

The following is the text of a report, prepared for the purpose of incorporation in this prospectus, received from the independent reporting accountants, KPMG, Certified Public Accountants, Hong Kong. As described in the section headed "Documents Available for Inspection" in Appendix VII to this prospectus, a copy of the accountants' report is available for inspection.



8th Floor
Prince's Building
10 Chater Road
Hong Kong

20th June, 2000

The Directors
Excel Technology International Holdings Limited
HSBC Investment Bank Asia Limited

Dear Sirs,

We set out below our report on the financial information relating to Excel Technology International Holdings Limited (the "Company") and its subsidiaries (hereinafter collectively referred to as the "Group") for each of the three years ended 31st December, 1999 (the "relevant period") for inclusion in the prospectus of the Company dated 20th June, 2000.

The Company was incorporated in Bermuda on 21st January, 2000 as an exempted company with limited liability under the Companies Act 1981 of Bermuda for the purpose of acting as the holding company of the subsidiaries now comprising the Group, details of which are set out in Section 6 below, which were acquired by the Group as part of a group reorganisation (the "Reorganisation"). References to the "Group" are to the Company and its subsidiaries, or, in respect of the period prior to the Reorganisation, the companies listed in Section 6 of this report that have been assumed by the Group pursuant to such Reorganisation.

We have examined the audited financial statements or unaudited management accounts of the companies now comprising the Group for the relevant period (or where the companies were incorporated at a date later than 1st January, 1997, from their respective dates of incorporation to 31st December, 1999) in accordance with the Auditing Guideline "Prospectuses and the Reporting Accountant" issued by the Hong Kong Society of Accountants. We have not audited any financial statements of the companies now comprising of the Group in respect of any period subsequent to 31st December, 1999.

No audited financial statements have been prepared for the Company since the date of its incorporation as the Company has not carried out any business other than the transactions related to the Reorganisation referred to herein and certain subsequent events as set out in Section 7 of this report. In addition, no audited financial statements have been prepared for Excel (BVI) Limited and Excel Technology International (BVI) Limited as there are no statutory audit requirements for these companies and as Excel Technology Center Limited (formerly known as Excel Solutions Limited) was declared dormant under section 344A of the Hong Kong

Companies Ordinance on 22nd July, 1998, it was not required to prepare audited financial statements for the years ended 31st December, 1998 and 1999. No audited financial statements of Excel Technology Center Limited were prepared for the year ended 31st December, 1997.

We have acted as auditors of all the other companies now comprising the Group for the year ended 31st December, 1999. For the years ended 31st December, 1997 and 1998, the financial statements of Excel Technology International (Hong Kong) Limited (formerly known as Excel Consultancy Limited), Excel Systems Limited and Excel International Limited were audited by Tam, Hui, Tse & Ho, Certified Public Accountants.

The auditors' report on the financial statements of Excel Technology International (Hong Kong) Limited for the year ended 31st December, 1997 was qualified by Tam, Hui, Tse & Ho, Certified Public Accountants, in respect of (i) a disagreement about accounting treatment on contract work in progress as the previous auditors considered that the contract work in progress was not calculated in accordance with Statement of Standard Accounting Practice No. 3 "Stocks and work in progress" issued by the Hong Kong Society of Accountants and (ii) a limitation in audit scope as the previous auditors were unable to obtain sufficient evidence to quantify the effects of any adjustments as a result of change in accounting policy for contract work in progress and to ascertain the value of contract work in progress at 31st December, 1997. The auditors' report on the financial statements of Excel Technology International (Hong Kong) Limited for the year ended 31st December, 1998 was qualified in respect of (i) a limitation in audit scope as the previous auditors were unable to obtain sufficient evidence as to the recoverability of amounts due from related parties and (ii) non compliance with an accounting standard relating to a change in accounting policy for contract work in progress. The auditors' reports on the financial statements of Excel Systems Limited for the years ended 31st December, 1997 and 1998 were qualified in respect of (i) a disagreement about accounting treatment as the previous auditors considered that a provision should be made against the amount due from the holding company of Excel Systems Limited and (ii) in respect of non preparation of consolidated financial statements. The auditors' reports on the financial statements of Excel International Limited for the years ended 31st December, 1997 and 1998 were qualified in respect of non preparation of consolidated financial statements and non disclosure of certain information as required by the Hong Kong Companies Ordinance. The auditors' reports on the financial statements of Excel Technology International (Hong Kong) Limited and Excel International Limited for the year ended 31st December, 1999 were qualified in respect of non preparation of consolidated financial statements. We have satisfied ourselves by carrying out additional procedures such that any material adjustments arising from the above audit qualifications have been incorporated into the Group's combined results for the relevant period presented in this report in accordance with the basis of presentation set out in Section 1 below.

The directors of the respective companies of the Group are responsible for the financial statements or, where financial statements are not prepared, management accounts, which give a true and fair view. In preparing the financial statements and management accounts which give a true and fair view, it is fundamental that appropriate accounting policies are selected and applied consistently, that judgements and estimates are made which are prudent and reasonable and that the reasons for any significant departure from applicable accounting standards are stated.

The summaries of the combined results of the Group for the relevant period and of the combined net assets of the Group as at 31st December, 1999 (the "Summaries"), for which the Directors of the Company are responsible, and which are set out in this report have been prepared by the Directors of the Company based on the audited financial statements or, where appropriate, unaudited management accounts of the companies now comprising the Group, after making such adjustments as are appropriate and on the basis set out in Section 1 below.

It is our responsibility to form an independent opinion on the Summaries. In our opinion, for the purpose of this report, and on the basis of presentation set out in Section 1 below, all adjustments considered necessary have been made and the Summaries set out below together with the notes thereto give a true and fair view of the combined results of the Group for the relevant period and of the combined net assets of the Group as at 31st December, 1999.

1. BASIS OF PRESENTATION

The summary of the combined results of the Group for the relevant period includes the results of the companies which now comprise the Group for the period from 1st January, 1997 to 31st December, 1999 as if the current group structure had been in existence and remained unchanged throughout the relevant period. The summary of the combined net assets of the Group as at 31st December, 1999 has been prepared to present the combined assets and liabilities of the Group as at that date as if the current group structure has been in existence as at that date.

All significant intra-group transactions and balances have been eliminated on combination.

2. PRINCIPAL ACCOUNTING POLICIES

(a) Basis of preparation

The financial information set out in this report has been prepared in accordance with the principal accounting policies set out below. These accounting policies conform with accounting principles generally accepted in Hong Kong. The information presented conforms with the disclosure requirements of the Growth Enterprise Market Listing Rules of The Stock Exchange of Hong Kong Limited as applicable to Accountants' Reports included in Listing Documents.

The measurement basis used in the preparation of the financial information set out in this report is historical cost as explained in the accounting policies set out below.

(b) 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 the profit and loss account as follows:

(i) *Income from fixed price contracts*

The Group enters into contracts with customers whereby a number of elements are bundled together in one contract - for example, resale of hardware and software products, sale of software licences and the development of customised software including completion of services provided for post delivery service support. The contract price is fixed prior to the commencement of the contract and the company refers to these as "fixed price contracts".

In instances where the contract price can be allocated on a reasonable basis into elements of resale of hardware and software products, sale of software licences and development of customised software, revenue is recognised in accordance with accounting policies as described in Section 2b(ii), (iii) and (iv) below.

Where the contract price cannot be allocated into individual elements of the fixed price contract, revenue is recognised by reference to the stage of completion of the fixed price contract, including post delivery service support, at the balance sheet date.

Work in progress is recorded in the balance sheet at the amount of contract costs incurred plus attributable profit less progress billings.

Amounts received before the related work is performed are included as deferred income in the balance sheet.

(ii) *Income from hardware and software resale*

Revenue is recognised when goods are delivered at the customers' premises, which is taken to be the point in time when the customer has accepted the goods and the related risks and rewards of ownership. Revenue is stated after deduction of any trade discounts.

(iii) *Sale of software licences*

Revenue from sale of software licences to end-users is recognised upon delivery of the software products to the customer when there are no significant post-delivery obligations.

(iv) *Development of customised software*

Revenue from the development of customised software is recognised in the profit and loss account by reference to the stage of completion of the customisation work, including post delivery service support, at the balance sheet date.

(v) *Income from time and material projects*

Time and material projects generally call for the company to provide technical support to customers.

Revenue from time and material projects is recognised in the profit and loss account upon the provision of services.

(vi) *Income from maintenance services*

Revenue from maintenance service contracts, which is received or receivable from customers once the maintenance service contracts are signed, is amortised and credited as revenue to the profit and loss account on a straight line basis over the term of the maintenance service contracts.

Where maintenance revenue is not separately invoiced, it is unbundled from license fees and deferred and credited as revenue to the profit and loss account on a straight line basis over the life of the maintenance service contract.

Other service revenue, primarily training and consulting, is recognised at the time the service is performed.

(vii) *Interest income*

Interest income from bank deposits is accrued on a time-apportioned basis on the principal outstanding and at the rate applicable.

(c) Property, plant and equipment

Property, plant and equipment are stated at cost less accumulated depreciation. Depreciation is calculated to write off the cost of such assets on a straight line basis at the following rates per annum:

Leasehold land	Over the unexpired term of the lease
Buildings	2.5%
Computer and office equipment	20% to 33 $\frac{1}{3}$ %
Furniture and fixtures	25%
Motor vehicles	30%

The carrying amount of property, plant and equipment is reviewed periodically in order to assess whether the recoverable amount has declined below the carrying amount. When such a decline has occurred, the carrying amount is reduced to the recoverable amount. The amount of the reduction is recognised as an expense in the profit and loss account. In determining the recoverable amount, expected future cash flows generated by the assets are discounted to their present values.

With effect from 1st January, 1999, following a re-appraisal of the estimated useful lives of computer and office equipment, the related useful lives were reduced from 5 to 3 years, resulting in an increased depreciation charge of HK\$883,007 for the year ended 31st December, 1999.

Gains or losses arising from the disposal of an item of property, plant and equipment are determined as the difference between the estimated net disposal proceeds and the carrying amount of the asset.

(d) Investments

Investment securities which are held on a continuing basis for an identified long term purpose are classified as "investment securities" and are stated in the statement of net assets at cost less provisions for diminution in value. Provisions are made when the fair values have declined below the carrying amounts, unless there is evidence that the decline is temporary, and are recognised as an expense in the profit and loss account, such provisions being determined for each investment individually.

Profits or losses on disposal of investment securities are determined as the difference between the estimated net disposal proceeds and the carrying amount of the investments and are accounted for in the profit and loss account as they arise.

(e) Research and development costs

Costs incurred in research and development of software products of the Group are expensed as incurred unless the development costs satisfy the criteria for the recognition of such costs as an asset. During the relevant period, all software research and development costs have been expensed as no expenses satisfied the criteria for capitalisation as an asset.

(f) Deferred taxation

Deferred taxation is provided under the liability method in respect of the taxation effect arising from all timing differences between the accounting and tax treatment of income and expenditure, which are expected with reasonable probability to crystallise in the foreseeable future.

Future deferred tax benefits are not recognised unless their realisation is assured beyond reasonable doubt.

(g) Translation of foreign currencies

The functional currency of the Group's operations is the Hong Kong dollar.

Foreign currency transactions during the period are translated into Hong Kong dollars at the exchange rates ruling at the transaction dates. Monetary assets and liabilities denominated in foreign currencies are translated into Hong Kong dollars at the exchange rates ruling at the balance sheet date. Differences arising on foreign currency translation are dealt with in the profit and loss account.

(h) Operating leases

Rentals payable under operating leases are charged to profit and loss account on a straight line basis over the periods of the respective leases.

(i) Borrowing costs

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

(j) Related parties

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

(k) Cash equivalents

Cash equivalents are short-term, highly liquid investments which are readily convertible into known amounts of cash without notice and which were within three months of maturity when acquired.

3. COMBINED RESULTS

The following is a summary of the combined results of the Group for the relevant period, prepared on the basis set out in Section 1 above:

	Note	Year ended 31st December,		
		1997 HK\$'000	1998 HK\$'000	1999 HK\$'000
		<i>(except per share data)</i>		
Turnover	(a)	77,126	74,984	98,071
Cost of computer hardware and software		<u>(18,373)</u>	<u>(17,773)</u>	<u>(43,623)</u>
		58,753	57,211	54,448
Other revenue	(b)	1,282	1,007	847
Other net income	(b)	11	—	108
Staff costs		(42,673)	(43,093)	(52,359)
Depreciation		(1,560)	(1,582)	(2,614)
Other operating expenses		<u>(13,722)</u>	<u>(10,485)</u>	<u>(10,749)</u>
Profit/(Loss) from operations		2,091	3,058	(10,319)
Finance costs	(c)	<u>(529)</u>	<u>(569)</u>	<u>(566)</u>
Profit/(Loss) from ordinary activities before taxation	(c)	1,562	2,489	(10,885)
Taxation	(f)	<u>(382)</u>	<u>(764)</u>	<u>227</u>
Profit/(Loss) for the year		<u>1,180</u>	<u>1,725</u>	<u>(10,658)</u>
Dividends	(g)	<u>—</u>	<u>—</u>	<u>(5,000)</u>
Basic and diluted earnings/(loss) per share (dollars)	(h)	<u>HK\$0.59</u>	<u>HK\$0.86</u>	<u>HK\$(5.33)</u>

Notes:

(a) **Turnover**

Turnover represents income from computer hardware and software sales and computer services rendered to customers during the year, net of returns and discounts allowed, after eliminating intra-Group transactions. The amount of each significant category of revenue recognised in turnover during the relevant period is as follows:

	Year ended 31st December,		
	1997	1998	1999
	HK\$'000	HK\$'000	HK\$'000
Fixed price projects	25,477	26,438	39,097
Hardware and software resale	22,982	15,506	35,699
Time and material projects	27,723	30,988	20,575
Maintenance services	944	2,052	2,700
	<u>77,126</u>	<u>74,984</u>	<u>98,071</u>

(b) **Other revenue and other net income**

	Year ended 31st December,		
	1997	1998	1999
	HK\$'000	HK\$'000	HK\$'000
Other revenue			
Interest income	217	339	202
Government grant and sponsorship income	—	434	—
Rental income from Net Fun Limited	—	—	180
Management fee income from Net Fun Limited	—	—	240
Recruitment services income	770	—	159
Payment in lieu of notice	25	167	66
Sundry income	270	67	—
	<u>1,282</u>	<u>1,007</u>	<u>847</u>
Other net income			
Profit on disposal of property, plant and equipment	11	—	108

(c) Profit/(Loss) from ordinary activities before taxation

Profit/(Loss) from ordinary activities before taxation is arrived at after charging:

	Year ended 31st December,		
	1997	1998	1999
	HK\$'000	HK\$'000	HK\$'000
(a) Finance costs:			
Interest on bank loans, overdrafts, and other borrowings repayable within five years	<u>529</u>	<u>569</u>	<u>566</u>
(b) To the extent that staff costs and direct overheads can be allocated by management on a reasonable basis to research and development activities, research and development expenses are as follows:			
— staff costs	8,153	9,216	9,758
— direct overheads	<u>2,097</u>	<u>2,013</u>	<u>2,053</u>
	<u>10,250</u>	<u>11,229</u>	<u>11,811</u>
Other costs such as depreciation of fixed assets and indirect overheads have not been included in the above analysis.			
(c) Other items:			
Auditors' remuneration	54	50	293
Rentals payable under operating leases in respect of land and buildings	<u>3,646</u>	<u>4,246</u>	<u>3,653</u>

(d) Directors' remuneration

Details of emoluments payable by the Group to the Directors of the Company in respect of the relevant period are as follows:

	Year ended 31st December,		
	1997	1998	1999
	HK\$'000	HK\$'000	HK\$'000
Basic salaries, housing and other allowances, and benefits in kind	<u>2,999</u>	<u>4,199</u>	<u>5,285</u>

An analysis of the Directors' emoluments by number of directors and emolument ranges is as follows:—

	Year ended 31st December,		
	1997 <i>Number</i>	1998 <i>Number</i>	1999 <i>Number</i>
Not more than HK\$1,000,000	2	1	1
HK\$1,000,001 — HK\$1,500,000	2	3	2
HK\$1,500,001 — HK\$2,000,000	—	—	1
	<u>4</u>	<u>4</u>	<u>4</u>

The four directors received emoluments of approximately HK\$567,000, HK\$1,112,000, HK\$1,320,000 and HK\$Nil for the year ended 31st December, 1997, approximately HK\$567,000, HK\$1,112,000, HK\$1,320,000 and HK\$1,200,000 for the year ended 31st December, 1998 and approximately HK\$1,789,000, HK\$976,000, HK\$1,320,000 and HK\$1,200,000 for the year ended 31st December, 1999. There were no amounts paid during the relevant period to former directors in connection with their retirement from employment with the Group.

There were no amounts paid during the relevant period to Directors as an inducement to join or upon joining the Group and no director waived any emoluments during the relevant period.

During the relevant period, no emoluments were paid or payable to independent non-executive directors of the Company.

(e) Senior management remuneration

Set out below are analyses of the emoluments (excluding amounts, if any, paid or payable by way of commission on sales generated by the employees concerned) of those employees of the Group who, not being directors of the Company, are among the top five paid individuals (including Directors of the Company and other employees of the Group) employed by the Group.

Aggregate emoluments

	Year ended 31st December,		
	1997 <i>HK\$'000</i>	1998 <i>HK\$'000</i>	1999 <i>HK\$'000</i>
Basic salaries, housing and other allowances, and benefits in kind	<u>910</u>	<u>975</u>	<u>975</u>

An analysis of the senior management's emoluments by number of employees and emolument ranges is as follows:

	Year ended 31st December,		
	1997 <i>Number</i>	1998 <i>Number</i>	1999 <i>Number</i>
Not more than HK\$1,000,000	<u>1</u>	<u>1</u>	<u>1</u>

No amounts were paid or payable to senior management as an inducement to join the Group or as compensation for loss of office during the relevant period.

(f) **Taxation**

The taxation charge comprises:

	Year ended 31st December,		
	1997 HK\$'000	1998 HK\$'000	1999 HK\$'000
Hong Kong profits tax charge for the year	390	823	—
(Over)/under provision in respect of prior years	(8)	1	3
Tax rebate from Hong Kong SAR Government	—	—	(73)
	<u>382</u>	<u>824</u>	<u>(70)</u>
Deferred taxation	—	(60)	(157)
	<u>—</u>	<u>(60)</u>	<u>(157)</u>
Taxation charge/ (credit)	<u>382</u>	<u>764</u>	<u>(227)</u>

The provision for Hong Kong profits tax is calculated separately on the taxable profit of each company comprising the Group at 16.5% and 16% during the years ended 31st December, 1997 and 1998, respectively.

No provision for Hong Kong profits tax has been made during the year ended 31st December, 1999 as the companies comprising the Group sustained losses for taxation purposes during the year.

(g) **Dividends**

No dividends has been paid or declared by the Company since its incorporation. Excel Technology International (Hong Kong) Limited proposed a final dividend to the former shareholder, Ms Zee Chan Mei Chu, Peggy, of HK\$5,000,000 in respect of the year ended 31st December, 1999, which was paid on 8th March, 2000.

(h) **Basic and diluted earnings/(loss) per share**

The calculation of the basic earnings/(loss) per share for each year is based on the combined profit/(loss) for each respective year and on the 2,000,000 shares of the Company outstanding after the Group's Reorganisation as if those shares had been outstanding for each year presented.

Diluted earnings/(loss) per share is the same as basic earnings/(loss) per share as there were no potential ordinary shares outstanding during any of the years presented.

(i) **Pension schemes**

The Group did not operate any retirement schemes for Directors or employees during the relevant period.

4. COMBINED NET ASSETS

		31st December, 1999
	<i>Note</i>	<i>HK\$'000</i>
Non-current assets		
Property, plant and equipment	(a)	8,362
Investment securities	(b)	<u>—</u>
		8,362

Current assets		
Work in progress	(c)	6,902
Trade receivables		20,519
Other receivables, deposits and prepayments	(d)	949
Taxation recoverable		56
Deposits with banks	(e)	100
Cash at bank and in hand		<u>6,140</u>
		34,666

Current liabilities		
Bank overdraft	(f)	1,699
Bank loans	(f)	376
Other loan	(g)	2,539
Trade payables		9,137
Other payables and accrued expenses		4,136
Deferred income	(h)	4,324
Amount due to a director	(i)	6,055
Dividend payable	3(g)	<u>5,000</u>
		33,266

Net current assets		<u>1,400</u>

Total assets less current liabilities		9,762
Non current liabilities		
Bank loans	(f)	<u>6,723</u>
Net assets		<u>3,039</u>

Notes:

(a) **Property, plant and equipment**

	31st December, 1999		
	Cost	Accumulated depreciation	Net book value
	<i>HK\$'000</i>	<i>HK\$'000</i>	<i>HK\$'000</i>
Land and buildings	7,856	712	7,144
Computer and office equipment	5,130	4,556	574
Furniture and fixtures	4,603	4,249	354
Motor vehicles	415	125	290
	<u>18,004</u>	<u>9,642</u>	<u>8,362</u>

All land and buildings are situated in Hong Kong under long leases. At 31st December, 1999, land and buildings with a net book value of HK\$7,144,000 were mortgaged to various banks to secure banking facilities granted to the Group (See Section 4(f)).

(b) **Investment securities**

The investment relates to a 10% interest in the share capital of Net Fun Limited, an unlisted Hong Kong incorporated company, which was retained by the Group as part of the Reorganisation at a consideration of HK\$1. Prior to the Reorganisation, the Group held a beneficial interest in 95% of the share capital of Net Fun Limited. Management intends to hold the investment for long term strategic purposes.

In addition to the 10% interest held by the Group in the share capital of Net Fun Limited, following the Reorganisation, the Company's principal shareholder had an additional beneficial interest of 90% in the share capital of Net Fun Limited held outside the Group.

(c) **Work in progress**

Work in progress represents the amount of contract costs incurred plus attributable profit less progress billings. All the amounts are expected to be recovered within one year.

(d) **Other receivables, deposits and prepayments**

	31st December, 1999
	<i>HK\$'000</i>
Utilities and rental deposits	876
Other debtors and prepayments	<u>73</u>
	<u>949</u>

Utilities and rental deposits which are expected to be recovered after more than one year amounted to HK\$870,000.

(e) **Deposits with banks**

The time deposit of HK\$100,000 was pledged by the Group in order to obtain a bank guarantee of HK\$100,000 in relation to the provision of services to a customer. The guarantee expired on 15th May, 2000 and the Group is arranging for the pledge to be released.

(f) Bank loans and overdrafts

At 31st December, 1999, bank loans and overdrafts were as follows:

	31st December, 1999 <i>HK\$'000</i>
Bank overdrafts	
- secured	583
- unsecured	<u>1,116</u>
	1,699
Bank loans (secured)	<u>7,099</u>
	<u>8,798</u>
The above bank loans and overdrafts were repayable as follows:	
- on demand or within a period not exceeding one year	<u>2,075</u>
- after one year but not more than two years	409
- after two years but not more than five years	1,711
- after five years	<u>4,603</u>
	<u>6,723</u>
	<u>8,798</u>

The banking facilities of the Group are secured by mortgages over the Group's land and buildings which had an aggregate carrying value of HK\$7,144,000 at 31st December, 1999 (See Section 4(a)). Such banking facilities, amounting to HK\$12,877,000 at 31st December, 1999, were utilised to the extent of HK\$7,700,000 at 31st December, 1999.

(g) Other loan

The loan was from Applied Research Council, bearing interest at the Hong Kong dollar prime rate and was repaid in cash in March 2000.

(h) Deferred income

Deferred income represents amounts received from customers before the related services have been rendered. All the amounts included in the deferred income are expected to be credited to the profit and loss account within one year.

(i) Amount due to a director

The amount represented loans from a director who is also the principal shareholder of the Company. The loan was provided to finance the Group's operations and is unsecured, interest free and was repaid in cash in March 2000.

(j) Deferred taxation

No deferred taxation has been provided for as at 31st December, 1999 as the Group had a potential deferred tax asset, the realisation of which is uncertain. The major components of the potential deferred tax asset not provided for as at 31st December, 1999 are as follows:

	31st December, 1999 <i>HK\$'000</i>
Future benefit of tax losses	1,840
Tax depreciation allowances in excess of related accounting depreciation	<u>(107)</u>
	<u><u>1,733</u></u>

(k) Distributable reserves

At 31st December, 1999 the Company had not been incorporated and hence the Company had no reserve available for distribution at that date.

(l) Commitments and contingencies**(i) Commitments under operating leases**

At 31st December, 1999, the Group had commitments to make payments in the next twelve months under operating leases which expire in the second to fifth years inclusive in respect of land and building amounting to HK\$2,872,000.

Subsequent to 31st December, 1999, the Group entered into a lease agreement to make payments in the year ending 31st December, 2000 under operating leases which expire after five years in respect of land and buildings amounting to HK\$4,875,000.

(ii) Capital commitments

The Group had no capital commitments outstanding at 31st December, 1999.

Subsequent to 31st December, 1999, the Group authorised contracts for an amount of HK\$5,600,000 in relation to the renovation of buildings.

(iii) Contingencies

A member of the Group (the "member") entered into an agreement on 1st May, 1993 to acquire from a third party vendor, inter alia, a software programme at a consideration of HK\$2,000,000, and paid an initial deposit of HK\$200,000. A dispute arose between the Group and the third party vendor in respect of the completeness of the software programme that was delivered and the representations made at the time of sale, and the Group rejected delivery of the software programme. On 9th January, 1995, the third party vendor filed a claim against the member for payment of HK\$1,800,000 plus damages and the costs of the legal action. However, the third party vendor did not place a security deposit for the litigation, and no further actions or proceedings had taken place in respect of the dispute since April, 1995. The Directors have been advised that as many years have elapsed since the commencement of the action, the member may apply to the court to strike out the claim of the third party vendor for want of prosecution. The court will take into account all circumstances of the case before exercising its discretion as to whether the striking out application would be granted. Ms. Peggy Chan has agreed to indemnify the member for any losses up to HK\$2,000,000 arising from the claim for the period up to and including 30th June, 2001.

It is the intention of the Directors to defend the claim vigorously in the event the third party vendor continues legal action. Accordingly, no provision for the claim and legal costs in respect thereof has been made in the financial statements of the Group.

Subsequent to 31st December, 1999, two members of the Group are in dispute with a firm of lawyers (the "Previous Lawyers") handling the Group's pre-listing restructuring, Convertible Notes issue and intellectual property registration in respect of several invoices for an aggregate amount of around HK\$2,300,000 rendered by the Previous Lawyers and are currently seeking a taxation of such invoices. The Group has already paid HK\$2,500,000 into court which covers the full amount of the bills and the costs of taxation. An amount of HK\$1,000,000 (plus taxation fees) has been paid out from the HK\$2,500,000 to the Previous Lawyers as interim payment without prejudice to demand for refund to the relevant members of the Group such amounts overpaid after taxation. The Previous Lawyers are required to lodge detailed bills of costs for the purpose of taxation within 45 days from 10th April, 2000. The members of the Group will raise objection to the detailed bills. The court will then decide and certify the ultimate amount to be paid by the relevant members of the Group. It is likely that the taxation process will take several months from the date the detailed bills are lodged with the court to a final assessment. As the dispute was in respect of work carried out subsequent to 31st December, 1999, no provision for the claim and legal costs in respect thereof has been made in the Group's financial statements. Ms. Peggy Chan has agreed to indemnify such two members of the Group for any loss in excess of the amount already paid by the two members of HK\$1,000,000, up to a limit of HK\$1,500,000 arising from the dispute for the period up to and including 31st December, 2000.

5 RELATED PARTY TRANSACTIONS

The following transactions represent material and significant related party transactions during the relevant period between the Group and related parties identified by management.

In the Directors' opinion, the transactions were entered into in the ordinary course of business and on normal commercial terms

	<i>Note</i>	Year ended 31st December,		
		1997	1998	1999
		<i>HK\$'000</i>	<i>HK\$'000</i>	<i>HK\$'000</i>
Rental receivable on land and buildings	(i)	—	—	180
Management fee receivable	(ii)	—	—	240
Housing allowance	(iii)	600	600	600
Interest paid to a related company	(iv)	—	60	—
Interest paid to a related party	(v)	60	—	—
Emoluments paid to Directors who are also initial management shareholders of the Company	(vi)	2,999	4,199	5,285

Notes:

- (i) This represents office rental receivable from Net Fun Limited. Subsequent to the Reorganisation, the Group holds a 10% interest in Net Fun Limited, in which the Company's principal shareholder and managing director, held a remaining beneficial interest of 90%. Rentals have been calculated based on the percentage of floor space occupied by Net Fun Limited.
- (ii) This represents management fee receivable from Net Fun Limited. The amount is based on estimated staff costs and overheads incurred by the Group.
- (iii) This represents housing allowance paid to a company, in which a director of the Company had a beneficial interest. The amount is based on the actual rentals payable in respect of the related property.

- (iv) This represents interest incurred on a loan provided to the Group by a related company which is beneficially owned by the Company's principal shareholder and managing director. The loan was unsecured and interest bearing at market rates.
- (v) This represents interest incurred on a loan provided to the Group by a related party of the Company's principal shareholder and managing director. The loan was unsecured and interest bearing at market rates.
- (vi) This represents emoluments paid to certain directors who are defined as initial management shareholders of the Company under the GEM Listing Rules during the relevant period. The total amount of directors' remuneration is disclosed in section 3(d).

Staff quarters have been provided to two directors during the relevant period. The related benefits in kind have been included in the emoluments of Directors and senior management detailed in Section 3 above.

At 31st December, 1999, the Company owed HK\$6,055,128 to the principal shareholder and managing director of the Company, which was repaid in March 2000.

At 31st December, 1999, two directors provided personal guarantees to banks for facilities of HK\$12,877,000 granted to the Group, of which \$7,700,000 was outstanding at 31st December, 1999, which were secured on the Group's land and buildings. On 9th May, 2000, these personal guarantees were released and replaced by guarantees given by the Company.

6. PARTICULARS OF SUBSIDIARIES

Immediately following the completion of the Reorganisation and for the purpose of these combined financial statements, the Company had the following subsidiaries:

Name of company	Place and date of incorporation/ establishment and operation	Attributable equity interest %		Issued share capital/ registered capital	Principal activities
		Direct	Indirect		
Excel (BVI) Limited	British Virgin Islands 4th January, 2000	100%		US\$5,000	Investment holding
Excel Technology International (Hong Kong) Limited (formerly known as Excel Consultancy Limited)	Hong Kong 10th November, 1987		100%	HK\$1,000	Development of computer software, systems integration and maintenance
Guangzhou Excel Technology Company Limited	The People's Republic of China 16th May, 2000		100%	HK\$705,000	Inactive

Name of company	Place and date of incorporation/ establishment and operation	Attributable equity interest %		Issued share capital/ registered capital	Principal activities
		Direct	Indirect		
Xena Trading Pte. Limited	Singapore 14th December, 1999		100%	S\$2	Inactive
Excel Systems Limited	Hong Kong 1st December, 1992		100%	HK\$1,000,000	(Note (i))
Excel International Limited	Hong Kong 13th May, 1988		100%	HK\$10,000	(Note (ii))
Excel Technology International (BVI) Limited	British Virgin Islands 1st October, 1999		100%	US\$1	Investment holding
Excel Technology Center Limited (formerly known as Excel Solutions Limited)	Hong Kong 5th December, 1996		100%	HK\$200,000	Dormant

Notes

- (i) The principal activity of Excel Systems Limited for the three years ended 31st December, 1999 was the resale of computer hardware and software packages. With effect from February, 2000, such activity has been undertaken by Excel Technology International (Hong Kong) Limited.
- (ii) The principal activity of Excel International Limited for the three years ended 31st December, 1999 was investment holding. Immediately following the completion of the Reorganisation, Excel International Limited no longer holds any investments and became inactive with effect from February 2000.

7. SUBSEQUENT EVENTS

The following events took place subsequent to 31st December 1999:

In February 2000, the Group completed the Reorganisation in preparation for the listing of the Company's shares on the Growth Enterprise Market of The Stock Exchange of Hong Kong Limited. As a result of the Reorganisation, the Company became the holding company of the Group in February 2000.

On 12th February, 2000, the Company entered into an agreement to issue convertible notes, and notes totalling US\$13.6 million were issued on 2nd March, 2000 pursuant to this agreement. The notes do not bear interest and have a maturity date of 2nd March, 2003 and shall automatically be converted into shares of the Company upon listing of the Company's shares on the Growth Enterprise Market, provided that such listing takes place within a specified period. If certain conditions contained in the related bond agreement are not

satisfied, the noteholders may request the Company to redeem the notes at a premium of between 10% and 30% depending on the circumstances.

On 14th March, 2000, the Company entered into an agreement with iBusiness Corporation, under which the parties have agreed to pursue a joint venture to establish the business of Application Service Provider ("ASP") under the brand name "i21", in which the Group holds a beneficial interest of 37.5% of the joint venture's capital. The Group anticipates investing HK\$37.5 million in the joint venture.

On 15th June, 2000, the convertible notes were converted into ordinary shares and 422,688 additional shares were issued upon conversion. HK\$6.1 million from the issue of the convertible notes was utilised to repay the loan from a major shareholder of the Company in March 2000.

On 15th June, 2000, the Company agreed to issue an additional convertible note totalling HK\$47,220,278. The note does not bear interest, matures on 31st May, 2002 and is convertible into shares of the Company. If the note is not converted to shares, the Company shall be required to redeem it at a premium of up to 125% of its principal amount on or before its maturity date.

Yours faithfully,
KPMG
Certified Public Accountants