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KELON 科龙

GUANGDONG KELON ELECTRICAL HOLDINGS COMPANY LIMITED 廣東科龍電器股份有限公司

*(A joint stock limited company incorporated in the People's Republic of China with limited liability)
(Stock Code: 0921)*

KPMG INVESTIGATION REPORT

The Company announces that KPMG has completed the Investigation and has issued the Report on 13 January 2006.

At the request of the Company, trading in H Shares of the Company was suspended with effect from 10:00 a.m. on 16 June 2005 pending the release of an announcement in relation to price sensitive information. Subject to the publication of a further announcement in relation to, amongst others, the financial, production and trading position of the Group, trading in H shares of the Company will remain suspended until further notice.

This announcement is made pursuant to Rule 13.09(2) of the Listing Rules.

Reference is made to the announcement dated 1 December 2005 of Guangdong Kelon Electrical Holdings Company Limited (the "Company") in relation to the formal appointment of KPMG by the Company to carry out an investigation on material cash flows of the Group (as defined in 1(i) below) incurred between 1 October 2001 and 31 July 2005 (the "Investigation Period").

BACKGROUND AND FINDINGS OF THE INVESTIGATION

As a result of the alleged breaches of the securities laws and regulations in the People's Republic of China (the "PRC") by the Company consequent upon the alleged economic crimes committed by Mr. Gu Chu Jun, the former chairman of the Company, the Company has appointed KPMG to carry out an investigation on the material cash flows incurred by the Group (as defined in 1(i) below) during the Investigation Period which are inconsistent with or are irrelevant to the business of the Company (the "Abnormal Cash Flows") with reference to the list provided by the Company containing Guangdong Greencool Enterprise Development Company Limited ("Guangdong Greencool") and its associated companies (together, the "Greencool Companies"), and to investigate, verify and analyse whether the Abnormal Cash Flows were incurred with the Greencool Companies (the "Investigation"). The Company will consider the results of the Investigation and decide the actions to be taken and so as to reach resolutions regarding the relevant questions.

The Company announces that KPMG has completed the Investigation and has issued a report on the results of the Investigation (the "Report") on 13 January 2006. According to the Report, the Abnormal Cash Flows incurred between the Group (as defined in 1(i) below) and the Greencool Companies during the Investigation Period amounted to cash outflows of approximately RMB 2,169 million and cash inflows of approximately RMB 2,462 million; the Abnormal Cash Flows incurred between the Group (as

defined in 1(i) below) and the companies which KPMG suspected to be associated with the Greencool Companies (the “Suspected Companies”) amounted to cash outflows of approximately RMB 1,902 million and cash inflows of approximately RMB 1,017 million; other Abnormal Cash Flows amounted to cash outflows of approximately RMB 208 million and cash inflows of approximately RMB 28 million.

THE REPORT

1. Scope of the Investigation

In accordance with the letter of appointment of KPMG signed between the Company and KPMG, the scope of the Investigation are as follows:

(i) The Company and its major subsidiaries

KPMG has conducted the Investigation in respect of the Company and the following 29 major subsidiaries of the Company (together, the “Group”), namely:

1. Guangdong Kelon Refrigerator Ltd. (“Kelon Refrigerator”);
2. Guangdong Kelon Air-Conditioner Co., Ltd. (“Kelon Air-Conditioner”);
3. Guangdong Kelon Refrigerator Co., Ltd.;
4. Zhuhai Kelon Industrial Development Co., Ltd.;
5. Guangdong Kelon Weili Electrical Appliances Company Limited;
6. Chengdu Kelon Refrigerator Co., Ltd.;
7. Yingkou Kelon Refrigerator Co., Ltd.;
8. Hangzhou Kelon Electrical Company Limited;
9. Yangzhou Kelon Electrical Company Limited;
10. Shangqiu Kelon Electrical Company Limited;
11. Jilin Kelon Electric Co., Ltd.;
12. Xi’an Kelon Cooling Co., Ltd.;
13. Jiangxi Kelon Industrial Development Co., Ltd.;
14. Jiangxi Kelon Combine Electrical Appliances Co., Ltd.;
15. Kaifeng Kelon Air-Conditioner Co., Ltd.;
16. Guangdong Kelon Fittings Co., Ltd.;
17. Guangdong Kelon Mould Co., Ltd.;
18. Shunde Rongsheng Plastic Products Co., Ltd.;
19. Shunde Kelon Household Electrical Appliance Company Limited;
20. Shunde Jiake Electronic Company Limited;
21. Shunde Wangao Import & Export Co., Ltd.;
22. Huaao Electrical Electronics Co., Ltd.;
23. Foshan Shunde District Qihui Services Co., Ltd.;
24. Shenzhen Kelon Procurement Co., Ltd.;
25. Wuhu Ecan Motors Company Limited;
26. Kelon Development Company Limited;
27. Kelon International Incorporation;
28. Kelon Electric Appliances Co., Ltd.; and
29. Pearl River Electric Refrigerator Company Limited.

(ii) *Material cash flows of the Group*

Due to the fact that the members of the Group differ largely in the size of their operations, number of bank accounts, and number of cash transactions, and in view of the timetable of the Investigation and after several consultations with the Company, KPMG has conducted the Investigation only in relation to the on-balance-sheet cash flows of the Group which equal to or exceed the stated materiality, which vary according to the circumstances of each of the members of the Group as set out in the table below:

Name of the Company	Level of materiality
The Company	RMB 50,000,000
Kelon Air-Conditioner, Kelon Refrigerator	RMB 10,000,000
Other members of the Group	RMB 100,000 to 10,000,000 (vary according to the size of operation of the company in question)

In addition, KPMG has requested the Group to require the banks with which the Group has set up bank accounts over the Investigation Period (the “Banks”) to reprint all the bank statements of the Group that were issued during the Investigation Period. KPMG compared the Banks’ reprinted bank statements with the bank statements provided to KPMG by the Group. During the comparison process, KPMG found that certain cash flows which were recorded in the Banks’ reprinted statements were not disclosed in the bank journals and bank statements of certain members of the Group which were provided by the Group. KPMG conducted investigation in respect of such off-balance-sheet cash flows.

(iii) *Investigation Period*

The period from 1 October 2001 to 31 July 2005.

(iv) *Source of information*

The main information and supporting evidence that KPMG has reviewed and relied on during the Investigation were information that KPMG received from the Group, statements made by the relevant members of management of the Group and the reprinted bank statements that KPMG obtained from the Banks as at 30 September 2005. Further, the scope of the Investigation is only limited to the members of the Group and does not include any other third party companies.

2. The Results of the Investigation

Cash Flow Category	Amounts Involved		Remarks
	Cash Outflows	Cash Inflows	
	<i>RMB (millions)</i>	<i>RMB (millions)</i>	
Abnormal Cash Flows between the Group and the Greencool Companies	(2,169)	2,462	2.1
Abnormal Cash Flows between the Group and the Suspected Companies	(1,902)	1,017	2.2
Total	<u>(4,071)</u>	<u>3,479</u>	(Note 2)

Note 1:

The Investigation has been conducted in accordance with the scope of the Investigation and work procedures provided in the letter of appointment signed between the Company and KPMG. As stated in 1(ii) above, the Investigation is focused on the material cash flows of the Group incurred during the Investigation Period, and is not intended to be a comprehensive audit on the financial statements of the Group. An investigation into cash flows is different from an audit of financial statements. As such, the amounts stated above are the results of the Investigation into the cash flows, but not the results as audited by KPMG.

Note 2:

The abnormal cash outflows incurred between the Group and the Greencool Companies or the Suspected Companies amounted to approximately RMB 4,071 million, while the abnormal cash inflows amounted to approximately RMB 3,479 million. From the above figures, it can be seen that the abnormal net cash outflows incurred between the Group and such companies during the Investigation Period is approximately RMB 592 million. Such net cash outflows represents only a minimum loss suffered by the Group. As there is no evidence as yet to indicate that the abnormal cash inflows are related to the abnormal cash outflows, the abnormal cash inflows may not be able to offset the abnormal cash outflows.

2.1 Abnormal Cash Flows between the Group and the Greencool Companies

Guangdong Greencool is interested in 262,212,194 Legal Person Shares in the Company, representing approximately 26.43% of the total issued share capital of the Company. Mr Gu Chu Jun, the former chairman of the Company, directly owns 60% of the total investment in Guangdong Greencool.

According to the results of the Investigation, the Abnormal Cash Flows incurred between the Group and the Greencool Companies during the Investigation Period mainly consist of:

- (i) the funds in the on-balance-sheet and off-balance-sheet bank accounts of some members of the Group have been transferred to the Greencool Companies without there being any business relationship between such members of the Group and the Greencool Companies, and the funds in the Greencool Companies have also been transferred to the on-balance-sheet and off-balance-sheet bank accounts of some members of the Group without there being any such business relationship. Such Abnormal Cash Flows amounted to cash outflows of approximately RMB 2,114 million and cash inflows of approximately RMB 2,462 million;
- (ii) the purchase from the Greencool Companies of an amount of raw materials which are not in proportion to the amount required by the business needs of the Group, and such Abnormal Cash Flows amounted to cash outflows of approximately RMB 13 million; and
- (iii) the payment of fees by the Group on behalf of certain authorised repairers to the Greencool Companies, and such Abnormal Cash Flows amounted to cash outflows of approximately RMB 42 million.

In light of the above, the Abnormal Cash Flows incurred between the Group and the Greencool Companies amounted to cash outflows of approximately RMB 2,169 million and cash inflows of approximately RMB 2,462 million.

KPMG conducted the Investigation with reference to the following list of the Greencool Companies provided by the Company in order to analyse whether the Abnormal Cash Flows were incurred with the Greencool Companies. The following are the Greencool Companies according to information obtained by the Company:

1. Guangdong Greencool;
2. Yangzhou Greencool Venture Capital Co., Ltd.;
3. Zhuhai Greencool Refrigerant Engineering Co., Ltd.;
4. Greencool Refrigerant (China) Co., Ltd.;
5. Beijing Greencool New Refrigerant Replacement Engineering Co., Ltd.;
6. Greencool Enterprise Development Company Limited;
7. Greencool Technology Environmental Protection Engineering (Shenzhen) Co., Ltd.;
8. Greencool Technology Development (Shenzhen) Company Limited;
9. Greencool Procurement Centre (Shenzhen) Co., Ltd.;
10. Hainan Greencool Environmental Protection Engineering Co., Ltd.;
11. Shanghai Greencool Environmental Protection Engineering Co., Ltd.;
12. Tianjin Greencool Environmental Protection Engineering Co., Ltd.;
13. Greencool (Zhuhai) Industrial Park Industrial Development Company;
14. Jiangxi Greencool Enterprise Development Company Limited; and
15. Aike Enterprises (Tianjin) Co., Ltd..

2.2 Abnormal Cash Flows between the Group and the Suspected Companies

According to the results of the Investigation, the Abnormal Cash Flows incurred between the Group and the Suspected Companies mainly consist of:

- (i) the funds of some members of the Group having been transferred to the Suspected Companies without there being any business relationship between such members of the Group and the Suspected Companies, or the funds of the Suspected Companies having been transferred to some members of the Group. Such Abnormal Cash Flows amounted to cash outflows of approximately RMB 1,142 million and cash inflows of approximately RMB 737 million;
- (ii) the purchase from the Suspected Companies of an amount of raw materials not in proportion to the amount required by the business needs of the Company, and without receiving part or all of the raw materials after prepayments made by the Group in respect of the majority of such purchases. Such Abnormal Cash Flows amounted to cash outflows of approximately RMB 455 million;
- (iii) the purchase of assets at overvalues from the Suspected Companies, and such Abnormal Cash Flows amounted to cash outflows of approximately RMB 58 million;
- (iv) the abnormal sales returns and receipt of funds from the Suspected Companies, and such Abnormal Cash Flows amounted to cash outflows of approximately RMB 240 million and cash inflows of approximately RMB 280 million; and
- (v) the abnormal consultancy and advisory fees paid to the Suspected Companies, and such Abnormal Cash Flows amounted to cash outflows of approximately RMB 7 million.

In light of the above, the Abnormal Cash Flows incurred between the Group and the Suspected Companies amounted to cash outflows of approximately RMB 1,902 million and cash inflows of approximately RMB 1,017 million.

In view of the following reasons, KPMG suspected that the third party companies with which the Group has incurred the above cash flows are associated with the Greencool Companies:

- (a) certain cash flows were incurred through some off-balance-sheet bank accounts or were off-balance-sheet transactions with some members of the Group, and other dealings in such off-balance-sheet bank accounts have been proved to be associated with the Greencool Companies;
- (b) through the interviews and enquiries conducted by KPMG, staffs of some of the members of the Group have confirmed that certain cash flows of the Suspected Companies are associated with the Greencool Companies;
- (c) although there are no documents to prove that certain cash flows of the Suspected Companies are associated with the Greencool Companies, such cash flows were incurred pursuant to the instructions of the former members of the management of the Company who are associated with the Greencool Companies (for example, Mr. Gu Chu Jun of the Company and other members of the management of the Company who have been arrested by the police department of the PRC) or current staff of the Company (such staff are currently assisting in the investigation by the police department of the PRC and the China Securities Regulatory Commission);
- (d) the raw materials which were the subject of certain prepayments were patented products manufactured by the Greencool Companies; and
- (e) according to the members of senior management of certain members of the Group, certain prepayments were transferred to the Greencool Companies subsequent to such prepayments being made to the relevant suppliers.

2.3 Other Abnormal Cash Flows

Apart from the above Abnormal Cash Flows between the Group and the Greencool Companies and the Suspected Companies, KPMG also found other Abnormal Cash Flows, including cash outflows of approximately RMB 208 million and cash inflows of approximately RMB 28 million. However, KPMG has insufficient evidence to establish that such cash flows are associated with the Greencool Companies or the Suspected Companies. Such amount includes approximately RMB 5 million of advertising costs and approximately RMB 4 million of legal fees, for which the Company has not received the corresponding services.

2.4 Abnormal Cash Flows within the Group

KPMG also found that certain Abnormal Cash Flows were only incurred between members of the Group (and such cash flows amounted to approximately RMB 801 million). There is no information to indicate that such cash flows are outflows or inflows involving companies which are not part of the Group. Such cash flows include mainly the abnormal withdrawal of the registered capital of some members of the Group, the transfer of funds without being supported by any business relationships, and bills discounted. KPMG has insufficient evidence to establish that such cash flows are associated with the Greencool Companies or the Suspected Companies.

2.5 Potential Impact and Damages to the Group

- 2.5.1 As stated in Note 2 to the table in Section 2 above, the abnormal net cash outflows incurred during the Investigation Period between the Group and the Greencool Companies or the Suspected Companies amounted to approximately RMB 592 million. Such net cash outflows represents only a minimum loss suffered by the Group. As there is no evidence as yet to indicate that the abnormal cash inflows is related to the abnormal cash outflows, the abnormal cash inflows may not be able to offset the abnormal cash outflows. As such, the actual impact and damages caused by the Abnormal Cash Flows to the Group may exceed the above net cash outflows;
- 2.5.2 During the Investigation, KPMG discovered that the Group has off-balance-sheet bank accounts, off-balance-sheet bank loans and bills that were issued or discounted but for which were not accounted. Since KPMG has not obtained all the reprinted bank statements of each member of the Group that were issued during the Investigation Period, plus the scope of the Investigation is only limited to the Group and not third party companies, KPMG may not be able to discover all of the Group off-balance-sheet bank accounts, off-balance-sheet bank loans and bills that were issued or discounted but for which were not accounted, and other assets, liabilities and guaranteed pledge that may not be reflected on the balance sheets;
- 2.5.3 As the Group's funds have been withdrawn, the Group's daily business operations may need to be funded through additional bank loans or by way of bills discounted, which may result in unnecessary interest costs and discounting fees to be borne by the Group. The finance costs incurred by the Group in the years 2002, 2003 and 2004 were approximately RMB 90.01 million, RMB 122.19 million and RMB 155.05 million respectively. As it is not possible to ascertain how much of the capital obtained through bank loans and by way of bills discounted were incurred due to the Group's shortage of capital as a result of its funds being withdrawn, KPMG cannot determine how much of the finance costs incurred in each of the years above were unnecessary interest costs and discounting fees borne by the Group as a result of its funds being withdrawn;
- 2.5.4 During the Investigation, KPMG also discovered evidence indicating that the Group may credit misleading increase in income by recognising the abnormal sales income obtained through sales to the Suspected Companies. If this is true, the Company needs to amend the relevant financial information and disclose such information according to the requirements of the relevant security laws and regulations; and
- 2.5.5 KPMG also discovered that the members of the Group are involved with certain fund transfers (involving an amount of approximately RMB 758 million). Although the relevant cash flows did not flow out of the Group, they may be treated as fund borrowing activities among enterprises as the relevant fund transfers are not supported by actual businesses. According to the relevant requirements of the "Lending General Provisions" 《貸款通則》 issued by The People's Bank of China, enterprises should not carry out loans and borrowings or disguised fund borrowing activities among themselves in breach of the country's regulations. As such, the Group may be enquired by the relevant supervising authority.

2.6 Recommendations

In light of the above, KPMG has given the following recommendations to the Company:

- (i) The Company may appoint solicitors to further investigate into the information obtained from the Investigation and determine whether the Company can use such information to pursue claims against the relevant companies;
- (ii) The Company may contact the relevant banks in relation to the off-balance-sheet bank accounts discovered during the Investigation and obtain such information of all of the accounts set up under the names of the members of the Group, so as to determine the number of off-balance-sheet accounts of the Group and thoroughly assess the impact of such off-balance sheet accounts to the Group (in particular whether any liabilities exist);
- (iii) Since the objective of the Investigation is mainly to review the material cash flows of the Group incurred during the Investigation Period, the Company may consider continuing to investigate the cash flows incurred during the Investigation Period which fall below the stated materiality, so as to evaluate whether these cash flows have any other impact on the Company's financial statements; and
- (iv) Since the findings of the Investigation may have significant impact on the Group's financial statements, KPMG recommends that the Company engage a professional institution to carry out a complete audit of the Group's financial statements, so as to have an overall evaluation of the possible impact of the above findings to the Group's financial statements.

THE OPINIONS OF THE BOARD OF DIRECTORS OF THE COMPANY (THE "BOARD") AND PROPOSED ACTIONS

1. The Opinions of the Board

- 1.1 The Board is of the view that the Investigation revealed some of the major Abnormal Cash Flows of the Group during the Investigation Period.
- 1.2 The Board is of the view that the results of the Investigation may be used by the Company as a basis of legal actions against Mr. Gu Chu Jun and the Greencool Companies.

2. Proposed Actions

The Company accepts the recommendations of KPMG, and propose to take the following actions in accordance with the opinions of KPMG:

- (i) The relevant departments of the Company have begun a comprehensive review and investigation of all of the bank accounts of the Company, in an effort to consolidate the control of bank accounts held by the Company;
- (ii) The Board will set up a department to investigate the cash flows which fall below the materiality stated by KPMG incurred by the Group during the Investigation Period;

- (iii) After obtaining relevant preliminary evidence relating to the damages which Mr. Gu Chu Jun and the Greencool Companies have caused to the interests of the Group, the Company shall provide such information to the Company's solicitors and initiate proceedings against Mr. Gu Chu Jun and the Greencool Companies in accordance with the relevant decisions of the Board so as to protect the Company and the interests of the shareholders of the Company as a whole; and
- (iv) The Company will assess the impact of the results of the Investigation on the financial statements of the Company in the audit of its financial statements for the financial year of 2005.

At the request of the Company, trading in H Shares of the Company was suspended with effect from 10:00 a.m. on 16 June 2005 pending the release of an announcement in relation to price sensitive information. Subject to the publication of a further announcement in relation to, amongst others, the financial, production and trading position of the Group, trading in H shares of the Company will remain suspended until further notice.

By order of the Board of
Guangdong Kelon Electrical Holdings Company Limited
Liu Cong Meng
Vice Chairman

As at the date of this announcement, the Company's executive directors are Mr. Gu Chu Jun, Mr. Liu Cong Meng, Mr. Li Zhen Hua, Mr. Yan You Song, Mr. Zhang Hong and Mr. Fang Zhi Guo; and the independent non-executive directors are Mr. Chan Pei Cheong, Andy, Mr. Li Kung Man and Mr. Xu Xiao Lu.

As disclosed in the Company's previous announcements, Mr. Gu, Mr. Yan and Mr. Zhang Hong had been formally arrested by the Foshan City Police. None of them can be contacted as at the date hereof. As such, Mr. Gu, Mr. Yan and Mr. Zhang Hong do not accept responsibility for the contents of this announcement.

Foshan City, Guangdong, the PRC, 20 January, 2006

“Please also refer to the published version of this announcement in China Daily”