other land in the PRC on which the Group's buildings are erected, the Group was formally granted the rights to use such land for periods of one to three years pursuant to various lease agreements between the Company and CSAHC. In this connection, rental payments totalling RMB22 million were paid to CSAHC during 2006 (2005: RMB24 million) in respect of these leases.

Notes to the Financial Statements (Cont'd)

(Prepared in accordance with International Financial Reporting Standards)
(Expressed in Renminbi)

18 PROPERTY, PLANT AND EQUIPMENT, NET (cont'd)

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

Subsequent to the 1996 revaluation, the property, plant and equipment of the Group are carried at revalued amount, being the fair value at the date of the revaluation less any subsequent accumulated depreciation. Revaluation is performed periodically to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet date. Based on a revaluation performed as of 30 September 2005, by Savills Valuation & Professional Services Limited, a firm of independent valuers, on a depreciated replacement cost basis, the carrying value of property, plant and equipment did not differ materially from their fair value.

At 31 December 2006, the carrying amount of such revalued property, plant and equipment approximated the historical carrying value of such assets had they been stated at cost less accumulated depreciation and impairment losses.

(e) As at 31 December 2006, certain aircraft of the Group and the Company with an aggregate carrying value of approximately RMB30,075 million and RMB25,761 million, respectively (2005: RMB30,408 million and RMB26,506 million, respectively) were mortgaged under certain loan and lease agreements (Notes 30 and 31).

(f) The Company leased out certain flight training facilities and buildings to a jointly controlled entity. The leases typically run for an initial period of one to three years, with an option to renew the lease after that date at which time all terms are renegotiated. None of the leases includes contingent rentals. In this connection, rental income totalling RMB35 million (2005: RMB31 million) was received by the Company during the year in respect of the leases (Note 40(c)(x)).

The Group's total future minimum lease payments under non-cancellable operating leases are receivable as follows:

	2006 **RMB'000**	2005 RMB'000
Within 1 year	**35**	31

As at 31 December 2006, the cost and accumulated depreciation of the relevant properties leased out by the Company under the operating leases amounted to RMB221 million and RMB94 million respectively (2005: RMB237 million and RMB84 million respectively). Depreciation of the relevant properties recognised during the year totalled RMB21 million (2005: RMB15 million).

Notes to the Financial Statements (Cont'd)

(Prepared in accordance with International Financial Reporting Standards)
(Expressed in Renminbi)

18 PROPERTY, PLANT AND EQUIPMENT, NET (cont'd)

(g) The Company entered into two separate arrangements (the "Arrangements") with certain independent third parties during each of 2002 and 2003. Under each of the Arrangements, the Company sold an aircraft and then immediately leased back the aircraft for an agreed period. The lease payment obligations, with pre-determined net present value, are to be satisfied solely out of the sale proceeds and such amount has been placed irrevocably by the Company in form of deposits and debt securities in favour of the lessors. The Company has an option to purchase the aircraft at a pre-determined date and an agreed purchase price to be satisfied by the balances of the deposits and debt securities outstanding at that date. In the event that the lease agreement is early terminated by the Company, the Company is liable to pay a pre-determined penalty to the lessor. Provided that the Company complies with the lease agreements, the Company is entitled to the continued possession and operation of the aircraft. Since the Company retains substantially all risks and rewards incidental to ownership of the aircraft and enjoys substantially the same rights to their use as before the Arrangements, no adjustment has been made to the property, plant and equipment. As at 31 December 2006, the net present value of the lease commitments and the corresponding defeased deposits and debt securities amounted to RMB2,272 million (2005: RMB2,376 million).

(h) As agreed with the companies having operations at Guangzhou Baiyun International Airport, the allocation of common facilities at the airport was revised. As a result, certain property, plant and equipment of the Group and the Company at Guangzhou Baiyun International Airport with a carrying amount of RMB539 million and RMB459 million, respectively were transferred to them during the year.

(i) As at 31 December 2006 and up to the date of approval of these financial statements, the Group is in the process of applying for the land use right certificates and property title certificates in respect of the properties located in Guangzhou Baiyun International Airport, in which the Group has interests and for which such certificates have not been granted. As at 31 December 2006, carrying value of such properties of the Group and the Company amounted to RMB1,586 million and RMB852 million, respectively (2005: RMB2,316 million and RMB1,527 million, respectively). The directors of the Company are of the opinion that the use of and the conduct of operating activities at the properties referred to above are not affected by the fact that the Group has not yet obtained the relevant land use right certificates and property title certificates.

(j) IAS 16 (amended 2004) Property, Plant and Equipment ("revised policy") has been adopted prospectively with effect from 1 January 2005. The effect of adoption of the revised policy was not material in 2005. For the year ended 31 December 2006, major overhaul costs of approximately RMB559 million were capitalised as component of property, plant and equipment. In addition, the Group derecognised certain components of property, plant and equipment with carrying amount of approximately RMB300 million which were replaced by the major overhauls incurred during the year. The additional depreciation charge during the year ended 31 December 2006 amounted to approximately RMB51 million.

19 CONSTRUCTION IN PROGRESS

	The Group		The Company	
	2006	2005	**2006**	2005
	RMB million	RMB million	**RMB million**	RMB million
At 1 January	**674**	565	**569**	232
Additions	**947**	678	**782**	470
Transferred to property, plant and equipment	**(670)**	(569)	**(547)**	(133)
At 31 December	**951**	674	**804**	569

The construction in progress as at 31 December 2006 mainly related to projects at the Guangzhou, Jilin and Fuzhou airports, Shenzhen cargo centre and Beijing Branch.

Notes to the Financial Statements (Cont'd)

(Prepared in accordance with International Financial Reporting Standards)
(Expressed in Renminbi)

20 INTEREST IN SUBSIDIARIES

	The Company	
	2006	2005
	RMB million	RMB million
Unlisted shares/capital contributions, at cost	**1,304**	1,482
Less: impairment loss	**(67)**	–
	1,237	1,482
Amounts due from subsidiaries	**538**	609
	1,775	2,091

In 2006, the management assessed the recoverable amounts of the loss-making subsidiaries and determined that the carrying amounts of the investments in these subsidiaries exceeded their recoverable amounts by approximately RMB67 million. Accordingly, a provision for impairment loss on investments in subsidiaries amounted to RMB67 million was recorded on 31 December 2006.

Details of the Group's principal subsidiaries are set out in Note 51.

21 INTEREST IN ASSOCIATES

	The Group		The Company	
	2006	2005	**2006**	2005
	RMB million	RMB million	**RMB million**	RMB million
Share of net assets	**149**	142	**–**	–
Unlisted capital contributions, at cost	**–**	–	**403**	354
Less: impairment loss	**–**	–	**(281)**	(214)
	149	142	**122**	140

In the Company's balance sheet, a provision for impairment loss of RMB281 million was recorded on 31 December 2006 (2005: RMB214 million) in respect of investments in certain associates in which their carrying amounts were determined to be not fully recoverable.

Details of the Group's principal associates are set out in Note 52, all of which are unlisted corporate entities.

Notes to the Financial Statements (Cont'd)

(Prepared in accordance with International Financial Reporting Standards)
(Expressed in Renminbi)

21 INTEREST IN ASSOCIATES (cont'd)

Summary of financial information on associates:

	100 Percent		Group's effective interest	
	2006	2005	**2006**	2005
	RMB million	RMB million	**RMB million**	RMB million
Non-current assets	**6,042**	5,334	**2,319**	2,081
Current assets	**2,281**	2,275	**502**	455
Non-current liabilities	**(3,525)**	(3,897)	**(1,372)**	(1,520)
Current liabilities	**(4,110)**	(3,318)	**(1,300)**	(874)
Net assets	**688**	394	**149**	142
Revenue	**4,485**	3,314	**1,727**	1,318
Expenses	**(4,487)**	(3,837)	**(1,722)**	(1,603)
Profit/(loss) for the year	**(2)**	(523)	**5**	(285)

22 INTEREST IN JOINTLY CONTROLLED ENTITIES

	The Group		The Company	
	2006	2005	**2006**	2005
	RMB million	RMB million	**RMB million**	RMB million
Share of net assets	**870**	805	**–**	–
Unlisted capital contributions, at cost	**–**	–	**663**	666
Less: impairment loss	**–**	–	**(9)**	–
	870	805	**654**	666

In the Company's balance sheet, a provision for impairment loss of RMB9 million was recorded on 31 December 2006 (2005: Nil) in respect of investment in a jointly controlled entity in which its carrying amount was determined to be not fully recoverable.

Details of the Group's principal jointly controlled entities are set out in Note 52, all of which are unlisted corporate entities.

Notes to the Financial Statements (Cont'd)

(Prepared in accordance with International Financial Reporting Standards)
(Expressed in Renminbi)

22 INTEREST IN JOINTLY CONTROLLED ENTITIES (cont'd)

Summary of financial information on jointly controlled entities:

	Group's effective interest	
	2006	2005
	RMB million	RMB million
Non-current assets	**925**	920
Current assets	**1,111**	877
Non-current liabilities	**(335)**	(369)
Current liabilities	**(831)**	(623)
Net assets	**870**	805
Revenue	**1,464**	1,115
Expenses	**(1,349)**	(1,079)
Profit for the year	**115**	36

23 OTHER INVESTMENTS IN EQUITY SECURITIES

	The Group		The Company	
	2006	2005	**2006**	2005
	RMB million	RMB million	**RMB million**	RMB million
Unlisted equity securities, at cost	**330**	320	**183**	170

Dividend income from unlisted securities of the Group amounted to RMB7 million during the year ended 31 December 2006 (2005: RMB4 million).

24 DEFERRED TAX ASSETS/(LIABILITIES)

Movements of net deferred tax assets/(liabilities) are as follows:

	The Group		The Company	
	2006	2005	**2006**	2005
	RMB million	RMB million	**RMB million**	RMB million
At 1 January	**(268)**	(287)	**74**	51
(Charged)/credited to income statement (Note 14(a))	**(9)**	19	**21**	23
At 31 December	**(277)**	(268)	**95**	74

Notes to the Financial Statements (Cont'd)

(Prepared in accordance with International Financial Reporting Standards)
(Expressed in Renminbi)

24 DEFERRED TAX ASSETS/(LIABILITIES) (cont'd)

The deferred tax assets/(liabilities) at 31 December 2006 were made up of the following tax effects:

	The Group		The Company	
	2006	2005	**2006**	2005
	RMB million	RMB million	**RMB million**	RMB million
Deferred tax assets:				
Tax losses	**–**	159	**–**	159
Repair charges capitalised	**203**	275	**203**	220
Accrued expenses	**465**	175	**463**	175
Others	**38**	29	**36**	28
Total deferred tax assets	**706**	638	**702**	582
Deferred tax liabilities:				
Accrued expenses	**(105)**	(58)	**(61)**	–
Depreciation allowances in excess of the related depreciation	**(878)**	(832)	**(546)**	(508)
Others	**–**	(16)	**–**	–
Total deferred tax liabilities	**(983)**	(906)	**(607)**	(508)
	(277)	(268)	**95**	74
Net deferred tax asset recognised on the balance sheet	**95**	74	**95**	74
Net deferred tax liability recognised on the balance sheet	**(372)**	(342)	**–**	–
	(277)	(268)	**95**	74

	The Group		The Company	
	2006	2005	**2006**	2005
	RMB million	RMB million	**RMB million**	RMB million
Gross amount of unused tax losses				
Expected to be utilised	**–**	891	**–**	891
Not expected to be utilised	**423**	710	**–**	346
	423	1,601	**–**	1,237

Tax losses in the PRC are available for carry forward to set off future PRC assessable income for a maximum period of five years. Of the RMB423 million tax losses at 31 December 2006, approximately RMB297 million and RMB126 million will expire in 2010 and 2011 respectively. In accordance with accounting policy set out in Note 2(u), the Group had not recognised deferred tax asset in respect of these unused tax losses as it was determined by management that it is not probable that future taxable profits against which the losses can be utilised will be available before they expire.

Notes to the Financial Statements (Cont'd)

(Prepared in accordance with International Financial Reporting Standards)
(Expressed in Renminbi)

25 OTHER ASSETS

Other assets of the Group and the Company include lump sum housing benefits of RMB145 million (2005: RMB171 million). Further details are set out in Note 41.

Movements of lump sum housing benefits are as follows:

	The Group and the Company	
	2006	2005
	RMB million	RMB million
At 1 January	**171**	197
Amortisation for the year	**(26)**	(26)
At 31 December	**145**	171

26 INVENTORIES

	The Group		The Company	
	2006	2005	**2006**	2005
	RMB million	RMB million	**RMB million**	RMB million
Expendable spare parts and maintenance materials	**1,236**	1,241	**1,041**	990
Other supplies	**79**	141	**48**	106
	1,315	1,382	**1,089**	1,096

The analysis of the amount of inventories recognised as an expense is as follows:

	The Group		The Company	
	2006	2005	**2006**	2005
	RMB million	RMB million	**RMB million**	RMB million
Consumption	**694**	720	**611**	596
Write-down of inventories	**161**	209	**144**	209
	855	929	**755**	805

Inventories had been written down as a result of fleet adjustment during the current and prior years.

Notes to the Financial Statements (Cont'd)

(Prepared in accordance with International Financial Reporting Standards)
(Expressed in Renminbi)

27 TRADE RECEIVABLES

Credit terms granted by the Group to sales agents and other customers generally range from one to three months. An ageing analysis of trade receivables, net of impairment losses for bad and doubtful debts, is set out below:

	The Group		The Company	
	2006	2005	**2006**	2005
	RMB million	RMB million	**RMB million**	RMB million
Within 1 month	**1,355**	1,366	**1,112**	1,076
More than 1 month but less than 3 months	**131**	137	**81**	73
More than 3 months but less than 12 months	**24**	14	**7**	7
More than 12 months	**2**	1	**–**	–
	1,512	1,518	**1,200**	1,156

As at 31 December 2006, the Group and the Company had an amount due from a fellow subsidiary of RMBNil (2005: RMB42 million) which were included in trade receivables.

All of the trade receivables are expected to be recovered within one year.

Included in trade receivables are the following amounts denominated in a currency other than the functional currency of the entity to which they relate:

	The Group		The Company	
	2006	2005	**2006**	2005
	million	million	**million**	million
United States Dollars	**USD19**	USD15	**USD16**	USD14

28 OTHER RECEIVABLES

Other receivables of the Group and the Company at 31 December 2005 included an amount due from Zhongyuan Airlines Company Limited of RMB98 million, which had been fully settled by transfer of certain properties of Zhongyuan Airlines to the Company during the year.

Notes to the Financial Statements (Cont'd)

(Prepared in accordance with International Financial Reporting Standards)
(Expressed in Renminbi)

29 CASH AND CASH EQUIVALENTS

	The Group		The Company	
	2006	2005	**2006**	2005
	RMB million	RMB million	**RMB million**	RMB million
Deposits with banks	**26**	23	**–**	–
Cash at bank and in hand	**2,238**	2,878	**1,786**	2,002
Cash and cash equivalents	**2,264**	2,901	**1,786**	2,002

Southern Airlines Group Finance Company Limited ("SA Finance") is a PRC authorised financial institution controlled by CSAHC and is an associate of the Group. In accordance with the financial agreement dated 22 May 1997 and subsequently revised on 31 December 2004 between the Company and SA Finance, all the Group's deposits accepted by SA Finance were simultaneously placed with several designated major PRC banks by SA Finance. As at 31 December 2006, the Group's and the Company's deposits with SA Finance amounted to RMB629 million and RMB597 million respectively (2005: RMB544 million and RMB480 million respectively) (Note 40(d)).

Included in cash and cash equivalents are the following amounts denominated in a currency other than the functional currency of the entity to which they relate:

	The Group		The Company	
	2006	2005	**2006**	2005
	million	million	**million**	million
United States Dollars	**USD16**	USD24	**USD12**	USD23
Japanese Yen	**JPY1,006**	JPY1,161	**JPY990**	JPY1,093

30 BANK AND OTHER LOANS

(a) At 31 December 2006, bank and other loans were repayable as follows:

	The Group		The Company	
	2006	2005	**2006**	2005
	RMB million	RMB million	**RMB million**	RMB million
Within 1 year or on demand	**23,822**	16,223	**22,218**	14,664
After 1 year but within 2 years	**2,986**	4,316	**2,138**	3,475
After 2 years but within 5 years	**4,533**	4,251	**3,309**	3,079
After 5 years	**2,499**	4,173	**1,924**	3,910
	10,018	12,740	**7,371**	10,464
	33,840	28,963	**29,589**	25,128

Notes to the Financial Statements (Cont'd)

(Prepared in accordance with International Financial Reporting Standards)
(Expressed in Renminbi)

30 BANK AND OTHER LOANS (cont'd)

(b) At 31 December 2006, bank and other loans are analysed as follows:

	The Group		The Company	
	2006	2005	**2006**	2005
	RMB million	RMB million	**RMB million**	RMB million
Short-term bank loans	**19,908**	14,346	**18,983**	13,286
Long-term bank and other loans due within one year (classified as current liabilities)	**3,914**	1,877	**3,235**	1,378
	23,822	16,223	**22,218**	14,664
Long-term bank and other loans due after one year (classified as non-current liabilities)	**10,018**	12,740	**7,371**	10,464
	33,840	28,963	**29,589**	25,128
Representing:				
Bank loans	**33,818**	28,960	**29,589**	25,128
Other loans	**22**	3	**–**	–
	33,840	28,963	**29,589**	25,128

(c) As at 31 December 2006, the Group's and the Company's weighted average interest rates on short-term borrowings were 5.77 % and 5.78 % per annum, respectively (2005: both 4.83% per annum).

Subsequent to 31 December 2006, the Group renewed certain short-term bank loans of RMB488 million. The renewed bank loans are unsecured, bear interest at floating rates ranging from 3-month HIBOR/6-month LIBOR + 0.50% to 0.60% per annum and are repayable within one year from their respective renewal dates.

Notes to the Financial Statements (Cont'd)

(Prepared in accordance with International Financial Reporting Standards)
(Expressed in Renminbi)

30 BANK AND OTHER LOANS (cont'd)

(d) Details of bank and other loans with original maturity over one year are as follows:

	The Group		The Company	
	2006 million	2005 million	**2006 million**	2005 million
Renminbi denominated loans				
Non-interest bearing loan from a municipal government authority	**3**	3	**–**	–
Floating interest rates ranging from 5.10% to 5.51% per annum as at 31 December 2006, with maturities through 2010	**325**	877	**–**	550
United States Dollars denominated loans				
Fixed interest rates ranging from 4.43% to 7.48% per annum as at 31 December 2006, with maturities through 2015	**1,863**	2,414	**1,440**	1,835
Floating interest rates ranging from 3-month LIBOR + 0.65% to 0.90% per annum as at 31 December 2006, with maturities through 2009	**1,727**	3,610	**1,727**	1,946
Floating interest rates ranging from 6-month LIBOR + 0.30% to 1.20% per annum as at 31 December 2006, with maturities through 2016	**9,995**	7,713	**7,439**	7,511
Hong Kong Dollars denominated loans				
Non-interest bearing loan from a minority shareholder repayable within five years (Note 40(g))	**19**	–	**–**	–
	13,932	14,617	**10,606**	11,842
Less: loans due within one year classified as current liabilities	**(3,914)**	(1,877)	**(3,235)**	(1,378)
	10,018	12,740	**7,371**	10,464

Notes to the Financial Statements (Cont'd)

(Prepared in accordance with International Financial Reporting Standards)
(Expressed in Renminbi)

30 BANK AND OTHER LOANS (cont'd)

(e) As at 31 December 2006, bank and other loans of the Group and the Company totalling RMB8,726 million and RMB5,788 million, respectively (2005: RMB8,116 million and RMB5,954 million, respectively) were secured by mortgages over certain of the Group's and the Company's aircraft with carrying amount of RMB10,345 million and RMB6,031 million, respectively (2005: RMB11,735 million and RMB7,833 million, respectively).

(f) As at 31 December 2006, certain bank and other loans were guaranteed by the following parties:

	The Group		The Company	
	2006	2005	**2006**	2005
	RMB million	RMB million	**RMB million**	RMB million
Guarantors				
Industrial Commercial Bank of China	**79**	111	**79**	111
Export-Import Bank of the United States	**828**	1,171	**404**	593
Bank of China	**74**	155	**74**	155
CSAHC	**1,484**	1,908	**1,270**	1,474
Shenzhen Yingshun Investment Development Company Limited	**22**	22	**–**	–
SA Finance	**5**	7	**–**	–
Industrial Bank Co., Ltd	**48**	–	**–**	–
	2,540	3,374	**1,827**	2,333

(g) As at 31 December 2006, loans to the Group and the Company from SA Finance amounted to RMB300 million and RMBNil, respectively (2005: RMB300 million and RMBNil, respectively) (Note 40(d)).

(h) As at 31 December 2006, the Group had banking facilities with several PRC commercial banks for providing loan finance up to approximately RMB49,041 million (2005: RMB39,294 million), of which approximately RMB28,295 million (2005: RMB28,242 million) was utilised.

(i) Included in bank and other loans are the following amounts denominated in a currency other than the functional currency of the entity to which they relate:

	The Group		The Company	
	2006	2005	**2006**	2005
	million	million	**million**	million
United States Dollars	**USD4,016**	USD3,208	**USD3,578**	USD2,834
Hong Kong Dollars	**HKD1,659**	HKD1,821	**HKD1,640**	HKD1,640

Notes to the Financial Statements (Cont'd)

(Prepared under International Financial Reporting Standards)
(Expressed in Renminbi)

31 OBLIGATIONS UNDER FINANCE LEASES

The Group and the Company have commitments under finance lease agreements in respect of aircraft and related equipment. The majority of these leases have terms of 10 to 15 years expiring during the years 2007 to 2016. As at 31 December 2006, future payments under these finance leases are as follows:

	The Group and the Company					
	2006			2005		
	Obligations RMB million	**Payments RMB million**	**Interest RMB million**	Obligations RMB million	Payments RMB million	Interest RMB million
Within 1 year	**3,091**	**3,769**	**678**	3,373	4,030	657
After 1 year but within 2 years	**2,800**	**3,330**	**530**	2,930	3,423	493
After 2 years but within 5 years	**7,625**	**9,154**	**1,529**	4,797	5,750	953
After 5 years	**1,882**	**2,150**	**268**	4,732	5,412	679
	15,398	**18,403**	**3,005**	15,832	18,615	2,782
Less: balance due within one year classified as current liabilities	**(3,091)**			(3,373)		
	12,307			12,459		

Certain lease financing arrangements comprised finance leases between the Company and certain of its subsidiaries, and corresponding borrowings between such subsidiaries and certain banks. The Company has guaranteed the subsidiaries' obligations under the bank borrowing arrangements and accordingly, the relevant leased assets and obligations are recorded in the Company's balance sheet as owned assets and bank loans, respectively, to reflect the substance of these transactions.

Under the terms of the leases, the Group has an option to purchase, at or near the end of the lease term, certain aircraft and related equipment at either fair market value or a percentage of the respective lessor's defined cost.

Security, including charges over the assets concerned and relevant insurance policies, is provided to the lessors. As at 31 December 2006, certain of the Group's and the Company's aircraft with carrying amount of RMB19,730 million (2005: RMB18,673 million) were mortgaged to secure finance lease obligations totalling RMB15,398 million (2005: RMB15,832 million).

Included in obligations under finance leases are the following amounts denominated in a currency other than the functional currency of the entity to which they relate:

	The Group and the Company	
	2006 million	2005 million
United States Dollars	**USD1,674**	USD1,556
Japanese Yen	**JPY35,400**	JPY47,795

Notes to the Financial Statements (Cont'd)

(Prepared under International Financial Reporting Standards)
(Expressed in Renminbi)

32 TRADE AND BILLS PAYABLES

	The Group		The Company	
	2006	2005	**2006**	2005
	RMB million	RMB million	**RMB million**	RMB million
Trade payables	**1,909**	3,033	**1,645**	2,576
Bills payable	**–**	896	**–**	896
	1,909	3,929	**1,645**	3,472

The following is the ageing analysis of trade and bills payables:

	The Group		The Company	
	2006	2005	**2006**	2005
	RMB million	RMB million	**RMB million**	RMB million
Within 1 month or on demand	**1,125**	2,000	**1,165**	1,797
More than 1 month but less than 3 months	**448**	1,225	**223**	1,043
More than 3 months but less than 6 months	**336**	704	**257**	632
	1,909	3,929	**1,645**	3,472

As at 31 December 2006, the Group and the Company had an amount due to a fellow subsidiary of RMB11 million (2005: RMB859 million) which was included in trade and bills payables.

All of the trade and bills payables are expected to be settled within one year.

Included in trade and bills payables are the following amounts denominated in a currency other than the functional currency of the entity to which they relate:

	The Group		The Company	
	2006	2005	**2006**	2005
	million	million	**million**	million
United States Dollars	**USD61**	USD147	**USD53**	USD129

Notes to the Financial Statements (Cont'd)

(Prepared under International Financial Reporting Standards)
(Expressed in Renminbi)

33 AMOUNTS DUE FROM/TO RELATED COMPANIES

(a) Amounts due from related companies

	The Group		The Company	
	2006	2005	**2006**	2005
	RMB million	RMB million	**RMB million**	RMB million
CSAHC and its affiliates	**4**	–	**4**	–
An associate	**2**	–	**2**	–
Jointly controlled entities	**122**	84	**122**	84
	128	84	**128**	84

The amounts due from related companies were unsecured, interest free and have no fixed terms of repayment.

(b) Amounts due to related companies

	The Group		The Company	
	2006	2005	**2006**	2005
	RMB million	RMB million	**RMB million**	RMB million
CSAHC and its affiliates	**167**	12	**167**	12
An associate	**–**	5	**–**	–
Jointly controlled entities	**87**	99	**67**	52
	254	116	**234**	64

The amounts due to related companies were unsecured, interest free and have no fixed terms of repayment.

34 ACCRUED EXPENSES

	The Group		The Company	
	2006	2005	**2006**	2005
	RMB million	RMB million	**RMB million**	RMB million
Jet fuel costs	**1,020**	686	**757**	493
Operating lease charges	**–**	86	**–**	86
Air catering expenses	**153**	132	**153**	131
Salaries and welfare	**346**	193	**295**	114
Lump sum housing benefits payable	**–**	92	**–**	92
Repairs and maintenance	**1,281**	996	**1,266**	960
Provision for major overhauls (Note 36)	**255**	151	**96**	123
Provision for early retirement benefits (Note 37)	**86**	–	**81**	–
Landing and navigation fees	**1,168**	1,129	**865**	890
Computer reservation services	**66**	190	**–**	105
Interest expense	**448**	338	**407**	312
Duties and levies	**–**	12	**–**	12
Property management fee	**–**	37	**–**	37
Others	**119**	208	**103**	162
	4,942	4,250	**4,023**	3,517

Notes to the Financial Statements (Cont'd)

(Prepared under International Financial Reporting Standards)
(Expressed in Renminbi)

35 OTHER LIABILITIES

	The Group		The Company	
	2006	2005	**2006**	2005
	RMB million	RMB million	**RMB million**	RMB million
CAAC Infrastructure Development Fund	**189**	177	**130**	125
Airport construction surcharge	**404**	542	**335**	482
Airport tax	**288**	198	**288**	198
Construction cost payable	**130**	793	**98**	531
Advance payments on charter flights	**100**	104	**90**	92
Sales agent deposits	**221**	198	**180**	155
Other tax payable	**494**	441	**274**	228
Lump sum housing benefits payable	**90**	–	**90**	–
Others	**1,341**	1,343	**965**	1,082
	3,257	3,796	**2,450**	2,893

36 PROVISION FOR MAJOR OVERHAULS

Details of provision for major overhauls in respect of aircraft held under operating leases are as follows:

	The Group		The Company	
	2006	2005	**2006**	2005
	RMB million	RMB million	**RMB million**	RMB million
At 1 January	**452**	359	**309**	248
Provision for the year	**683**	129	**370**	86
Transfer from Guangxi Airlines (Note 51(d))	**–**	–	**34**	–
Provision utilised during the year	**(75)**	(36)	**(61)**	(25)
At 31 December	**1,060**	452	**652**	309
Less: current portion included in accrued expenses (Note 34)	**(255)**	(151)	**(96)**	(123)
	805	301	**556**	186

Notes to the Financial Statements (Cont'd)

(Prepared under International Financial Reporting Standards)
(Expressed in Renminbi)

37 PROVISION FOR EARLY RETIREMENT BENEFITS

Details of provision for early retirement benefits in respect of obligations to early retired employees are as follows:

	The Group		The Company	
	2006	2005	**2006**	2005
	RMB million	RMB million	**RMB million**	RMB million
At 1 January	**–**	–	**–**	–
Provision for the year (Note 10)	**392**	–	**376**	–
At 31 December	**392**	–	**376**	–
Less: current portion included in accrued expenses (Note 34)	**(86)**	–	**(81)**	–
	306	–	**295**	–

The Group has implemented an early retirement plan for certain employees. The benefits of the early retirement plan are calculated based on factors including the remaining number of years of services from the date of early retirement to the normal retirement date and the salary amount on the date of early retirement of the employees. The present value of the future cash flows expected to be required to settle the obligation is recognised as provision for early retirement benefits.

38 SHARE CAPITAL

	The Group and the Company	
	2006	2005
	RMB million	RMB million
Registered, issued and paid up capital:		
2,200,000,000 domestic state-owned shares of RMB1.00 each	**2,200**	2,200
1,174,178,000 H shares of RMB1.00 each	**1,174**	1,174
1,000,000,000 A shares of RMB1.00 each	**1,000**	1,000
	4,374	4,374

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

Notes to the Financial Statements (Cont'd)

(Prepared under International Financial Reporting Standards)
(Expressed in Renminbi)

39 RESERVES

	The Group		The Company	
	2006	2005	**2006**	2005
	RMB million	RMB million	**RMB million**	RMB million
Share premium				
At 1 January and 31 December	**5,325**	5,325	**5,325**	5,325
Statutory surplus reserve (Note a)				
At 1 January	**410**	402	**349**	349
Transfer from retained earnings	**12**	8	**–**	–
Transfer from statutory public welfare fund	**198**	–	**177**	–
At 31 December	**620**	410	**526**	349
Statutory public welfare fund (Note b)				
At 1 January	**198**	193	**177**	177
Transfer from retained earnings	**–**	5	**–**	–
Transfer to statutory surplus reserve	**(198)**	–	**(177)**	–
At 31 December	**–**	198	**–**	177
Discretionary surplus reserve (Note c)				
At 1 January	**83**	77	**77**	77
Transfer from retained earnings	**29**	6	**–**	–
At 31 December	**112**	83	**77**	77
Retained earnings/(accumulated losses)				
At 1 January	**(390)**	1,477	**(1,997)**	(322)
Profit/(loss) for the year	**188**	(1,848)	**(81)**	(1,675)
Appropriations to reserves	**(41)**	(19)	**–**	–
At 31 December	**(243)**	(390)	**(2,078)**	(1,997)
Total	**5,814**	5,626	**3,850**	3,931

Notes to the Financial Statements (Cont'd)

(Prepared under International Financial Reporting Standards)
(Expressed in Renminbi)

39 RESERVES (cont'd)

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

Statutory surplus reserve can be used to offset prior years' losses, if any, and may be converted into share capital by the issue of new shares to shareholders in proportion to their existing shareholding or by increasing the par value of the shares currently held by them, provided that the balance after such issue is not less than 25% of the registered capital.

(b) According to the PRC Company Law and the Articles of Association of the Company and certain of its subsidiaries, the Company and the relevant subsidiaries were required to transfer between 5% and 10% of their annual net profits after taxation, as determined under the PRC accounting rules and regulations, to the statutory public welfare fund. This fund could only be utilised on capital items for the collective benefits of the Company's and the relevant subsidiaries' employees such as the construction of dormitories, canteen and other staff welfare facilities. This fund is non-distributable other than in liquidation. The transfer to this reserve must be made before distribution of a dividend to shareholders and is subject to respective shareholders' approval.

According to the revised PRC Company Law effective 1 January 2006, appropriation to the statutory public welfare fund is no longer required and the balance of statutory public welfare fund at 31 December 2005 was transferred to statutory surplus reserve.

(c) The appropriation to this reserve is subject to shareholders' approval. The usage of this reserve is similar to that of statutory surplus reserve.

(d) Dividend distributions may be proposed at the discretion of the Company's board of directors, after consideration of the transfers referred to above and making up cumulative prior years' losses. Pursuant to the Articles of Association of the Company, the net profit of the Company for the purpose of profit distribution is deemed to be the lesser of (i) the net profit determined in accordance with the PRC accounting rules and regulations, and (ii) the net profit determined in accordance with IFRSs; or if the financial statements of the Company are not prepared in accordance with IFRSs, the accounting standards of one of the countries in which its shares are listed. As at 31 December 2006, the Company did not have any distributable reserves (2005: Nil).

40 MATERIAL RELATED PARTY TRANSACTIONS

(a) Key management personnel remuneration

Remuneration for key management personnel of the Group, including amounts paid to the Company's directors and certain of the highest paid employees as disclosed in Note 13, is as follows:

	2006 RMB'000	2005 RMB'000
Short-term employees benefits	**6,638**	5,926
Post-employment benefits	**220**	221
	6,858	6,147
Directors and supervisors (Note 13)	**4,334**	3,461
Senior management	**2,524**	2,686
	6,858	6,147

Total remuneration is included in "staff costs" (Note 10).

Notes to the Financial Statements (Cont'd)

(Prepared under International Financial Reporting Standards)
(Expressed in Renminbi)

40 MATERIAL RELATED PARTY TRANSACTIONS (cont'd)

(b) Contributions to post-employment benefit plans

The Group participates in various defined contribution retirement plans organised by municipal and provincial governments for its staff. Details of the Group's employee benefits plan are disclosed in Note 41.

(c) Transactions with CSAHC and its affiliates (the "CSAHC Group"), and the associates and jointly controlled entities of the Group

The Group obtained various operational services provided by the CSAHC Group and the associates and jointly controlled entities of the Group during the normal course of its business.

Details of the significant transactions carried out by the Group are as follows:

	Notes	**2006** **RMB million**	2005 RMB million
Expenses paid to the CSAHC Group			
Handling charges	(i)	**29**	32
Air catering supplies	(ii)	**194**	173
Commission expense	(iii)	**43**	26
Sundry aviation supplies	(iv)	**86**	88
Lease charges for aircraft	(v)	**3**	10
Lease charges for land and buildings	(vi)	**99**	90
Property management fee	(vii)	**26**	28
Expenses paid to jointly controlled entities			
Ground service expenses	(viii)	**43**	32
Repairing charges	(ix)	**1,183**	1,118
Flight simulation service charges	(x)	**133**	126
Income received from a jointly controlled entity			
Rental income	(x)	**35**	31
Acquisition of CSAHC Hainan	(xi)	**5**	–
Disposal of properties to the CSAHC Group	(xii)	**23**	–

Notes to the Financial Statements (Cont'd)

(Prepared under International Financial Reporting Standards)
(Expressed in Renminbi)

40 MATERIAL RELATED PARTY TRANSACTIONS (cont'd)

(c) Transactions with CSAHC and its affiliates (the "CSAHC Group"), and the associates and jointly controlled entities of the Group (cont'd)

(i) The Group acquires aircraft, flight equipment and other airline-related facilities through Southern Airlines (Group) Import and Export Trading Company ("SAIETC"), a wholly-owned subsidiary of CSAHC.

(ii) The Group purchases certain inflight meals and related services from Shenzhen Air Catering Company Limited and Southern Airlines (Group) Catering Co., Ltd, which are an associate and a wholly owned subsidiary of CSAHC respectively.

(iii) Commission is earned by certain subsidiaries of CSAHC in connection with the air tickets sold by them on behalf of the Group. Commission is calculated based on fixed rates ranging from 3% to 6% on the ticket value.

(iv) Certain sundry aviation supplies are purchased from Southern Airlines (Group) Economic Development Company ("SAGEDC"), a subsidiary of CSAHC.

(v) The Group leased an aircraft from CSAHC Hainan Co., Ltd. ("CSAHC Hainan"), a wholly-owned subsidiary of CSAHC. The lease was terminated on 30 April 2006.

(vi) The Group leases certain land and buildings in the PRC from CSAHC. Rental payments for land and buildings amounted to RMB99 million (2005: RMB90 million) were paid or payable to CSAHC in 2006.

(vii) Guangzhou China Southern Airlines Property Management Co., Ltd, a subsidiary of CSAHC, provides property management services to the Group.

(viii) Beijing Ground Service Co., Ltd., a jointly controlled entity of the Group, provides airport ground service to the Group.

(ix) Guangzhou Aircraft Maintenance Engineering Company Limited and MTU Maintenance Zhuhai Co., Ltd, jointly controlled entities of the Group, provide comprehensive maintenance services to the Group.

(x) Zhuhai Xiang Yi, a jointly controlled entity of the Group, provides flight simulation services to the Group. In addition, the Group entered into operating lease agreements to lease certain flight training facilities and buildings to Zhuhai Xiang Yi.

(xi) On 30 April 2006, the Company acquired certain assets of CSAHC Hainan at a total consideration of RMB294 million, which was partly satisfied by assumption of debts and liabilities of CSAHC Hainan totalling RMB289 million outstanding as at that date. The remaining balance of RMB5 million had been settled in cash during the year (Note 43(b)).

(xii) On 28 December 2006, the Company disposed of certain properties to CSAHC at a consideration of RMB23 million.

Notes to the Financial Statements (Cont'd)

(Prepared under International Financial Reporting Standards)
(Expressed in Renminbi)

40 MATERIAL RELATED PARTY TRANSACTIONS (cont'd)

(c) Transactions with CSAHC and its affiliates (the "CSAHC Group"), and the associates and jointly controlled entities of the Group (cont'd)

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

Details of amounts due from/to the CSAHC Group, and the associates and jointly controlled entities of the Group:

	2006 **RMB million**	2005 RMB million
Receivables:		
The CSAHC Group	**4**	42
An associate	**2**	–
Jointly controlled entities	**122**	84
Payables:		
The CSAHC Group	**178**	871
An associate	**–**	5
Jointly controlled entities	**87**	99

The amounts due from/to the CSAHC Group, the associate and jointly controlled entities of the Group are unsecured, interest free and have no fixed terms of repayment.

(d) Loans from and deposits placed with SA Finance

(i) Loans from SA Finance

At 31 December 2006, loans from SA Finance to the Group amounted to RMB300 million (2005: RMB300 million). The loans are unsecured and repayable within one year.

Interest expense paid on such loans amounted to RMB16 million (2005: RMB37 million) and the interest rates ranged from 5.02% to 5.26% per annum during the year ended 31 December 2006 (2005: 3.30% to 5.02% per annum).

The loans are guaranteed by CSAHC (included in the amount as disclosed in (e) below).

(ii) Deposits placed with SA Finance

At 31 December 2006, the Group's deposits with SA Finance amounted to RMB629 million (2005: RMB544 million). The applicable interest rates are determined in accordance with the rates published by the PBOC.

Interest income received on such deposits amounted to RMB5 million (2005: RMB3 million).

Notes to the Financial Statements (Cont'd)

(Prepared under International Financial Reporting Standards)
(Expressed in Renminbi)

40 MATERIAL RELATED PARTY TRANSACTIONS (cont'd)

(e) Guarantees from CSAHC and SA Finance

Certain bank loans of the Group were guaranteed by the following related parties:

	2006 **RMB million**	2005 RMB million
CSAHC	**1,484**	1,908
SA Finance	**5**	7

(f) Transactions with other state-controlled entities

The Company is a state-controlled entity and operates in an economic regime currently dominated by entities directly or indirectly controlled by the PRC government ("state-controlled entities") through its government authorities, agencies, affiliations and other organisations.

Other than those transactions with the CSAHC Group, and the associates and jointly controlled entities of the Group as disclosed in Notes 40(c), (d) and (e) above, the Group conducts transactions with other state-controlled entities which include but are not limited to the following:

- Transportation services;
- Leasing arrangements;
- Purchase of equipment;
- Purchase of ancillary materials and spare parts;
- Ancillary and social services; and
- Financial services arrangement.

These transactions are conducted in the ordinary course of the Group's business on terms comparable to those with other entities that are not state-controlled. The Group has established its buying, pricing strategy and approval process for purchases and sales of products and services. Such buying, pricing strategy and approval processes do not depend on whether the counterparties are state-controlled entities or not.

Having considered the potential for transactions to be impacted by related party relationships, the Group's pricing strategy, buying and approval processes, and what information would be necessary for an understanding of the potential effect of the relationship on the financial statements, the directors are of the opinion that the following transactions with other state-controlled entities require disclosure:

(i) The Group's transactions with other state-controlled entities, including state-controlled banks in the PRC

	2006 **RMB million**	2005 RMB million
Jet fuel cost	**13,054**	9,592
Interest income	**33**	48
Interest expense	**1,405**	694

Notes to the Financial Statements (Cont'd)

(Prepared under International Financial Reporting Standards)
(Expressed in Renminbi)

40 MATERIAL RELATED PARTY TRANSACTIONS (cont'd)

(f) Transactions with other state-controlled entities (cont'd)

(ii) The Group's balances with other state-controlled entities, including state-controlled banks in the PRC

	2006 RMB million	2005 RMB million
Cash and deposits at bank	**1,434**	2,001
Short-term bank loans and current portion of long-term bank loans	**21,209**	14,319
Long-term bank loans, less current portion	**8,223**	10,175

(iii) Guarantees from other state-controlled entities, including state-controlled banks in the PRC

	2006 RMB million	2005 RMB million
Guarantees on certain bank loans of the Group	**201**	266

(g) Loan from a minority shareholder

During the year, the Group obtained a loan from a minority shareholder amounted to RMB19 million. The loan is unsecured, interest free and repayable within five years.

41 RETIREMENT AND HOUSING BENEFITS

Employees of the Group participate in several defined contribution retirement schemes organised separately by PRC municipal governments in regions where the major operations of the Group are located. The Group is required to contribute to these schemes at the rates ranging from 10% to 23% (2005: 9% to 20%) of salary costs including certain allowances. A member of the retirement schemes is entitled to pension benefits equal to a fixed proportion of the salary at the retirement date. The retirement benefit obligations of all retired staff of the Group are assumed by these schemes.

In addition, the Group has established a supplementary defined contribution retirement scheme in accordance with relevant regulations in the PRC. In this connection, employees of the Group participate in a supplementary defined contribution retirement scheme whereby the Group is required to make contributions not exceeding one-twelfth of the prior year's total salaries.

The Group has no obligation for the payment of pension benefits beyond the contributions described above.

Pursuant to an additional staff housing benefit scheme effective September 2002, the Group agreed to pay lump sum housing allowances to certain employees who have not received quarters from CSAHC or the Group according to the relevant PRC housing reform policy, for subsidising their purchases of houses. An employee who quits prior to the end of the vesting benefit period is required to pay back a portion of the lump sum housing benefits determined on a pro-rata basis of the vesting benefit period. The Group has the right to effect a charge on the employee's house and to enforce repayment through selling the house in the event of default in repayment. Any shortfall in repayment would be charged against income statement. As at 31 December 2006, the Group and the Company had made payments totalling RMB170 million (2005: RMB168 million) under the scheme and recorded its remaining contractual liabilities totalling RMB90 million (2005: RMB92 million) on the balance sheets. Housing allowances are payable when applications are received from eligible employees.

Notes to the Financial Statements (Cont'd)

(Prepared under International Financial Reporting Standards)
(Expressed in Renminbi)

42 SEGMENTAL INFORMATION

The Group operates principally as a single business segment for the provision of air transportation services. The analysis of turnover and operating profit/(loss) by geographical segment is based on the following criteria:

(i) Traffic revenue from domestic services within the PRC (excluding Hong Kong and Macau) is attributed to the domestic operation. Traffic revenue from inbound/outbound services between the PRC and Hong Kong/Macau, and the PRC and overseas destinations is attributed to the Hong Kong and Macau operation and international operation, respectively.

(ii) Other revenue from ticket selling, general aviation services, ground services, air catering and other miscellaneous services is attributed on the basis of where the services are performed.

	Domestic	**Hong Kong and Macau**	***International**	**Total**
	RMB million	RMB million	RMB million	RMB million
2006				
Traffic revenue	**35,707**	**1,329**	**8,051**	**45,087**
Other operating revenue	**1,132**	**–**	**–**	**1,132**
Turnover	**36,839**	**1,329**	**8,051**	**46,219**
Operating profit/(loss)	**925**	**4**	**(617)**	**312**
2005				
Traffic revenue	29,533	1,298	6,588	37,419
Other operating revenue	874	–	–	874
Turnover	30,407	1,298	6,588	38,293
Operating loss	(282)	(97)	(926)	(1,305)

* Asian market accounted for approximately 64% (2005: 74%) of the Group's total international traffic revenue for the year ended 31 December 2006. The remaining portion was mainly derived from the Group's flights to/from European, North American and Australian regions.

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

Notes to the Financial Statements (Cont'd)

(Prepared under International Financial Reporting Standards)
(Expressed in Renminbi)

43 MATERIAL NON-CASH TRANSACTIONS

(a) Acquisitions of aircraft

During the year ended 31 December 2006, aircraft acquired under finance leases amounted to RMB3,759 million (2005: RMB6,938 million).

(b) Effect of the acquisition of CSAHC Hainan

The Company acquired certain assets of CSAHC Hainan on 30 April 2006. Details are as follows:

	RMB million
Assets acquired:	
Property, plant and equipment, net	131
Lease prepayment	35
Inventories	28
Trade receivables	30
Cash and cash equivalents	38
Other receivables	32
	294
Liabilities assumed:	
Trade payables	28
Accrued expenses	14
Other liabilities	247
	289
Net identifiable assets and liabilities	5
Satisfied by:	
Cash	5

Analysis of the net inflow of cash and cash equivalents in respect of the acquisition:

Cash consideration	(5)
Cash and cash equivalents acquired	38
Net inflow of cash and cash equivalents in respect of the acquisition	33

Notes to the Financial Statements (Cont'd)

(Prepared under International Financial Reporting Standards)
(Expressed in Renminbi)

44 FINANCIAL INSTRUMENTS

Exposure to liquidity, interest rate, currency, jet fuel price risk credit risks arises in the normal course of the Group's business. These risks are limited by the Group's financial management policies and practices described below.

(a) Liquidity risk

As at 31 December 2006, the Group's current liabilities exceeded its current assets by RMB32,180 million. For the year ended 31 December 2006, the Group recorded a net cash inflow from operating activities of RMB2,295 million, a net cash outflow from investing activities of RMB5,482 million and a net cash inflow from financing activities of RMB2,550 million, and resulted in a net decrease in cash and cash equivalents of RMB637 million.

In 2007 and thereafter, the liquidity of the Group is primarily dependent on its ability to maintain adequate cash inflow from operations to meet its debt obligations as they fall due, and on its ability to obtain adequate external finance to meet its committed future capital expenditures. The Group has obtained firm commitments from its principal bankers to renew its short-term bank loans outstanding at 31 December 2006 when they fall due during 2007. Subsequent to 31 December 2006, the Group renewed short-term loans outstanding of RMB488 million (Note 30). The directors of the Company believe that sufficient financing will be available to the Group.

The directors of the Company have carried out a detailed review of the cash flow forecast of the Group for the twelve months ending 31 December 2007. Based on such forecast, the directors have determined that adequate liquidity exists to finance the working capital and capital expenditure requirements of the Group during that period. In preparing the cash flow forecast, the directors have considered historical cash requirements of the Group as well as other key factors, including the availability of the above-mentioned loan finance which may impact the operations of the Group during the next twelve-month period. The directors are of the opinion that the assumptions and sensitivities which are included in the cash flow forecast are reasonable. However, as with all assumptions in regard to future events, these are subject to inherent limitations and uncertainties and some or all of these assumptions may not be realised.

(b) Interest rate risk

The interest rates and maturity information of the Group's bank and other loans, and maturity information of the Group's finance lease obligations are disclosed in Notes 30 and 31 respectively.

(c) Foreign currency risk

The Renminbi is not freely convertible into foreign currencies. All foreign exchange transactions involving Renminbi must take place either through the PBOC or other institutions authorised to buy and sell foreign exchange or at a swap centre.

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

The exchange rate of Renminbi to US dollar was set by the PBOC and had fluctuated within a narrow band prior to 21 July 2005. Since then, a managed floating exchange rate regime based on market supply and demand with reference to a basket of foreign currencies has been used and US dollar exchange rate has gradually declined against the Renminbi.

Notes to the Financial Statements (Cont'd)

(Prepared under International Financial Reporting Standards)
(Expressed in Renminbi)

44 FINANCIAL INSTRUMENTS (cont'd)

(d) Jet fuel price risk

The Group allows for the judicious use of approved derivative instruments such as swaps and options with approved counter-parties and within approved limits to manage the risk of surge of jet fuel price. In addition, counter-party credit risk is generally restricted to any gains on changes in fair value at any time, and not the principal amount of the instrument. Therefore, the possibility of material loss arising in the event of non-performance by counter-party is considered to be unlikely.

The fair values of derivative financial instruments of the Group and the Company at the balance sheet date are as follows:

	2006		2005	
	Assets	**Liabilities**	Assets	Liabilities
	RMB million	**RMB million**	RMB million	RMB million
Fuel option contracts	**–**	**26**	–	–

At 31 December 2006, the Group had outstanding fuel option contracts to buy approximately 6,150,000 barrels of crude oil at prices which ranging from USD55 to USD79 per barrel. On the other hand, the Group sold fuel put option contracts to approved counter-party and had outstanding option contracts at 31 December 2006 of approximately 12,300,000 barrels of crude oil at price which ranging from USD43 to USD60. All of which will expire between 2007 and 2008.

(e) Credit risk

Substantially all of the Group's cash and cash equivalents are deposited with PRC financial institutions, which management believes are of high credit quality.

A significant portion of the Group's air tickets are sold by agents participating in the Billing and Settlement Plan ("BSP"), a clearing scheme between airlines and sales agents organised by International Air Transportation Association which has insignificant credit risk to the Group. As at 31 December 2006, the balance due from BSP agents amounted to RMB863 million (2005: RMB782 million). The credit risk exposure to BSP and the remaining trade receivables balance has been monitored by the Group on an ongoing basis and the impairment losses for bad and doubtful debts have been within management's expectations.

Notes to the Financial Statements (Cont'd)

(Prepared under International Financial Reporting Standards)
(Expressed in Renminbi)

44 FINANCIAL INSTRUMENTS (cont'd)

(f) Fair value

(i) All financial instruments are carried at amounts not materially different from their fair values as at 31 December 2006 and 2005 except the following:

	2006		2005	
	Carrying amount RMB million	Fair value RMB million	Carrying amount RMB million	Fair value RMB million
The Group				
Bank and other loans	33,840	33,838	28,963	28,989
The Company				
Bank and other loans	29,589	29,574	25,128	25,132

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

– Cash and cash equivalents, trade receivables, other receivables and other current assets, obligations under finance leases, trade and bills payables, taxes payable and other liabilities

The carrying values approximate their fair values because of the short maturities of these instruments.

– Financial liabilities

The fair values of fuel option contracts are determined based on dealer price quotations and options pricing model without any deduction for transaction costs.

– Bank and other loans

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

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

(ii) The economic characteristics of the Group's finance leases vary from lease to lease. It is impractical to compare such leases with those prevailing in the market within the constraints of timeliness and cost for the purpose of estimating the fair value of such leases.

(iii) Other non-current investments represent unlisted equity securities of companies established in the PRC. There is no quoted market price for such equity securities and accordingly a reasonable estimate of the fair value could not be measured reliably.

(iv) Amounts due from/to related companies are unsecured, interest-free and have no fixed terms of repayment. Given these terms, it is not meaningful to disclose fair values of these balances.

Notes to the Financial Statements (Cont'd)

(Prepared under International Financial Reporting Standards)
(Expressed in Renminbi)

45 COMMITMENTS

(a) Capital commitments

As at 31 December 2006, the Group and the Company had capital commitments as follows:

	The Group		The Company	
	2006	2005	**2006**	2005
	RMB million	RMB million	**RMB million**	RMB million
Commitments in respect of aircraft and flight equipment				
– authorised and contracted for	**66,881**	45,628	**59,967**	33,955
Other commitments				
– authorised and contracted for	**420**	90	**420**	90
– authorised but not contracted for	**1,404**	2,085	**1,352**	2,002
	1,824	2,175	**1,772**	2,092
	68,705	47,803	**61,739**	36,047

As at 31 December 2006, the Group had on order 130 aircraft and certain flight equipment, scheduled for deliveries in 2007 to 2011. Deposits of RMB8,692 million have been made towards the purchase of these aircraft and related equipment. As at 31 December 2006, the approximate total future payments, including estimated amounts for price escalation through anticipated delivery dates for these aircraft and flight equipment are as follows:

	The Group		The Company	
	2006	2005	**2006**	2005
	RMB million	RMB million	**RMB million**	RMB million
2006	**–**	7,341	**–**	5,914
2007	**12,299**	8,945	**10,886**	7,240
2008	**22,572**	14,354	**21,276**	13,046
2009	**17,483**	5,300	**15,280**	3,511
2010	**14,232**	9,688	**12,399**	4,244
2011	**295**	–	**126**	–
	66,881	45,628	**59,967**	33,955

Notes to the Financial Statements (Cont'd)

(Prepared under International Financial Reporting Standards)
(Expressed in Renminbi)

45 COMMITMENTS (cont'd)

(a) Capital commitments (cont'd)

As at 31 December 2006, the Group's and the Company's attributable share of the capital commitments of jointly controlled entities was as follows:

	2006 **RMB million**	2005 RMB million
Authorised but not contracted for	**1**	74

(b) Operating lease commitments

As at 31 December 2006, the total future minimum lease payments under non-cancellable aircraft and flight equipment operating leases were payable as follows:

	The Group		**The Company**	
	2006 **RMB million**	2005 RMB million	**2006** **RMB million**	2005 RMB million
Payments due				
Within 1 year	**3,077**	3,340	**2,756**	3,113
After 1 year but within 5 years	**10,846**	10,798	**10,143**	10,309
After 5 years	**8,046**	10,456	**7,812**	10,444
	21,969	24,594	**20,711**	23,866

(c) Investing commitments

As at 31 December 2006, the Group and the Company committed to make capital contributions in respect of:

	2006 **RMB million**	2005 RMB million
A jointly controlled entity	**83**	83

46 CONTINGENT LIABILITIES

The Group leases from CSAHC certain land in Guangzhou and certain land and buildings in Wuhan, Haikou and Zhengzhou. The Group has a significant investment in buildings and other leasehold improvements located on such land. However, such land in Guangzhou and such land and buildings in Wuhan, Haikou and Zhengzhou lack adequate documentation evidencing CSAHC's rights thereto.

The Group cannot predict the magnitude of the effect on its financial condition or results of operations to the extent that their uses of one or more of the above parcels of land or the related facilities were successfully challenged. Pursuant to an indemnification agreement dated 22 May 1997 entered into between CSAHC and the Company, CSAHC has agreed to indemnify the Group against any loss or damage caused by any challenge or interference with the Group's use of any of its land and buildings.

Notes to the Financial Statements (Cont'd)

(Prepared under International Financial Reporting Standards)
(Expressed in Renminbi)

47 NON-ADJUSTING POST BALANCE SHEET EVENTS

(a) On 16 March 2007, the Fifth Plenary Session of the Tenth National People's Congress passed the Corporate Income Tax Law of the People's Republic of China ("new tax law") which will take effect on 1 January 2008. The Company and certain subsidiaries of the Group are entitled to preferential income tax rates in the range of 15% to 27%. From 1 January 2008, the income tax rate of companies who are currently enjoying preferential income tax rates lower than 25% is expected to increase to the standard rate of 25% over a five-year transition period. However, the new tax law has not set out the details as to how the existing preferential tax rate will increase to the standard rate of 25%. Consequently, the Company is not able to make an estimate of the expected financial effect of the new tax law on its deferred tax assets and liabilities. The expected financial effect of the new tax law, if any, will be reflected in the Company's 2007 financial statements. The enactment of the new tax law is not expected to have any financial effect on the amounts accrued in the balance sheet in respect of current tax payable.

(b) As disclosed in the announcement dated 13 April 2007, the Company issued a notice to holders of the listed and circulating A Shares ("Circulating A Shares") to convene a relevant shareholders' meeting on 17 May 2007 ("Relevant Shareholders' Meeting") for the purpose of seeking shareholders' approval of the proposal for converting all the Company's unlisted and non-circulating shares ("Non-circulating Shares") to Circulating A Shares ("Share Reform Proposal"). CSAHC is the only holder of the Non-circulating Shares.

The consideration payable as proposed by CSAHC to the holders of Circulating A Shares in connection with the Share Reform Proposal is a total of 500,000,000 put warrants of the Company's shares ("Put Warrants"). The holders of the Circulating A Shares registered on the shareholders' register on 8 May 2007 will be granted 5 Put Warrants for every 10 A Shares held by such shareholders, equivalent to 0.9327 shares for every 10 A Shares. The exercise ratio is one warrant to one share and the initial exercise price of the Put Warrant is RMB7. The rights of the Put Warrants (European style) are exercisable by the holders during the last five trading days of the warrant period which is twelve months. CSAHC will announce the exercise method of rights under the Put Warrants within six months after the listing of the Put Warrants.

CSAHC undertakes that it will not trade or transfer any of the Company's shares it holds for a twelve-month period commencing from the effective date of the Share Reform Proposal ("Lock-up Period"). After expiration of the Lock-up Period, CSAHC may sell the Non-circulating Shares through trading on the Shanghai Stock Exchange, and the number of shares it will sell within the 12-month period and 24-month period will not exceed 5% and 10%, respectively, of the total number of shares held by CSAHC. The shares subject to restriction as mentioned above do not include those shares purchased by CSAHC upon the exercise of rights under the Put Warrants after the implementation of the share reform plan.

In accordance with the provisions of "Provisional Measures of the Shanghai Stock Exchange for Warrants" and the relevant requirements of the Shanghai Stock Exchange, CSAHC will place deposits to China Securities Depository and Clearing Corporation Limited Shanghai Branch as a performance bond for the Put Warrants.

Up to the date of approval of these financial statements, the Share Reform Proposal was being communicated to the holders of the Circulating A Shares. The share reform plan will be proposed for resolution in the Relevant Shareholders' Meeting.

48 IMMEDIATE AND ULTIMATE CONTROLLING PARTY

As at 31 December 2006, the directors of the Company consider the immediate parent and ultimate controlling party of the Group to be CSAHC, a state-owned enterprise established in the PRC. CSAHC does not produce financial statements available for public use.

Notes to the Financial Statements (Cont'd)

(Prepared under International Financial Reporting Standards)
(Expressed in Renminbi)

49 ACCOUNTING ESTIMATES AND JUDGEMENTS

The Groups' financial position and results of operations are sensitive to accounting methods, assumptions and estimates that underlie the preparation of the financial statements. The Group bases the assumptions and estimates on historical experience and on various other assumptions that the Group believes to be reasonable and which form the basis for making judgements about matters that are not readily apparent from other sources. On an on-going basis, management evaluates its estimates. Actual results may differ from those estimates as facts, circumstances and conditions change.

The selection of critical accounting policies, the judgements and other uncertainties affecting application of those policies and the sensitivity of reported results to changes in condition and assumptions are factors to be considered when reviewing the financial statements. The principal accounting policies are set forth in Note 2. The Group believes the following critical accounting policies involve the most significant judgements and estimates used in the preparation of the financial statements.

Impairment of long-lived assets

If circumstances indicate that the net book value of a long-lived asset may not be recoverable, this asset may be considered "impaired", and an impairment loss may be recognised in accordance with IAS 36 "Impairment of Assets". The carrying amounts of long-lived assets are reviewed periodically in order to assess whether the recoverable amounts have declined below the carrying amounts. These assets are tested for impairment whenever events or changes in circumstances indicate that their recorded carrying amounts may not be recoverable. When such a decline has occurred, the carrying amount is reduced to recoverable amount. The recoverable amount is the greater of the net selling price and the value in use. In determining the value in use, expected cash flows generated by the asset are discounted to their present value, which requires significant judgement relating to the level of traffic revenue and the amount of operating costs. The Group uses all readily available information in determining an amount that is a reasonable approximation of recoverable amount, including estimates based on a reasonable and supportable assumptions and projections of traffic revenue and amount of operating costs.

Depreciation

Property, plant and equipment are depreciated on a straight-line basis over the estimated useful lives, after taking into account the estimated residual value. The Group reviews the estimated useful lives of the assets regularly in order to determine the amount of depreciation expense to be recorded during any reporting period. The useful lives are based on the Group's historical experience with similar assets and taking into account anticipated technological changes. The depreciation expense for future periods is adjusted if there are significant changes from previous estimates.

Impairment of trade receivables

The Group maintains an impairment loss for bad and doubtful debts for estimated losses resulting from the inability of the debtors to make required payments. The Group bases the estimates of future cash flows on the ageing of the trade receivables balance, debtors' credit-worthiness, and historical write-off experience. If the financial condition of the debtors were to deteriorate, actual write-offs would be higher than estimated.

Notes to the Financial Statements (Cont'd)

(Prepared under International Financial Reporting Standards)
(Expressed in Renminbi)

50 POSSIBLE IMPACT OF AMENDMENTS, NEW STANDARDS AND INTERPRETATIONS ISSUED BUT NOT YET EFFECTIVE FOR THE YEAR ENDED 31 DECEMBER 2006

Up to the date of issue of these financial statements, the IASB has issued a number of amendments, new standards and interpretations which are not yet effective for the year ended 31 December 2006 and which have not been adopted in these financial statements:

The Group is in the process of making an assessment of what the impact of these amendments, new standards and new interpretations is expected to be in the period of initial application. So far it has concluded that the adoption of them is unlikely to have a significant impact on the Group's results of operations and financial position.

In addition, the following developments may result in new or amended disclosures in the financial statements:

	Effective for accounting periods beginning on or after
IFRS 7, Financial instruments: disclosure	1 January 2007
Amendments to IAS 1, Presentation of financial statements – capital disclosures	1 January 2007

Notes to the Financial Statements (Cont'd)

(Prepared under International Financial Reporting Standards)
(Expressed in Renminbi)

51 SUBSIDIARIES

The particulars of the Group's principal subsidiaries as of 31 December 2006 are as follows:

Name of company	Place of establishment/ operation	Registered capital	Proportion of ownership interest held by the Company	Principal activities
Guangxi Airlines Company Limited ("Guangxi Airlines") (a), (d)	PRC	RMB170,900,000	100%	Airline
Southern Airlines (Group) Shantou Airlines Company Limited (a)	PRC	RMB280,000,000	60%	Airline
Zhuhai Airlines Company Limited (a)	PRC	RMB250,000,000	60%	Airline
Xiamen Airlines Company Limited (a)	PRC	RMB700,000,000	60%	Airline
Guizhou Airlines Company Limited (a)	PRC	RMB80,000,000	60%	Airline
Guangzhou Air Cargo Company Limited (a)	PRC	RMB238,000,000	70%	Cargo services
Guangzhou Baiyun International Logistic Company Limited (a)	PRC	RMB50,000,000	61%	Logistics operations
Guangzhou Nanland Air Catering Company Limited (b)	PRC	RMB120,000,000	75%	Air catering
China Southern West Australian Flying College Pty Limited	Australia	AUD100,000	65%	Pilot training services
Xinjiang Civil Aviation Property Management Limited (a)	PRC	RMB251,332,832	51.8%	Property management

(a) These subsidiaries are PRC limited liability companies.

(b) This subsidiary is Sino-foreign equity joint venture company established in the PRC.

(c) Certain of the Group's subsidiaries are PRC joint ventures which have limited lives pursuant to the PRC law.

(d) To rationalise the Group's airline operations, the assets and liabilities of Guangxi Airlines were transferred to the Company on 31 December 2006.

Notes to the Financial Statements (Cont'd)

(Prepared under International Financial Reporting Standards)
(Expressed in Renminbi)

52 ASSOCIATES AND JOINTLY CONTROLLED ENTITIES

The particulars of the Group's principal associates and jointly controlled entities as of 31 December 2006 are as follows:

		Proportion of ownership interest held by			
Name of company	**Place of establishment/ operation**	**Group's effective interest**	**The Company**	**Subsidiaries**	**Principal activities**
Guangzhou Aircraft Maintenance Engineering Company Limited (a)	PRC	50%	50%	–	Provision of aircraft repair and maintenance services
China Southern Airlines Group Finance Company Limited	PRC	34%	21.1%	12.9%	Provision of financial services
Sichuan Airlines Corporation Limited	PRC	39%	39%	–	Airline
MTU Maintenance Zhuhai Co. Ltd (a)	PRC	50%	50%	–	Provision of engine repair and maintenance services
China Postal Cargo Airlines Limited (a)	PRC	49%	49%	–	Airline
Zhuhai Xiang Yi Aviation Technology Company Limited (a)	PRC	51%	51%	–	Provision of flight simulation services
Beijing Southern Airlines Ground Services Company Limited (a)	PRC	50%	50%	–	Provision of airport ground services

(a) These are jointly controlled entities.

(b) Certain of the Group's jointly controlled entities are PRC joint ventures which have limited lives pursuant to the PRC law.