

EURO TECH HOLDINGS CO LTD  
Form 20-F  
June 29, 2006

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**FORM 20-F**

**REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR  
(g) OF THE SECURITIES EXCHANGE ACT OF 1934**

**OR**

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934**

**For the fiscal year ended December 31, 2005**

**OR**

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934**

**SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934**

**For the transition period from** \_\_\_\_\_ **to** \_\_\_\_\_

Commission file number **000-22113**

**EURO TECH HOLDINGS COMPANY LIMITED**  
(Exact name of Registrant as specified in its charter)

**EURO TECH HOLDINGS COMPANY LIMITED**

(Translation of Registrant's name into English)

**British Virgin Islands**

(Jurisdiction of incorporation or organization)

**18/F Gee Chang Hong Centre, 65 Wong Chuk Hong Road, Hong Kong**

(Address of principal executive offices)

Securities registered or to be registered pursuant to Section 12(b) of the Act.

<b>Title of each class</b>	<b>Name of each exchange on which registered</b>
Not Applicable	

Securities registered or to be registered pursuant to Section 12(g) of the Act.

**Ordinary Shares, \$0.01 par value**

(Title of Class)

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act.

(Title of Class)

Indicate the number of issued and outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report.

**8,198,641 Ordinary Shares**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes

No

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes

No

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

Yes

No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one).

Large Accelerated Filer  Accelerated Filer  Non-Accelerated Filer

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes

No

Indicate by check mark which financial statement item the registrant has elected to follow.

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## INTRODUCTION

In this Form 20-F, reference to us, we, the Company and Euro Tech are to Euro Tech Holdings Company Limited and its subsidiaries unless otherwise expressly stated or the context otherwise requires.

### Forward Looking Statements

This annual report contains forward looking statements. Additional written or oral forward looking statements may be made by the Company from time to time in filings with the Securities and Exchange Commission (the Commission) or otherwise. Such forward looking statements are within the meaning of that term in Section 21E of the Exchange Act of 1934. Such statements may include, but not be limited to, projections of revenues, income, or loss, capital expenditures, plans for future operations, financing needs or plans, and plans relating to products or services of the Company, as well as assumptions relating to the foregoing. The words believe, expect, anticipate, estimate, project, and similar expressions identify forward looking statements, which speak only as of the date the statement was made. Forward looking statements are inherently subject to risks and uncertainties, some of which cannot be predicted or quantified. Future events and actual results could differ materially from those set forth in, contemplated by, or underlying the forward looking statements. Statements in this Annual Report, including those contained in the sections entitled Part I, Item 3D. Risk Factors and Item 5. Operating and Financial Review and Prospects and the notes to the Company's Consolidated Financial Statements, describe factors, among others, that could contribute to or cause such differences.





## GLOSSARY

The following glossary of terms may be helpful in understanding the terminology used in this Annual Report.

<b>Anaerobic:</b>	Treating waste water biologically in the absence of air.
<b>Ambient Air:</b>	Atmospheric air (outdoor as opposed to indoor air).
<b>Atomic Spectrometer:</b>	An analytical instrument used to measure the presence of an element in a substance by testing a sample which is aspirated into a flame and atomized. The amount of light absorbed or emitted is measured. The amount of energy absorbed or emitted is proportional to the concentration of the element in the sample.
<b>Coalescer:</b>	A process that coalesces smaller oil particles to form larger oil particles that can readily float to a tank's surface.
<b>Colorimeter:</b>	An analytical instrument that measures substance concentration by color intensity when the substance reacts to a chemical reagent.
<b>Flow Injection Analyzer:</b>	An analytical instrument with a special sampling system that uses a continuous stream of reagent(s) into which fluid samples are injected.
<b>Human Machine Interface Software:</b>	A type of software to interface (or coordinate) the interaction between machine or equipment and a human being.
<b>Lamella:</b>	Synthetic media installed in a clarifier tank to assist in particle flocculation (coming together in a floc or flakes )
<b>pH Controller:</b>	A process instrument that measures and controls the acidity or alkalinity of a fluid.
<b>Reagent:</b>	A chemical substance used to cause a chemical reaction and detect another substance.
<b>Mass Spectrometer:</b>	An analytical instrument that separates and identifies chemical constituents according to their mass-to-charge ratios and is used to identify organic compounds.
<b>Multi-Channel Digital Recorder:</b>	A device that measures and records more than one input of a digitized signal (signal in the form of pulses).

<b>Multi-Channel and Analogue Recorder:</b>	A device that measures and records more than one input of a signal in multi-voltage or milliampere (e.g. temperature in degrees Centigrade or degrees Fahrenheit).
<b>Process Analyzer:</b>	An analyzer that continuously samples, monitors and measures fluids or gases.
<b>Process Feed:</b>	Treating water that had been used industrially.
<b>Process Turbidimeter:</b>	An analytical instrument that continually measures the clarity of water based on light scattering or deflection.
<b>Programmable Logic Controller:</b>	A device used to automate the monitoring and control of an industrial plant.
<b>SCADA:</b>	Supervisory Control and Data Acquisition. An industrial device used to monitor and control an industrial plant's status and provide facilities to record the progress of a machine or project.
<b>Sequential Event Recorder:</b>	High-speed instrumentation that can record a sequence of events in chronological order in millisecond resolution.
<b>Telemetry:</b>	The science and technology of automatic measurement and transmission of data by wire, radio or other means from remote sources.
<b>Total Organic Carbon Analyzer:</b>	An analytical instrument that measures organic contamination in water.





**PART I****ITEM 1. IDENTITY OF DIRECTORS, SENIOR  
MANAGEMENT AND ADVISERS**

Not applicable.

**ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE**

Not applicable.

**ITEM 3. KEY INFORMATION****Item 3A. Selected Financial Data**

**SELECTED FINANCIAL INFORMATION**  
(Amounts expressed in thousands, except  
share and per share data and unless otherwise stated)

The selected consolidated income statement data for years ended December 31, 2005, 2004 and 2003, and the selected consolidated balance sheet data as of December 31, 2005 and 2004 set forth below are derived from audited consolidated financial statements of the Company included herein and should be read in conjunction with, and are qualified in their entirety by reference to such financial statements, including the notes thereto and Item 5. Operating and Financial Review and Prospects. The selected consolidated income statement data for the years ended December 31, 2002 and 2001 and the selected consolidated balance sheet data as of December 31, 2003, 2002 and 2001 set forth below are derived from audited consolidated financial statements of the Company which are not included herein.

	As of December 31,				
	2005	2004	2003	2002	2001
	US\$	US\$	US\$	US\$	US\$
<b>Balance Sheet Data:</b>					
Cash and cash equivalents	5,362	5,242	2,752	3,173	3,551
Working capital(1)	6,931	5,457	4,914	4,363	4,123
Total assets	17,377	15,699	13,308	12,716	11,379
Short-term debt(2)	0	0	0	0	90
Net assets	9,754	7,837	7,243	6,714	6,206
Capital Stock	74	68	45	32	32

(1) Current assets minus current liabilities.

(2) Short-term debt includes short-term borrowings and current portion of long-term bank loans.

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	For the Year Ended December 31,				
	2005	2004	2003	2002	2001
	US\$	US\$	US\$	US\$	US\$
<b>Income Statement Data:</b>					
<b>Revenue</b>	<b>31,250</b>	<b>32,282</b>	<b>27,442</b>	<b>23,497</b>	<b>19,685</b>
Cost of revenue	(24,681 )	(27,033 )	(22,805 )	(18,735 )	(15,396 )
Gross profit	6,569	5,249	4,637	4,762	4,289
Selling and Administrative Expenses	(5,418 )	(4,801 )	(4,108 )	(4,173 )	(3,734 )
Operating income	1,151	448	529	589	555
Interest Income	35	17	13	18	66
Other income, net	172	104	6	9	126
Income before taxes	1,358	569	548	616	747
Income taxes	(328 )	(167 )	(108 )	(123 )	(163 )
Share of equity in net income of affiliates	21	192	91	7	
Minority Interest	(318 )				
Net income	733	594	531	500	584
Net income per Ordinary Share					
Basic	0.11	0.09	0.08	0.08	0.09
Diluted	0.07	0.06	0.08	0.08	0.09
Weighted Average Number of Ordinary Shares Outstanding					
Basic	6,598,201	6,434,667	6,434,667	6,434,667	6,434,667
Diluted	10,698,482	10,034,687	6,434,667	6,434,667	6,434,667

The Company maintains its books and records in United States dollars ( US\$ ). Its subsidiaries, retail shops and affiliates maintain their books and records either in Hong Kong dollars or in Chinese Renminbi ( RMB ).

The Hong Kong dollar is freely convertible into other currencies (including the US dollar). Since 1983, the Hong Kong dollar has effectively been officially linked to the US dollar at the rate of approximately HK\$7.80 = US\$1.00. However, the market exchange rate of the Hong Kong dollar against the US dollar continues to be influenced by the forces of supply and demand in the

foreign exchange market. Exchange rates between the Hong Kong dollar and other currencies are influenced by the rate between the US dollar and the Hong Kong dollar.

Since 1994, the conversion of Renminbi into foreign currencies, including U.S. dollars, has been based on rates set by the People's Bank of China, which are set daily based on the previous day's interbank foreign exchange market rates. From 1994 through 2004, the official exchange rate for the conversion of Renminbi to U.S. dollars was generally been stable and maintained at the rate of approximately RMB8.30 = US\$1.00. However, in 2005, the Renminbi appreciated and at the end of 2005, the exchange rate was approximately RMB8.0702 = US\$1.00. The value of the Renminbi fluctuates and is subject to changes in PRC political and economic conditions.

The high, low and average exchange rate set forth below:

<u>The Following Months</u>	Low	High	Average
<b>US\$ to RMB</b>			
July 2005	8.1156	8.2865	8.2381
August 2005	8.1054	8.1162	8.1116
September 2005	8.0987	8.1118	8.1049
October 2005	8.0954	8.1078	8.1027
November 2005	8.0830	8.1068	8.0896
December 2005	8.0734	8.0860	8.0802
<b>US\$ to HK\$</b>			
July 2005	7.7650	7.7820	7.7749
August 2005	7.7692	7.7720	7.7718
September 2005	7.7538	7.7722	7.7626
October 2005	7.7447	7.7595	7.7557
November 2005	7.7513	7.7577	7.7547
December 2005	7.7529	7.7561	7.7543

Item 3B.

### **Capitalization and Indebtedness**



Not applicable.

*Item 3C.*

***Reasons for the Offer and Use of Proceeds***

Not applicable.

*Item 3D.*

## ***Risk Factors***

You should carefully consider all of the information set forth in this annual report and the following risk factors. The risks below are not the only ones we face. Additional risks not currently known by us or that we deem immaterial may also impair our business operations. Our business, financial condition or results of operations could be materially adversely effected by any of these risks. This annual report also contains forward looking statements that involve risks and uncertainties. Our results could materially differ from those anticipated in these forward looking

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statements as a result of certain factors, including the risks we face as described below and elsewhere. See Forward Looking Statements.

**Certain Risks Relating to Doing Business in Hong Kong and the People's Republic of China (the PRC or China).**

**PRC Sovereignty Over Hong Kong Still Developing**

- The Company's executive and principal offices are located in Hong Kong, a Special Administrative Region of China (or SAR; Hong Kong is sometimes herein referred to as the Hong Kong SAR).
- As provided in the Sino-British Joint Declaration on the Question of Hong Kong (the Joint Declaration) and the Basic Law of the Hong Kong SAR of China (the Basic Law), the Hong Kong SAR is provided a high degree of autonomy except in foreign and defense affairs. The PRC's political system and policies are not practiced in Hong Kong. Under this principle of "one country, two systems", Hong Kong maintains a legal system that is based on common law and is different from that of the PRC.
- The Company's results of operations and financial condition may be influenced by the political situation in Hong Kong and by the general state of the Hong Kong economy. See Economic Stability Uncertain.
- There can be no assurance that these past or any prospective future changes in political, economic or commercial conditions in Hong Kong and the PRC will not result in a material adverse effect upon the Company.

**Economic Stability Uncertain**

- Most economies in the Far East had suffered from large debts, declining company earnings and economic growth, and significant currency devaluation. Although the region, including the PRC, appears to have recovered, there can be no assurance that the recovery will continue.

**The PRC's Economic, Political and Social Conditions.**

- The PRC economy differs from the economies of most developed countries in many respects, including the amount of government involvement, level of development, growth rate, control of foreign exchange and allocation of resources. While the PRC economy has experienced significant growth in the past twenty years, growth has been

uneven, both geographically and among the various sectors of the economy. The PRC government has implemented various measures to encourage economic growth and guide the allocation of resources. Some of these measures benefit the overall PRC economy, but may also have a negative effect on us. For example, our financial condition and results of operations may be adversely affected by changes in tax regulations that are applicable to us.

- The PRC economy appears to be moving from a planned economy to a more market-oriented economy. Although the PRC government has implemented measures since the late 1970s emphasizing the utilization of market forces for economic reform, the reduction of state ownership of productive assets and the establishment of improved corporate governance in business enterprises, a substantial portion of productive assets in the PRC is still owned by the PRC government. In addition, the PRC government continues to play a significant role in regulating industry development by imposing industrial policies. The PRC government also exercises significant control over the PRC's economic growth through the allocation of resources, controlling payment of foreign currency-denominated obligations, setting monetary policy and providing preferential treatment to particular industries or companies. These actions, as well as future actions and policies of the PRC government, could materially affect our business and operations.
- The success of the Company's activities in the PRC depends on the Company's continued ability to overcome circumstances specifically effecting the industrial sector, including the relatively poor infrastructure, road transportation and communications network and an uncertain legal and regulatory environment.
- Over the past several years, the PRC's government has pursued economic reform policies including encouraging private economic activities and decentralization of economic deregulation. The PRC government may not continue to pursue these policies or may significantly alter them to our detriment from time to time without notice.

**Economic Reforms May Not Continue or Impact Positively On The Company; Changing Business Environment**

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Changes in policies by the PRC government resulting in changes in laws, regulations, or their interpretation, or the imposition of confiscatory taxes, restrictions on currency conversion and imports could materially and adversely effect our business and operating results. The nationalization or other expropriations of private enterprises by the PRC government could result in a loss of our investments in actual funds and time and effort, in China.

- The Company's results at times may also be adversely effected by:
  - changes in political, economic and social conditions in the PRC;
  - by changes in government policies such as changes in laws and regulations (or their interpretation);
  - the introduction of additional measures to control inflation;
  - changes in the rate or method of taxation;
  - imposition of additional restrictions on currency conversion remittances abroad;
  - reduction in tariff protection and other import restrictions;
  - a return to the more centrally-planned economy that existed previously

**We are subject to international economic and political risks, over which we have little or no control.**

- Doing business outside the United States subjects us to various risks, including changing economic and political conditions, exchange controls, currency fluctuations, armed conflicts and unexpected changes in United States and foreign laws relating to tariffs, trade restrictions, transportation regulations, foreign investments and taxation. We have no control over most of these risks and other unforeseeable risks and may be unable to anticipate changes in international economic and political conditions and, therefore, unable to alter our business practice in time to avoid the adverse effect of any of these changes.

**SARS and Avian Flu**

- From December 2002 to June 2003, the PRC and certain other countries experienced an outbreak of a new and highly contagious form of atypical pneumonia now known as severe acute respiratory syndrome, or SARS. On July 5, 2003, the World Health Organization declared that the

SARS outbreak had been contained. Since September 2003, however, a number of isolated new cases of SARS have been reported, most recently in central China in April 2004. During May and June of 2003, many businesses in the PRC were closed by the PRC government to prevent transmission of SARS. Recently, concerns have been raised with respect to the spread of avian flu in various regions in the PRC. Any recurrence of the SARS outbreak, outbreak of avian flu or the development of a similar health hazard in the PRC, may adversely affect our business and operating results. For instance, a recurrence of SARS, outbreak of avian flu or any other epidemic may reduce the level of economic activity in affected areas and, as a result, have a material and adverse effect on our business. In addition, health or other government regulations may require temporary closure of offices, or the offices of our suppliers and customers, which will severely disrupt our business operations and have a material adverse effect on our financial condition and results of operations.

**Uneven Economic Growth**

- The PRC's economy has experienced significant growth in recent years, but that growth has been uneven among various geographic regions and economic sectors. Economic reforms and growth in the PRC have been more successful in certain provinces than in others, and the continuation or increase of such disparities could adversely effect political or social stability.

**PRC Inflation**

- In recent years, the PRC has not experienced significant inflation, and thus inflation has not had a significant effect on our business historically. In response to the increased inflation rate during 2004, the Chinese government announced measures to restrict lending and investment in the PRC in order to reduce inflationary pressure on the PRC's economy; and the inflation rate reduced in 2005. If the PRC experiences increased inflation in future, the Chinese government may introduce further measures intended to reduce the inflation rate in the PRC. Any such measures adopted by the Chinese government may not be successful in reducing or slowing the increase in the PRC's inflation rate. Sustained or

increased inflation in the PRC may have an adverse impact on the PRC's economy and may materially and adversely affect our business and financial results.

**Uncertain Legal System and Application of Laws**

- The legislative trend in the PRC over the past decade has been to enhance the protection afforded to foreign investment and allow for more active control by foreign parties of foreign invested enterprises. There can be no assurance that this will continue. In addition, as the PRC economy, business and commercial framework and legal system all continue to develop, that development may adversely affect the Company's activities in the PRC or the ability of the Company to enter into Sino-foreign agreements.

**PRC Legal System Business Laws Developing**

- The PRC does not yet possess a comprehensive body of business law or a consolidated body of laws governing foreign investment enterprises. As a result, the enforcement, interpretation and implementation of existing laws, regulations or agreements may be sporadic, inconsistent and subject to considerable discretion. The PRC's judiciary has not had sufficient opportunity to gain experience in enforcing laws that exist, leading to a higher than usual degree of uncertainty as to the outcome of any litigation. As the legal system develops, entities such as the Company may be adversely effected by new laws, changes to existing laws (or interpretations thereof) and preemption of provincial or local laws by national laws. Even when adequate law exists in the PRC, it may not be possible to obtain speedy and equitable enforcement of the law.

**Government Currency Controls**

- The PRC government imposes control over its foreign currency reserves in part through direct regulation of the conversion of its currency, Renminbi ( RMB ) into foreign exchange and through restrictions on foreign imports. The conversion of RMB into Hong Kong and United States Dollars ( U.S. Dollars ) must be based on rates set by the People's Bank of China ( PBOC ), which rates are set daily based on the previous day's Chinese interbank foreign exchange market rate with reference to current exchange rates on the world financial markets.
- Although the RMB to U.S. dollar exchange rate has generally been stable since January 1, 1994 and the PRC



- government has stated its intention to intervene in the future to support the value of the RMB, there can be no assurance that exchange rates will not again become volatile or that the RMB will not devalue further against the U.S. dollar or Hong Kong dollar. Exchange rate fluctuations may adversely effect the Company because of foreign currency denominated liabilities, and may materially adversely effect the value, translated into U.S. dollars, of the Company's net fixed assets situated and to be situated in the PRC, earnings and dividends.

**Turbulent Relations with the United States of America ( United States )**

- Differences between the United States and PRC governments on some political issues continue occasionally to color the relationship. These occasional controversies could materially and adversely effect our business and operations. Political or trade friction between the two countries could also materially and adversely effect the market price of our Ordinary Shares, whether or not they adversely effect our business.

**Certain Risks Relating to Company's Business.**

**We Have Made and May Make Further Acquisitions Without Your Approval**

- Although we endeavor to evaluate the risks inherent in any particular acquisition, there can be no assurance that we will properly or accurately ascertain all such risks. We will have virtually unrestricted flexibility in identifying and selecting prospective acquisition candidates and in deciding if they should be acquired for cash, equity or debt, and in what combination of cash, equity and/or debt.

In October of 2005, we completed our acquisition of 51% of the capital stock of two entities, making the two entities our majority owned subsidiaries. We will not seek stockholder approval for any additional acquisitions unless required by applicable law and regulations. Our stockholders will not have an opportunity to review financial and other information on acquisition candidates prior to consummation of any acquisitions under almost all circumstances.

Investors will be relying upon our management, upon whose judgment the investor must depend, with only limited information concerning management's specific intentions.

There can be no assurance that the Company will locate and successfully complete such additional acquisition, or any acquisition will perform as anticipated, will not result in significant unexpected liabilities or will ever contribute significant revenues or profits to the Company or that the Company will not lose its entire investment in any acquisition candidate.

**Dependence upon Management**

- The Company is dependent upon the services of its executive officers, in particular Mr. T.C. Leung, the Chairman of the Company's Board of Directors and its Chief Executive Officer. The business of the Company could be adversely effected by the loss of services of, or a material reduction in the amount of time devoted to the Company by its executive officers. The Company does not maintain Key Man life insurance on the lives of any of its officers and directors. See Item 6. Directors, Senior Management and Employees.

**Adverse Impact upon Company of PRC's Credit Restrictions**

- The Company faces competition from other distributors of substantially similar products and manufacturers themselves, both foreign and Chinese. The Company faces its principal competition from foreign manufacturers and other distributors of their products situated in Hong Kong and the PRC. Competition may cause purchaser demands for price reductions and reduced profit margin.

**Competition with Vendors**

- As the Company plans to assemble products of the kind that it presently distributes, the Company may directly compete with certain of its vendors. Any such direct competition may adversely effect its relationship with its vendors. See Item 4. Information on the Company.

**Dependence on Vendors;  
Lack of Long  
Term Agreements**

- The Company distributes supplies manufactured by a number of vendors, including Hioki E.E. Corp. ( Hioki ), US Filter/Chemical Feed and Disinfection Group ( USF ) and Lachat Instruments, Inc. ( Lachat ), which are the

Company's largest suppliers. The Company has only a letter from Hioki appointing the Company as Hioki's sales representative in the PRC, Hong Kong and Macau. Although alternative sources of supply exist, there can be no assurance that the termination of the Company's relationship with any of the above or other vendors would not have a short-term adverse effect on the Company's operations due to the Company's dependence on these vendors.

**Risks Relating to the Company  
Itself. Control by T.C. Leung;  
Potential Conflict of Interests**

- T.C. Leung, the Company's Chairman of the Board and Chief Executive Officer, as a practical matter, is able to nominate and cause the election of all the members of the Company's Board of Directors, control the appointment of its officers and the day-to-day affairs and management of the Company. As a consequence, Mr. Leung can have the Company managed in a manner that would be in his own interests and not in the interests of the other shareholders of the Company. See Item 7. Major Shareholders and Related Party Transactions and Item 6. Directors, Senior Management and Employees.

**Certain Legal Consequences  
of Incorporation in the**

**British Virgin Islands;  
Rights of Shareholders  
Not as Extensive as in  
U.S. Corporations**

- Principles of British Virgin Islands ( BVI ) corporate law relating to such matters as the validity of the Company procedures, the fiduciary duties of management and the rights of the Company's shareholders may differ from those that would apply if the Company were incorporated in a jurisdiction within the United States.
- The rights of shareholders under British Virgin Islands law are not as extensive as the rights of shareholders under legislation or judicial precedent in many United States jurisdictions. Under United States law, majority and controlling shareholders generally have certain fiduciary responsibilities to the minority shareholders. United States shareholder action must be taken in good faith and actions by controlling shareholders in a United States jurisdiction and executive compensation which are obviously unreasonable may be declared null and void.

- The BVI law protecting the interests of the minority shareholders is not as protective in all circumstances as the law protecting minority shareholders in United States jurisdictions. The shareholders of the Company may have more difficulty in protecting their interests in the face of actions by the Company's Board of Directors, and may have more limited rights, than they might have as shareholders of a company incorporated in many United States jurisdictions.

**Anti-takeover Provisions**

- The Company has 5,000,000 shares of blank check preferred stock authorized. The blank check preferred stock is intended to strengthen the Company's ability to resist an unsolicited takeover bid and may be deemed to have an anti-takeover effect. The Board of Directors has the right to fix the rights, terms and preferences at the time of issue of blank check preferred stock without further action by our shareholders.

**Uncertainty of  
Enforcing United  
States Judgments**

- There is some uncertainty whether BVI courts would enforce judgments of the courts of the United States and of other foreign jurisdictions, or enforce actions brought in the BVI which are based upon the securities laws of the United States. A final monetary judgment obtained in the United States will be treated as a cause of action in itself by the BVI courts so that no retrial of the issues would be necessary, provided that material preconditions are met and the proceedings pursuant to which judgment was obtained were not contrary to the rules of natural justice.
- All of the Company's directors and executive officers reside outside of the United States, service of process upon the Company and such persons may be difficult to effect in the United States upon all such directors and officers.
- All of the Company's assets are and will be located outside of the United States, in Hong Kong and the PRC, and any judgment obtained in the United States may not be enforced in those jurisdictions. Hong Kong courts will not directly enforce against the Company or such persons judgments obtained in the United States. There is also substantial doubt as to the enforceability in the PRC of actions to enforce judgments of the United States courts arising out of or based on the ownership of the securities, including judgments arising out of or based on the civil liability provisions of

United States federal or state securities laws or otherwise. See Certain Legal Consequences of Incorporation in the British Virgin Islands; Rights of Shareholders not as Extensive as in U.S. Corporations.

**Being a Foreign Private Issuer Exempts Us From Certain Securities and Exchange Commission ( Commission ) and National Association of Securities Dealers Automated Quotation System ( NASDAQ ) Requirements**

We are a foreign private issuer within the meaning of rules promulgated under the Securities Exchange Act of 1934 (the Exchange Act ). As such, we are exempt from certain provisions applicable to United States public companies including:

- the rules under the Exchange Act requiring the filing with the Commission of quarterly reports on Form 10-Q or current reports on Form 8-K;
- the sections of the Exchange Act regulating the solicitation of proxies, consents or authorizations in respect of a security registered under the Exchange Act;
- the provisions of Regulation FD aimed at preventing issuers from making selective disclosures of material information;
- the sections of the Exchange Act requiring insiders to file public reports of their stock ownership and trading activities and establishing insider liability for profits realized from any short-swing trading transaction (i.e., a purchase and sale, or sale and purchase, of the issuer's equity securities within less than six months);

Because of these exemptions, investors are not afforded the same protections or information generally available to investors holding shares in public companies organized in the United States.

**Our Securities Must Continue To Meet Qualitative And Quantitative Listing Maintenance Criteria For The NASDAQ SmallCap Market**

- Our securities are quoted and traded on the NASDAQ SmallCap Market. There can be no assurance that we will continue to meet both the qualitative and quantitative criteria for continued quotation and trading of our securities on the NASDAQ SmallCap Market. That criteria, which undergoes periodic NASDAQ review.

If we are unable to meet the continued quotation criteria of the NASDAQ SmallCap Market and are suspended from trading on these markets, our securities could possibly be traded in the over-the-counter market and be quoted in the so-called pink sheets or, if then available, the OTC Bulletin Board. In such an event, an investor would likely find it more difficult to dispose of, or even obtain accurate quotations of, our securities. See - We Are Also Required To Meet Certain, But Not All NASDAQ Corporate Governance Criteria.

**We Are Also Required To Meet Certain, But Not All, NASDAQ Corporate Governance Criteria**

- Although, in the past, we have been able to satisfy NASDAQ's SmallCap Market corporate governance criteria, those criteria are difficult to comply with and include, among other things:
  - a heightened degree of independence of members of the board of directors with independent directors to, among other things: hold regular meetings among themselves only;
  - establishment of a code of conduct addressing compliance with laws; and
  - a limit on payments to independent directors and their family members (other than for services on the board of directors).

These corporate governance requirements and a strict definition of independent director make it more difficult to find independent directors for our Board of Directors. There is intense competition for qualified independent directors, including those persons with accounting

experience and financial statement acumen to serve on audit committees. We believe that continued compliance with NASDAQ's corporate governance requirements may be difficult and increase our costs and expenses as the costs of finding and compensating independent directors escalate and the costs of administering their new powers and responsibilities is an added financial burden. If we are unable to attract and keep a sufficient number of independent directors willing to take on the responsibilities imposed by such rules on what we believe to be commercially reasonable terms, our securities may be delisted from NASDAQ. (See "Being a Controlled Company Exempts Us From Certain Other NASDAQ Corporate Governance Criteria.")

**Being a Controlled Company Exempts Us From Certain Other NASDAQ Corporate Governance Criteria**

As a result of T.C. Leung, the Company's Chairman of the Board and Chief Executive Officer beneficially owning in excess of the majority voting power of our Ordinary Shares, we are a controlled company as that term is defined in NASDAQ's rules and regulations. As a controlled company, we are not required to comply with certain NASDAQ corporate governance criteria, including, among other things, the requirements that the majority of our Board be independent directors, and their having the authority to approve director nominations and executive officer compensation.

**We Are Not Subject To Various Corporate Governance Measures, Which May Result In Shareholders Having Limited Protections**

Recent Federal legislation, including the Sarbanes-Oxley Act of 2002 ("SOX"), has resulted in the adoption of various corporate governance measures by securities exchanges and NASDAQ designed to promote the integrity of the corporate management and the securities markets. Being a controlled company, we will be exempt from many, but not all, of those requirements. Furthermore, the absence of such practices with respect to our Company may leave our shareholders without protections against interested director transactions, conflicts of interest and similar matters.

**We May Be Exposed  
To Potential Risks  
Relating To Our Internal  
Controls Over Financial  
Reporting And Having  
Those Controls Attested  
To By Our Independent  
Auditors**

- Pursuant to Section 404 of SOX, the SEC adopted rules requiring public companies to include a report of management on the company's internal controls over financial reporting in their annual reports, including Form 20-F. In addition, the independent registered public accounting firm auditing a company's financial statements must also attest to and report on management's assessment of the effectiveness of a company's internal controls over financial reporting as well as the operating effectiveness of a company's internal controls. We were not subject to these requirements for the fiscal year ended December 31, 2005. We are evaluating our internal control systems in order to allow our management to report on, and our independent auditors attest to, our internal controls, as a required part of our Annual Report on Form 20-F beginning with our report for the fiscal year to end December 31, 2007.

While we expect to expend significant resources in developing the necessary documentation and testing procedures required by SOX, there is a risk that we will not comply with all of these requirements. At present, there is no precedent available with which to measure compliance adequacy. Accordingly, there can be no assurance that we will receive a positive attestation from our independent auditors.

In the event we identify significant deficiencies or material weaknesses in our internal controls that we cannot remediate in a timely manner or we are unable to receive a positive attestation from our independent auditors with respect to our internal controls, investors and others may lose confidence in the reliability of our financial statements, our ability to obtain equity or debt financing could suffer and the market price of our shares could decline.



**The Market Price Of Our Securities Has Been Fluctuating Widely**

- During the past five years, the market price of our Ordinary Shares has been subject to wide fluctuations. Additionally, the Company knows of no reason for these wide fluctuations. See Item 9.A - Markets.

**There Are Risks In Purchasing Low-Priced Securities**

- If our securities were to be suspended or delisted from the NASDAQ SmallCap Market, they could be subject to rules under the Securities Exchange Act of 1934 ( Exchange Act ) which impose additional sales practice requirements on broker-dealers who sell such securities to persons other than established clients and accredited investors (for example, individuals with a net worth in excess of US\$1,000,000 or an annual income exceeding US\$200,000 or US\$300,000 together with their spouses). For transactions covered by such rules, a broker-dealer must make a special suitability determination of the purchaser and have received the purchaser's written consent to the transaction prior to the sale. Consequently, such rules may affect the ability of broker-dealers to sell our securities and the ability to sell any of our securities in any secondary market that may develop for such securities.

The SEC has enacted rules that define a penny stock to be any equity security that has a price (as therein defined) of less than US\$5.00 per share or an exercise price of less than US\$5.00 per share, subject to certain exceptions, including securities listed on the NASDAQ SmallCap Market or on designated exchanges. For any transaction involving a penny stock, unless exempt, the rules require the delivery, prior to any transaction in a penny stock, of a disclosure statement prepared by the SEC relating to the penny stock market. Disclosure also has to be made about the risks of investing in penny stocks in both public offerings and in secondary trading. In the event our securities are no longer listed on the NASDAQ SmallCap Market or are not otherwise exempt from the provisions of the SEC's penny stock rules, such rules may also affect the ability of broker-dealers and investors to sell our securities.

**There Is No Assurance Of A**

- There can be no assurance that a trading market for our Ordinary Shares will continue.

**Continued Public Market**

**For Our Securities**

**ITEM 4.**

**INFORMATION ON THE COMPANY**

**Item 4A.**

**History and Development of the Company**

The Company was organized under the laws of the British Virgin Islands on September 30, 1996 for the purposes of raising capital and for acquiring all the outstanding capital stock of Euro Tech (Far East) Limited, a Hong Kong corporation ( "Far East" ). The Company successfully completed a public offering ( "Public Offering" ) receiving net proceeds of approximately US\$1,817,000, in March 1997. Contemporaneously, the Company acquired all the issued and outstanding capital stock of Far East and it became a wholly-owned subsidiary and the primary operational entity of the Company. Far East was established in 1971 and has been in continuous operation since that time. See Item 5. "Operating and Financial Review and Prospects." Far East engages in its core business of distributing various equipment, instruments and supplies used in connection with the treatment, analysis and testing of water and wastewater.

Far East was established in 1971 under the name of Eurotherm (Far East) Limited, to market and distribute its ex-parent's industrial control equipment in Hong Kong and Southeast Asia, and expanded its activities into the PRC in 1973. In the early 1980's, Far East began distributing high-tech equipment manufactured in the United States, Europe and Japan within the PRC, in addition to its distribution of its parent's products. In 1988, the activities of the parent and Far East were separated into Eurotherm International and Far East. In or around 1994, all the capital stock of Far East was purchased by its management, principally T.C. Leung, the Company's Chairman of the Board of Directors and Chief Executive Officer. See Item 7. "Major Shareholders and Related Party Transactions."

During Fiscal 2005, we completed our plan to increase our equity position in Yixing Pact Environmental Technology Company Limited ( "Yixing" ) and Pact Asia Pacific Limited ( "Pact" ). We had previously owned thirty (30%) percent of their capital stock. With the addition of twenty-one (21%) percent of Pact's and Yixing's capital stock in October 2005, they became our majority-owned subsidiaries.

**Item 4B.**

**Business Overview**

The Company is engaged in three different major activities:

(1) *Trading.*

The Company is primarily a distributor of a wide range of advanced water treatment equipment (including chlorination equipment), laboratory instruments, analyzers, test kits and related supplies and power generation equipment (including recorders and power quality analyzers).

The Company acts as an exclusive and non-exclusive distributor for well-known manufacturers of such equipment, primarily to commercial customers and governmental agencies or instrumentalities in Hong Kong and the PRC. During its fiscal year ended December 31, 2005 ( Fiscal 2005 ) the Company distributed products to in excess of 1,000 customers, including the Hong Kong Environmental Protection Department, China Light & Power Co., Ltd., Hong Kong Electric Co., Ltd., the Kowloon-Canton Railway Corporation, China's National Environmental Protection Agency, Harbin Water, Harbin Environmental Monitoring Center, Inbev Group, Beijing Huai Rou and Shunyi District CDC, Liaoning Jinzhou Wastewater Treatment Plant and to subdistributors located in Hong Kong, the PRC and Macau. These products are manufactured by a substantial number of major American, European and Japanese corporations, including Hioki, USF and Lachat, which are the Company's largest suppliers, with purchases from them accounting for approximately 15%, 4% and 7%, respectively, of the Company's Fiscal 2004 sales and approximately 29%, 8% and 6%, respectively, of the Company's sales during Fiscal 2005.

The Company distributes products through its Hong Kong headquarters, its representative offices located in Beijing, Shanghai, Guangzhou, Chongqing, Xi'an, Shenyang, Wuhan and Fuzhou, and through non-exclusive arrangements with independent sub-distributors located in Hong Kong, the PRC and Macau.

The Company believes that the continuing growth of industrial activity in particular and overall business activity in general, in the PRC over the last five years has produced a strong and increasing demand for its products in the PRC. The Company further believes that in the near future the need and demand for the products it distributes will grow as a result of increased regulations governing the environment and industrial pollution output, projected growing demands of the PRC's population for clean water and a healthier and safer environment, the potential for the contamination or depletion of existing clean fresh water sources and the burgeoning demand for power in the PRC.

(2) *Manufacturing.*

The Company believes that by assembling the products it distributes, it may realize increased gross profit margins and greater revenues and net income than if it remained only a distributor of such products with sales of the Company first product offering, an Infrared Photometric Oil Analyzer, commencing in 2003. Similarly, the Company believes that by expanding its regional sales efforts in the PRC, it may realize higher revenues and net income.

(3) *Engineering.*

In January 2002, we acquired a 30% equity interest in Pact and Yixing. Pact and Yixing were privately owned engineering firms situated in Shanghai specializing in the design, manufacture and operation of water and wastewater treatment plant in several industries situated in China, Pact and Yixing, through associates and business alliances, also conduct similar operations in the Middle East.

In October 2005, we, through our subsidiary Euro Tech (Far East) Limited ( Far East ) purchased approximately 21% of the issued and outstanding shares of Pact and Yixing for approximately US\$1,000,000 from Tamworth Industrial Limited ( Tamworth ).

Also, during Fiscal 2005, our Special Products and Engineering Department continued to take on engineering projects in the wastewater treatment for power generation industries. This department is currently working on a project to treat 40,000 cubic meters of wastewater per day for a power plant in Inner Mongolia.

#### **Expansion Plans for the Near Term**

Acid rain and sulphur dioxide emissions are serious problems in China, we are planning to expand our activities in the air pollution control business by investing or acquiring some interest in companies involved in (i) the dust removal and/or (ii) the flue gas desulphurization for power plant industries and other similar industries.

We have engaged a business consultant to assist in this search, and are in discussions with several companies engaged in manufacturing these products and equipment and in engineering companies which design and build pollution control systems. We anticipate that the costs of any such acquisition would be drawn from our general working capital and, possibly, by private sales of our securities including the potential exercise by officers and directors of their options. We have no commitments or indications of interest for the private sales of our securities and only a few persons have exercised their options to date.

As revenue and income from trading activities are declining gradually due to a greater number of our significant suppliers apparently plan to market and sell their products into the China market through other distributors as well as the Company. Many of these other distributors are local Chinese companies and can operate with a lower overhead.

Our plans for the near term, include, but are not limited to the following:

- Continued use of our retail shops to sell low-tech products such as those manufactured by Hioki and our own products. We believe that these shops are operating with a lower overhead than the rest of the Company.
- We believe that the continued low-tech product sales through our retail shops coupled with our on-line product sales will allow us to continue to offer products at lower prices than our competitors.

Having low-tech products offered through our retail shops and the availability of on-line product offering are anticipated to allow our sales force to focus on high-tech and other products requiring personal or telephone contact directly with customers and potential customers.

Our plan to establish our own calibration laboratory in Hong Kong has been cancelled in November 2005. Most of the equipment and instruments that we planned to calibrate and issue certificates for, are now sold in the PRC and it is not economical and, in some instances, not

feasible to have the equipment and instruments returned to Hong Kong and then returned to their origin. We are in the process of gathering further information to determine if establishing a calibration laboratory in our Shanghai factory is feasible.

#### Manufacturing

Sales of the Infrared Photometric Oil Analyzer commenced in 2003. During 2004, we began selling turbidity instruments and spectrometers that we developed and manufactured ourselves and began assembling and selling the Total Organic Analyzer of O.I. Corporation. During 2005, the Company built a demonstration Integrated Water Quality Monitoring System ( WQMS ) that incorporates, among other features: intake sampling, flow through testing with the ability to auto clean sensors with monitoring for ammonia, nitrate and organic pollution; electronic measurements, transmission (via telephone, radio data network, cellular or similar transmission for monitoring purposes) and recordation; and housing to customer's specifications.

In 2005, the Company also began offering two new company manufactured turbidimeters. One of the new turbidimeters is directed at water treatment plants, environmental monitoring stations, hydrological stations and the second is directed at beer and other beverage processing facilities and it analyzes the particles contained in the beverage. See - Product Assembly Operations . During the next twelve months, we intend to assemble and/or manufacture additional products in the future and seek opportunities with our suppliers to assemble their products, secure manufacturing and/or assembly facilities and seek another manufacturer of analytical instruments to acquire.

#### Engineering

To allow the Company to bid on larger water, wastewater and power generation projects, we acquired Pact and Yixing and continue our search for other engineering companies and/or a system integrator (a company that provides hardware, software and solutions in the field of engineering) or enter into a joint venture with a third party to work in connection with our process control and engineering department.

Pact-Yixing have completed a substantial number of industrial water and wastewater treatment projects in the PRC. The majority of these projects are for large multinational manufacturing facilities for clients from the USA, Europe and Japan. Process design as well as mechanical and electrical engineering are completed in-house and manufacturing contracted to approved fabricators of components. Fabrication drawings are also done in-house for submittal to said fabricators under the supervision of Pact-Yixing's quality control engineers.

Pact-Yixing clients cover a varied spectrum of industries covering semiconductor, pharmaceutical, petrochemicals, auto & auto parts, steel, food & beverage and beauty products.

The water and wastewater treatment processes applied at Pact-Yixing cover chemical, physical, biological and membrane separation. A combination of those processes are normally used to treat a specific industrial process feed or effluent. With respect to the water treatment side of Pact-Yixing's business, they design and build filtration equipment, ion-exchange softeners and demineralizers, reverse osmosis, electro-deionization, chemical treatment systems

and package type mobile water treatment plants. As for wastewater treatment, Pact-Yixing design and build biological treatment systems, oil coalescers, dissolved air flotation, lamella clarifiers, chemical reactor tanks, ultrafiltration, microfiltration, dewatering systems and package type mobile sewage treatment plants. Biological treatment plants cover both aerobic and anaerobic processes. State-of-the-art aerobic processes of SBR (sequential batch reactors) and MBBR (membrane bioreactors) are technologies also covered by Pact-Yixing. See Glossary.

In 2006, Pact-Yixing commenced selling water and wastewater treatment equipment. The equipment are components of systems traditionally marketed by Pact-Yixing. The equipment are partially manufactured to Pact-Yixing's in-house design and partially procured from approved Chinese suppliers. It is contemplated that Pact-Yixing's trading operation will mainly sell equipment to clients from outside China, starting with the Middle East, Africa and European and American companies operating in the Middle East and Africa.

The Company believes that the Pact-Yixing business is complementary to the Company's business as the Company continues to sell and market products of others. The Company expects that with this acquisition it may be able to gain a competitive advantage by offering customers and potential customers not only hardware but solutions to engineering problems as well. Also, the Company believes that its equity stake in Pact-Yixing enhances its position as a supplier to Pact. The Company continues to seek to make a similar acquisition of an engineering company specializing in air pollution control or other complementary environmental protection fields or in the power generation field. See Item 10.C Material Contracts.

A purpose of this acquisition was to reconfirm our direction to place a greater emphasis on developing an engineering solution business, instead of relying on its then current activities.

During Fiscal 2005, Fiscal 2004 and Fiscal 2003, our share of Pact-Yixing's net income represented 48%, 32% and 17%, respectively, of our net income.

#### **Products, Services and Customers**

Laboratory instruments, analyzers and test kits are used to analyze the chemical content and ascertain the level of impurities or other contaminants in water. The Company distributes analytical re-agents and chemicals to support testing systems of laboratory and portable instruments, process analyzers and portable test kits and assist in the analysis process. The Company offers a wide variety of test kits to test water quality. The Company believes that these portable test kits are easy to use and preadapted for rugged field use. These test kits are used to monitor drinking water distribution systems.

Laboratory and portable instruments generally consist of analytical instruments including but not limited to the following: spectrophotometers, colorimeters, turbidimeters, ion-selective electrodes, chemical oxygen demand apparatus, digestion apparatus, and precision re-agent dispensing devices which are used to test and monitor impurities and contaminants in water systems. See Glossary.

The Company also distributes continuous-reading process analyzers, process turbidimeters, pH controllers and analyzer accessories. These products are generally used to monitor and control drinking water quality to ensure that water treatment procedures comply with regulatory standards. See Glossary.

**Scientific Instruments.** The Company distributes analytical instruments, environmental monitoring instruments and general purpose laboratory instruments. Analytical instruments include, but are not limited to, chromatographs, mass spectrometers, flow injector analyzers and atomic spectrometers. Environmental monitoring instruments include both air and water quality monitoring instruments. Air quality monitoring instruments are generally divided into those which monitor ambient (i.e., atmospheric) air, and those which monitor pollution sources. Additionally, the Company offers general purpose laboratory instruments including a variety of water quality monitoring and analysis equipment, such as continuous reading process analyzers, process turbidimeters, pH controllers, and test kits for monitoring chemical content in water (i.e., chlorine, fluorides, etc.). See Glossary.

Customers for the analytical instruments include government agencies, academic and research institutions and major laboratories. The Company also distributes products to beverage producers and restaurants, including water quality test kits to more than twelve bottling plants of a well known United States soft drink producer, which are located in the PRC; water quality monitoring instruments to well known United States fast food franchisor's restaurants located in Hong Kong and the PRC, and to well known United States and European beer producers bottling plants located in Wuhan, PRC. Each such soda producer, restaurant and beer bottler do not account for a significant portion of our sales.

Customers for air and water quality monitoring instruments also include government agencies such as the Hong Kong Environmental Protection Department, which uses a Company distributed water quality monitoring system to monitor the water quality of Hong Kong's Victoria Harbor, more than ten water treatment plants located in the PRC (including sites at Beijing, Tianjin, Guangzhou and Wuhan), China's National Environmental Protection Agency, Harbin Water, Harbin Environmental Monitoring Centre, Beijing Huai Rou, Shunyi District CDC and Liaoning Jinzhou Wastewater Treatment Plant and the Beijing Environmental Monitoring Centre.

The Company derived approximately 34.8%, 37% and 41.3% of its revenues from the sale of Scientific Instruments during Fiscal 2005, Fiscal 2004 and Fiscal 2003, respectively.

**Process Control and Engineering Products.** The Company provides process control systems specifically designed for the industrial needs of clients including sensors, temperature gauges, pressure gauges, flow meters, valves, temperature and pressure transmitters and control devices, temperature and pressure calibrators, moisture, power, energy and harmonic analyzers. Chlorination disinfection systems are also distributed by Far East in conjunction with water treatment, sewage discharge and swimming pool water treatment. Customers for the foregoing distributed products include government water supply agencies, water treatment facilities, power and electric companies, petrochemical plants and instrument manufacturers. For example, the Company distributes chlorination disinfection systems to Hong Kong's Chek Lap Kok airport and its environs.

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The Company derived approximately 30.4%, 21.8% and 21.6% of its revenues from the sale of Process Control and Engineering Products during Fiscal 2005, Fiscal 2004 and Fiscal 2003, respectively.

**Special Projects and Engineering Department.** In conjunction with the distribution of products such as programmable logic controllers, telemetry units and SCADA systems and software, the Company also provides systems engineering to government agencies, wastewater treatment and power generation plants and beverage producers.

The Company derived approximately 10.2%, 22.3% and 20.7% of its revenue from its Special Project Operation during Fiscal 2005, Fiscal 2004 and Fiscal 2003, respectively. This revenue was derived primarily from sales of products and supply systems. The Company is placing a greater emphasis on developing an engineering solution to business as one of our key suppliers Eurotherm has been directly marketing and selling their process automation product directly into the PRC.

Our special projects and engineering department is believed by the Company to be the main contractor and system integrator of a large number of industrial and municipal wastewater, water treatment and power generation plants in the PRC. Specific services provided by this group include automated control system design, the operation and management of various wastewater, water and power generation projects. We endeavor to introduce, develop, and promote new and advanced technologies, products, and appropriate technical developments from abroad. We have also been cooperating with established technology companies and engage in systems and special projects in Programmable Logic Control, Telemetry unit, SCADA systems, Human Machine Interface Software and Sequential Event Recording.

**Other Products.** The Company distributes general testing and measuring equipment including multi-channel digital and analogue recorders, signal amplifiers and calibration equipment and power quality analyzers to industries including power plants, railway and aero-space industries, utilities, educational institutions and telecommunications companies.

The Company derived approximately 23.3%, 17.6% and 14.8% of its revenues from the sale of these Other Products during Fiscal 2005, Fiscal 2004 and Fiscal 2003, respectively.

**Technical Support.** The Company's technical support staff provides customers with maintenance, installation assistance, and calibration services, and assists sales personnel in giving technical advice to and performing product demonstrations for customers. The Company derived approximately 1.3%, 1.3% and 1.6% of its revenues from Technical Support Operations during Fiscal 2005, Fiscal 2004, Fiscal 2003, respectively.

**Customers.** During Fiscal 2004, the Company distributed products to in excess of 1,000 customers, including sub-distributors, located in Hong Kong, the PRC and Macau. During Fiscal 2005, the State Environmental Protection Agency accounted for approximately 6% of the Company's revenues. No other single customer accounted for more than 5% of the Company's



revenues during Fiscal 2005. The Company does not believe that any single customer or sub-distributor is material to its operations.

### **Product Assembly Operations**

The Company, through its PRC Corporation, Shanghai Euro Tech Limited established in 1999 in the Pudong Jin Qiao Export Processing Zone of Shanghai, engages in the development, production, sales and servicing of environmental equipment, including the development of modern laboratory analyzers, on-line measuring equipment and other analyzers for chemicals. Our products are tailor-made for the diversified needs of equipment users. Main products include Infrared Photometric Oil Analyzer (IPOA), COD analyzers, Total Organic Carbon Analyzer, turbidity meters, total suspended solid analyzers, dissolved oxygen analyzers, various types of spectrophotometers as well as a full spectrum of matching chemical reagents. In late 2005, we began offering two new turbidity meters, manufactured by the Company and our own WQMS.

This facility produces the Infrared Photometric Oil Analyzer, together with the two types of specialized reagents have been the best customer accepted products from this plant. Sale of the Infrared Photometric Oil Analyzer commenced in 2003. This plant also manufactures multi-function reactors, spectrophotometers, reagents for chemical oxygen demand and chlorine and silica measurement, used in water-related testing, monitoring and treatment. The manufacturing plant moved to a larger facility in 2003 under a lease that now expires in July 2006. It is contemplated that the Company will import components, assemble the finished products and then distribute the products through its distribution network. The Company believes that by establishing product assembly operations in the PRC and expanding the number of its regional sales offices in the PRC, it will not only increase revenues by expanding its customer base and increasing distribution capabilities, but also its net income since the Company believes it will enjoy higher overall profit margins by assembling certain products which it now distributes rather than by only purchasing the finished product from vendors.

In June 2003, the Company entered into an agreement with O.I. Corporation ( O.I. ) permitting the Company to assemble O.I.'s Total Organic Carbon Analyzer ( TOC ) at the Company's manufacturing facility. The Company believes that O.I.'s TOC is more advanced than the products currently sold by the Company and that by assembling O.I.'s TOC, it may be able to increase its market share for advanced analytical equipment at more competitive prices than it is now offering. Also, the Company anticipates that this agreement will trigger closer cooperation with its vendors to develop other products. Although the Company had entered into assembly agreements for products with other vendors, this agreement is a departure from past practice because, for the first time, the Company is assembling advanced analytical equipment for one of our vendors as opposed to lower tech analytical equipment. We believe that by producing products locally in the PRC, we can reduce our production costs and be able to compete better with lower costs to our customers while maintaining our profit margins. During 2005, we succeeded in producing all components locally in the PRC and developed a Chinese version of the necessary software to build and operate the TOC. Previously, all component parts and only an English language version of the software were provided by O.I.

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### **Infrared Photometric Oil Analyzer**

The Company developed an Infrared Photometric Oil Analyzer by infrared absorption method and began sales of this product in 2004. This analyzer detects concentrations of petroleum, animal and vegetable oils in surface water, underground water, municipal and industrial wastewater. Customers are environmental water monitoring stations, water purification and waste treatment facilities, underground water and harbor water monitoring stations located in China.

Our perceived advantage of the analyzer is that samples under its testing protocols are measured by three different wavelengths simultaneously thus giving more accurate readings against one fixed wavelength used by most of our potential competitors' products.

### **Sources of Supply**

The Company distributes products manufactured by a number of vendors, including Hioki, USF and Lachat, which are the Company's primary suppliers, see - Business Overview . The Company has exclusivity agreements for specified geographic areas with many of its suppliers for certain products. Those agreements do not encompass all products distributed by the Company or all of the market areas serviced by the Company. In addition, some of these agreements are memorialized not as formal contracts but rather through other acknowledgements or correspondence which may contain a vague, if any, description of the terms and conditions of such agreement or arrangement, and therefore may be unenforceable. The Company has only a letter from Hioki appointing the Company as Hioki's sales representative in the PRC, Hong Kong and Macau. The Company's agreement with USF continues in effect for successive renewal terms of one year each, unless either party gives written notice of non-renewal at least 30 days prior to the end of any renewal term. The Company's agreement with Lachat continues in effect for successive renewal terms of one year and is terminable on ninety days notice by either party. The Company's agreement with Hach is terminable on ninety days notice by either party. Although alternative sources of supply exist, there can be no assurance that the termination of the Company's relationship with any of the above or other vendors would not have a short-term adverse effect on operations.

### **Expansion**

The Company continues to seek: development of manufacturing and engineering operations as part of its core business through (a) the development and assembly of more of the Company's own environment-related equipment (see Product Assembly Operations ), (b) forming joint ventures with some of our suppliers, (c) potential acquisitions of manufacturing plants in the air pollution business, and (d) potential acquisitions of engineering companies to enhance our ability to bid for and take on larger engineering projects.

### **Regulatory Environment**

Concerns about and awareness of pollution problems and environmental issues have grown at all levels of PRC government as the PRC experienced economic growth. Environmental

protection laws and strict regulations have been enacted and are buttressed by increased budget allocations for environmental regulation, monitoring and enforcement. The PRC's primary environmental protection agency is the State Environmental Protection Agency (SEPA), under which there are Environment Protection Bureaus in each city and county. According to oral information received by management from SEPA, under bureau management, there are two environment monitoring systems: one system consists of over 2,200 monitoring stations to collect and analyze the environmental data of each city and county; another system consists of over 2,500 stations to monitor specific industrial districts or factories which have been identified as major pollution sources due to their non-compliance with environmental regulations. The Company has supplied water and air quality monitoring and analytic instruments to these monitoring stations for several years. There can be no assurance that the agencies will continue to use the Company's products for these purposes, or that other market competitors will not enter the market with superior products, distribution systems or more competitive prices. See Competition.

### **Competition**

The Company faces competition from other distributors of substantially similar products as well as the manufacturers of such products, and in both foreign and Chinese markets. The Company faces its principal competition from manufacturers and other distributors of its core products located in Hong Kong and the PRC. Moreover, the Company has implemented plans to assemble products of the kind that it presently distributes (see Product Assembly Operations). Assembly operations have developed to the stage where some products have already been presented to the market and the Company is in direct and unavoidable competition with certain of its vendors. There can be no assurance that the existence of this direct competition will not impair the Company's ability or such competitor's willingness to continue providing other products for continued distribution by the Company and that such a development would not materially adversely affect the Company's core business.

During Fiscal 2005, Fiscal 2004 and Fiscal 2003, the Company's gross profit margins were approximately 21%, 16.3% and 16.9%, respectively. The Company believes that it competes with the PRC manufacturers on the basis of quality and technology. The Company believes it offers foreign-manufactured products which are of higher quality and use more advanced technology than products manufactured in the PRC. The Company believes that it competes with foreign manufacturers and other distributors of their products on the basis of the Company's more extensive distribution network and an established reputation.

### **B2B Website**

The Company, through its subsidiary, ChinaH2O.com Limited, a Hong Kong corporation, has a bilingual Business-to-Business ( B2B ) internet platform. The website is located at (<http://www.chinah2o.com>). The B2B website is directed at environmental businesses in China. The purpose of the B2B website is to connect manufacturers, distributors and suppliers of environmental protection equipment and related consultants and engineering firms in the West with potential clients in China (i.e., water, wastewater treatment plants, environmental protection bureaus, environmental monitoring stations, and related industries). The website provides environmental news, directories of western suppliers, potential clients in China, advertisement space and business opportunities. The business and other activities generated by ChinaH2O.com Limited have had a synergistic effect with those of the Company indirectly by feeding market information, sales leads and tender information to the Company.

### **Sales and Marketing**

The Company distributes products through its principal office located in Hong Kong and its representative PRC offices located in Beijing, Shanghai, Guangzhou, Chongqing, Xi´An, Shenyang, Wuhan and Fuzhou. The Company has a marketing and sales force of 80 people who are paid a salary plus commission based on sales. The Company´s offices also coordinate the sales efforts of approximately fifty other companies located in the PRC which act as sub-distributors. These sub-distributors are engaged on a non-exclusive basis to distribute the products of other distributors. Each of the fifty sub-distributors accounted for less than two percent of the Company´s sales during Fiscal 2005, Fiscal 2004 and Fiscal 2003.

Following the opening of our first retail shop in Shanghai in 2001, Euro Tech retail outlets are now found in a number of major cities in the PRC, including Beijing and Guangzhou. Our staff at these shops assists customers in selecting the equipment, auxiliary parts and products to suit customer specifications. Equipment that needs to be repaired or provided with routine maintenance can be returned to us via these shops, as our retail shops, except for the Beijing shop, are also maintenance centers. The Company has found the seven existing shops to be useful as demonstration locations easily accessed by local customers who can pay in local currency while off the shelf sales are made which move its inventory more readily. In addition to the shops, we also have four branches or representative offices of these shops. All of the foregoing are perceived by the Company to have had a positive impact on its business reputation while reducing the Company´s dependency on sub-distributors who may not be loyal to the Company and distribute products of our competitors. As foreign entities are not generally permitted to own these facilities, these shops are owned by non-officer/director, employees of the Company with funds from the Company through non-fixed term loans aggregating approximately US\$388,000 bearing a nominal rate of interest. The shops do not have financing from other sources. There can be no assurance that these shops will continue to be economically viable, that the Company will not sustain losses in connection with the loans to the shops; or the shops will result in any significant revenues or profits for the Company. Also, similar shops may be established by our competitors and/or third parties. These shops (or their representative offices) were opened on the following dates:

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Retail Shops

Shanghai  
Beijing  
Chongqing  
Guangzhou  
Xi'An  
Wuhan  
Shenyang

April 2001  
October 2001  
March 2002  
June 2002  
July 2002  
November 2002  
December 2002

Representative Offices

Dalian  
Suzhou  
Dongguan  
ChengDu  
Qingdao  
Urumqi

November 2003  
July 2004  
September 2004  
February 2005  
April 2005  
September 2005

*Item 4C.*

## ***Organizational Structure***

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The Company presently wholly-owns Far East, a Hong Kong corporation, which, in turn, owns the following corporations:

### **Wholly-Owned**

- Euro Tech Trading (Shanghai) Limited a People's Republic of China corporation
- Euro Tech (China) Limited a Hong Kong corporation
- ChinaH2O.com Limited a Hong Kong corporation
- Shanghai Euro Tech Limited a People's Republic of China corporation

### **Majority Owned**

- Yixing Pact Environmental Technology Company Limited a PRC corporation
- Pact Asia Pacific Limited a BVI corporation

The Company's wholly-owned subsidiary and primary operational arm is Far East, which it acquired in March 1997. Far East has engaged in the distribution of various industrial control equipment, which continues to be the core business of the Company, since its inception in 1971.

*Item 4D. Property, Plant and Equipment*

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The Company maintains an executive office at 18/F Gee Chang Hong Centre, 65 Wong Chuk Hang Road, Hong Kong. The Company occupies approximately 12,800 square feet of office and warehouse storage space under a two (2) year lease that expires in May 2007 for

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monthly rental payments of approximately US\$7,050. The warehouse storage space is used to hold products for distribution to our customers via common carriers.

In August 1995, the Company purchased approximately 1,200 square feet of space in a building in Hong Kong. This property is now used as ChinaH2O.com Limited's office.

The Company also maintains representative offices within the PRC in the cities of Beijing, Shanghai, Guangzhou, Chongqing, Xi'an, Wuhan, Shenyang and Fuzhou. The Beijing and Shanghai sales offices are owned by the Company. The Beijing and Shanghai sales offices are situated on Company owned property. The remaining sales offices are rented pursuant to short-term leases aggregating approximately US\$3,000 per month.

One of Euro Tech Trading (Shanghai) Ltd.'s office is rented pursuant to a lease expiring in August 2006 that provides for a monthly rental of approximately US\$237, with a second office rented pursuant to a lease expiring in July 2006 that provides for a monthly rental of approximately US\$618. Shanghai Euro Tech Limited's premises are rented pursuant to a lease expiring in July 2006 with monthly rental payments of approximately US\$2,800.

Pact occupies a 700 square meter facility in Shanghai, pursuant to a 3 year lease expiring in March, 2008, providing for a monthly rental of approximately US\$5,136.

The Company's registered office in the British Virgin Islands is located at TrustNet Chambers, P.O. Box 3444, Road Town, Tortola, British Virgin Islands and its telephone number is (284) 494-5296.

## ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### Overview

The Company is primarily a distributor of a wide range of advanced water treatment equipment (including chlorination equipment), laboratory instruments, analyzers, test kits and related supplies and power generation equipment (including recorders and power quality analyzers).

The Company's operations are located almost entirely within, and revenues are almost entirely generated from Hong Kong and the PRC. The Company derived approximately 19% and approximately 80% of its revenue from Hong Kong and the PRC, respectively in Fiscal 2005. Net income increased approximately US\$457,000, or 76.9%, in Fiscal 2005 to US\$1,051,000, compared to US\$594,000 in Fiscal 2004, primarily due to the Company's diversification into engineering and contributions from its engineering subsidiary, Yixing-Pact.

The Company continued to expand its trading business by expanding its regional sales efforts in the PRC and using the retail shops and online ordering in the PRC to sell the Company's products. The Company manufactures and sells its own developed products such as Infrared Photometric Oil Analyzer, turbidity instruments and spectrophotometers and assembles and sells the Total Organic Analyzer of O.I. Corporation. The Company intends to assemble

and/or manufacture additional products in the future and seek opportunities with its suppliers to assemble their products, secure manufacturing and/or assembly facilities and seek another manufacturer of analytical instruments to acquire.

The Company continued to accept more engineering projects in water and wastewater industries and also in power generation industries. During 2005, the Company acquired a majority interest in Yixing-Pact. The Company intends to continue its search for acquisition candidates of other firms engaged in engineering and/or system integration or enter into a joint venture with a third party to work in connection with its process control and engineering department.

## *Item 5A.* **Operating Results**

### **Background - Political and Economic Conditions in Hong Kong and the People's Republic of China**

The Company's operations are located almost entirely within, and revenues are almost entirely generated from Hong Kong and the PRC. Set forth below are the approximate percentage of the Company's sales made to customers in the PRC and Hong Kong for the fiscal years indicated:

Fiscal Year	PRC		Hong Kong	
2003	74	%	26	%
2004	78	%	21	%
2005	80	%	19	%

Sales to customers situated in Macau and elsewhere in Fiscal 2003 through Fiscal 2005 were nominal. This makes the Company particularly susceptible to changes in the political and economic climate of either Hong Kong or the PRC.

**Hong Kong.** Hong Kong has been one of the prime centers for commercial activity and economic development recently in Southeast Asia. On July 1, 1997, sovereignty over Hong Kong was transferred from the United Kingdom to the PRC. As provided in the Sino-British Joint Declaration and the Basic Law, the Hong Kong SAR is provided a high degree of autonomy except in foreign and defense affairs. The Basic Law provides that the Hong Kong SAR is to have its own legislature, legal and judicial system and full economic autonomy for 50 years after the transfer of sovereignty. Based on the current political conditions and the Company's understanding of the Basic Law, the Company does not believe that the transfer of sovereignty over Hong Kong has had or will have an adverse impact on its financial and operating environment. Although the Chinese government has pledged to maintain the economic and political autonomy of Hong Kong over its internal affairs, there is no assurance that such pledge will continue to be honored if there are changes in the Chinese political or economic climate. See Item 3D. Key Information Risk Factors.

**PRC.** The PRC has been a socialist state since 1949. For more than forty years, the PRC's economy has been, and presently continues to be, a socialist economy operating under government controls promulgated under various State Plans adopted by central Chinese government authorities and implemented, to a large extent, by provincial and local authorities which may set production and development targets. However, since approximately the early 1980s, the PRC's national government has undertaken certain reforms to permit greater provincial and local economic autonomy and private economic activities. Any change in political or economic conditions may substantially adversely effect these reform initiatives and, in turn, the Company. See Item 3D. Key Information Risk Factors.

### Results from Operations

The following operating and financial review should be read in conjunction with the Consolidated Financial Statements and notes thereto appearing elsewhere in this Annual Report. All financial data referred to in the following discussion has been prepared in accordance with accounting principles generally accepted in the United States ( US GAAP ).

The following table presents selected statement of operations data expressed in thousands of US\$ and as a percentage of revenue for the Company's fiscal years indicated below:

	Year Ended December 31,											
	2005			2004			2003			2002		
	US\$		%	US\$		%	US\$		%	US\$		%
Revenue	31,250	100	%	32,282	100	%	27,442	100	%	23,497	100.0	%
Cost of revenue	24,681	79.0	%	27,033	83.7	%	22,805	83.1	%	18,735	79.7	%
Gross Profit	6,569	21.0	%	5,249	16.3	%	4,637	16.9	%	4,762	20.3	%
Selling and administrative expenses	5,418	17.3	%	4,801	14.9	%	4,108	15.0	%	4,173	17.8	%
Income before income taxes	1,358	4.3	%	569	1.8	%	548	2.0	%	616	2.6	%
Income taxes	328	1.0	%	167	0.5	%	108	0.4	%	123	0.5	%
Share of equity in net income of affiliates	21	0.0	%	192	0.6	%	91	0.3	%	7	0.0	%
Net income	1,051	3.3	%	594	1.8	%	531	1.9	%	500	2.1	%

	2001		
	US\$		%
Revenue	19,685		100.0 %
Cost of revenue	15,396		78.2 %
Gross Profit	4,289		21.8 %
Selling and administrative expenses	3,734		19.0 %
Income before income taxes	747		3.8 %
Income taxes	163		0.8 %
Share of equity in net income of affiliates	0		0.0 %
Net income	584		3.0 %

**Fiscal Year Ended December 31, 2005 Compared to Fiscal Year Ended December 31, 2004**

*Revenue; Gross Profit and Cost of Revenue.* Revenue decreased by approximately US\$1,032,000 or 3.2% to approximately US\$31,250,000 in Fiscal 2005 from approximately US\$32,282,000 in Fiscal 2004. The decrease in revenues included a decrease of approximately US\$4,694,000 in revenues from continuing operations that were primarily due to declining revenues from trading activities as a greater number of our key or exclusive suppliers have been marketing their products or selling into the China market, either directly or through other distributors, as well as the Company. This decrease was partially offset by the inclusion of revenues approximately US\$3,662,000 from Yixing-Pact for the period after the Company acquired its majority interest in October 2005 as their results were consolidated with the Company's.

Gross profits increased by approximately US\$1,320,000 or 25.1% to approximately US\$6,569,000 for Fiscal 2005 as compared to approximately US\$5,249,000 for Fiscal 2004. During Fiscal 2005, the Company's cost of revenue was approximately US\$24,681,000, or 79% of revenue, in comparison to approximately US\$27,033,000, or 83.7% of revenue for Fiscal 2004. Cost of revenue expressed as a percentage of revenue decreased by 4.7% in Fiscal 2005 as compared with Fiscal 2004. Gross profits from continuing operations increased by approximately US\$310,000 or 5.9% to approximately US\$5,539,000 for Fiscal 2005 as compared to approximately US\$5,249,000 for Fiscal 2004. The gross profit margin percentage increase was due principally to an increase in revenues from our engineering solution business of approximately US\$1,113,000, representing an approximately 41% of our gross profit margin. Yixing-Pact contributed approximately US\$1,010,000 to our gross profit margin in Fiscal 2005.

*Selling and Administrative Expenses.* Selling and administrative expenses were approximately US\$5,418,000 in Fiscal 2005, an increase of approximately US\$617,000 or 12.9% from approximately US\$4,801,000 in Fiscal 2004. Expenses from continuing operations increased approximately US\$495,000 principally as a result of employee expenses increasing as a result of the hiring of additional personnel, incremental increases in the salaries of our employees and other expenses resulting from general inflation. Yixing-Pact expenses of approximately \$122,000 were included in our expenses for Fiscal 2005.

*Equity in Profit of Affiliates.* Equity in profit of affiliates decreased by approximately US\$171,000 or 89% to approximately US\$21,000 in Fiscal 2005 from approximately US\$192,000 in Fiscal 2004. The decrease in equity in profit of affiliates was principally due to the results of Yixing-Pact being consolidated after the Company acquired its majority interest in October 2005.

*Interest Income.* Interest income increased by approximately US\$18,000 or 105.9% to approximately US\$35,000 in Fiscal 2005 from approximately US\$17,000 for Fiscal 2004. The increase of \$12,000 from our continuing operations was primarily due to the general increase in interest rates for bank deposits during Fiscal 2005. The US\$6,000 balance of the increase in interest income was contributed by Yixing-Pact.

*Other Income.* Other income increased by approximately US\$68,000 or 65.4% to approximately US\$172,000 in Fiscal 2005 from approximately US\$104,000 in Fiscal 2004. The increase in other income was principally due to increase in exchange gain of US\$85,000 in Fiscal 2005.

*Income Taxes.* Taxes increased by US\$161,000 to approximately US\$328,000 in Fiscal 2005 from approximately US\$167,000 in Fiscal 2004. This increase was primarily the result of increased taxable profits.

*Net Income.* Income from continuing operations increased by approximately US\$457,000 or 76.9% to approximately US\$1,051,000 in Fiscal 2005 from approximately US\$594,000 in Fiscal 2004. The Company's net income, excluding Yixing-Pact's contribution, was approximately US\$381,000 and US\$402,000 for Fiscal 2005 and Fiscal 2004, respectively. The slight decrease of US\$21,000 was primarily due to the decrease in revenues with the effect on the Company being cushioned by the increase in revenues from our engineering solution business that has a higher gross profit margin. The net income from Yixing Pact was approximately US\$670,000 for 2005. The Company recognized equity in profit of Yixing-Pact of approximately US\$192,000 for its 30% share ownership in Fiscal 2004. Net income attributable to the shareholders of the Company, after deducting minority interest amounted to US\$733,000 and US\$594,000 for Fiscal 2005 and Fiscal 2004, respectively.

#### **Fiscal Year Ended December 31, 2004 Compared to Fiscal Year Ended December 31, 2003**

*Revenue; Gross Profit and Cost of Revenue.* Revenue increased by approximately US\$4,840,000 or 17.6% to approximately US\$32,282,000 in Fiscal 2004 from approximately US\$27,442,000 in Fiscal 2003. The increase was primarily due to: the inclusion of revenue of approximately US\$1,200,000, the retail shops as these shops are qualified as Variable Interest Entities ( VIE ) as the Company is subject to a majority of risk of loss from the VIE activities and entitled to receive a majority of the VIE residual returns, and their results were consolidated starting in Fiscal 2004; increase in revenues from special project and engineering department sales to water and power plants of approximately US\$1,700,000 and increased revenues from sales of Hioki products of approximately US\$1,200,000 to power industries as a result of our expansion of the Company's distribution and retail network. Revenue increased from special projects and engineering department sales as a result of (a) increasing demand from water suppliers and waste water treatment plants, following increased PRC regulations governing pollution output and an overall increasing demands for clear water; and (b) the construction of new power generation plants to meet the burgeoning demand for electricity in the PRC. The increased sales of Hioki products was the result of (a) the Company establishing representative offices in Suzhou and Dongguan, (b) on-line internet ordering; (c) increasing our sales staff, (d) our enhancing Hioki's brand name in the PRC via promotional activities (i.e. seminars and attending/giving exhibitions) in past years, and (c) with Hioki's assistance, a limitation on sales of Hioki's products by other dealers.

Gross profits increased by approximately US\$612,000 or 13.2% to approximately US\$5,249,000 for Fiscal 2004 as compared to approximately US\$4,637,000 for Fiscal 2003. During Fiscal 2004, the Company's cost of revenue was approximately US\$27,033,000, or

83.7% of revenue, in comparison to approximately US\$22,805,000, or 83.1% of revenue for Fiscal 2003. Cost of revenue expressed as a percentage of revenue increased by 0.6% in Fiscal 2004 as compared with Fiscal 2003. The gross profit margin percentage decrease is attributed to the fact that the Company sold a greater amount of low tech products through its retail shops. The weakening of US\$ against other foreign currencies also had an adverse impact on the gross margin percentage as the Company's sales were mainly denominated in US\$, HK\$ and RMB while some of the Company's cost of revenue were denominated in Japanese Yen, the Euro and Sterling Pound, such as cost of revenue for Hioki products was denominated in Japanese Yen.

*Selling and Administrative Expenses.* Selling and administrative expenses were approximately US\$4,801,000 in Fiscal 2004, an increase of approximately US\$693,000 or 16.87% from approximately US\$4,108,000 in Fiscal 2003. The increase was primarily due to inclusion of expenses of the retail shops of approximately US\$417,000 as these shops are qualified as VIEs and its results were consolidated starting from Fiscal 2004, and the expense increase resulted from increases in sales, general inflation and audit and consulting fees. Audit and consulting fee increases are the result of newly adopted securities laws, rules and regulations that impose further responsibilities and potential liabilities on companies and their officers, directors, auditors and attorneys that are publicly traded in the U.S.

*Equity in Profit of Affiliates.* Equity in profit of affiliates increased by approximately US\$101,000 or 111% to approximately US\$192,000 in Fiscal 2004 from approximately US\$91,000 in Fiscal 2003. The increase in equity in profit of affiliates was principally due to the increase in net profits of Yixing-Pact from approximately US\$304,000 in Fiscal 2003 to approximately US\$641,000 in Fiscal 2004.

*Interest Income.* Interest income increased by approximately US\$4,000 or 30.8% to approximately US\$17,000 in Fiscal 2004 from approximately US\$13,000 for Fiscal 2003. The increase was primarily due to the increase in bank deposits during the year. There was no interest expense in Fiscal 2004 and Fiscal 2003 because the Company has not utilized any loan or overdraft facilities under its banking arrangements.

*Other Income.* Other income increased by approximately US\$98,000 or 1,633.3% to approximately US\$104,000 in Fiscal 2004 from approximately US\$6,000 in Fiscal 2003. The increase in other income was principally due to an exchange gain of US\$73,000 in Fiscal 2004 compared with an exchange loss of approximately US\$35,000 in Fiscal 2003.

*Income Taxes.* Taxes increased by US\$59,000 to approximately US\$167,000 in Fiscal 2004 from approximately US\$108,000 in Fiscal 2003. This increase was primarily the result of increased taxable profits, and an increase of valuation allowances.

*Net Income.* Income from continuing operations increased by approximately US\$63,000 or 11.9% to approximately US\$594,000 in Fiscal 2004 from approximately US\$531,000 in Fiscal 2003. The increase in net income resulted from an increase in gross profit. However, the general increase in selling and administrative expenses and inclusion of expenses of PRC retail shops resulted in a decrease of operating profit. Nevertheless, the Company achieved an increase

in net income for Fiscal 2004 as a result of the exchange gain and the contribution from its share of the profits of approximately US\$192,000 from Pact.

*Item 5B.* **Liquidity and Capital Resources**

The Company has primarily used its funds to finance accounts receivable, inventories, and capital expenditures including purchases of property, office furniture and equipment, computers and calibration equipment. The Company has historically met its cash requirements from cash flows from operations, short-term borrowings, bank lines of credit, and long-term mortgage bank loans. The Company expects, but can make no assurances that its present cash reserves, cash from operations, existing available bank credit facilities and proceeds from the issuance of our ordinary shares pursuant to stock option exercises would be sufficient to fund its future capital expenditure requirements. Working capital at the end of Fiscal 2005 and Fiscal 2004 was approximately US\$6,931,000 and US\$5,457,000, respectively.

During Fiscal 2004, the Company generated net cash of approximately US\$2,536,000 in its operating activities from net income, reduction in accounts receivable, increase in accounts payable while funding an increase in inventories resulting from delays in shipments in customers. During Fiscal 2005, the Company used approximately US\$258,000 in its operating activities to fund the increase in accounts receivable, a reduction in the amounts due to related companies and other payables, that in total, exceeded the funds generated from net income and a decrease in inventory. At the end of Fiscal 2005 and Fiscal 2004, the Company's accounts receivable were approximately US\$5,467,000 and US\$4,139,000, respectively.

The Company generated approximately US\$72,000 from investing activities in fiscal 2005 and used approximately US\$46,000 for investing activities in Fiscal 2004. The Company used approximately US\$110,000 and US\$101,000 to purchase facilities and equipment in Fiscal 2005 and Fiscal 2004, respectively. During Fiscal 2005, the Company derived approximately US\$486,000 from its acquisition of Yixing-Pact. Although the cash consideration, plus other costs paid by the Company, was US\$1,034,000 for Yixing-Pact, Yixing-Pact had approximately US\$1,520,000 in cash on hand at the time of their acquisition. During Fiscal 2005, the Company used approximately US\$304,000 as restricted cash to issue performance guarantees to its customers through its banks. During Fiscal 2004, the Company received a US\$55,000 dividend from Pact.

The Company received approximately US\$306,000 in Fiscal 2005 from financing activities resulting from the issuance of its ordinary shares being issued on stock options that were exercised while in the prior two fiscal years no expenditures were needed for financing activities. The Company had various banking facilities available for overdraft, import and export credits and foreign exchange contracts from which the Company can access up to approximately US\$4,167,000 at December 31, 2005. The aforementioned available credit facilities were obtained on the conditions that, among other things, the Company not create a charge or lien on its other assets in favor of third parties without such bank's consent, and the Company maintaining a certain level of net worth.

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Cash increased from approximately US\$5,242,000 at the end of Fiscal 2004 to approximately US\$5,660,000 at the end of Fiscal 2005. The principal reasons for the increase in cash were the decreases in inventories of approximately US\$2,387,000, a net cash inflow of approximately US\$486,000 of Yixing-Pact's cash on hand, proceeds of approximately US\$306,000 from the exercise of stock options by Company management and employees. However, the Company used cash to fund its increases in accounts receivable of approximately US\$1,237,000, decrease the amounts due to related companies by approximately US\$1,267,000 and decrease the other payables by approximately US\$1,665,000. During Fiscal 2004, the Company received a US\$55,000 dividend from an affiliate, Pact. The Company plans to use cash on hand primarily to acquire a manufacturing plant and/or environmental engineering company in the PRC and to expand its manufacturing plant and environmental engineering business.

The Company's net accounts receivable increased from approximately US\$4,139,000 at the end of Fiscal 2004 to approximately US\$5,467,000 at the end of Fiscal 2005. This increase is principally attributable to the inclusion of Yixing-Pact's accounts receivable of approximately US\$1,028,000.

The Company's inventory decreased from approximately US\$3,564,000 at the end of Fiscal 2004 to approximately US\$2,732,000 at the end of Fiscal 2005. This decrease at the end of Fiscal 2005 was principally due to inventory of approximately US\$835,000 for a SEPA contract not yet shipped at the end of Fiscal 2004 that was shipped in 2005.

The Company's capital expenditures were approximately US\$101,000 and US\$110,000 in Fiscal 2004 and Fiscal 2005, respectively. Capital expenditures during Fiscal 2004 and Fiscal 2005 were incurred primarily in connection with the purchase of office equipment, furniture and fixtures. The Company continues to seek targets for acquisition, such as facilities for assembly operations or engineering companies. If such acquisitions are indeed made, the Company may expect to incur significantly larger capital expenditures, for which the Company presently intends, but as to which no assurance can be made, to use existing cash reserves, cash from operations, available bank credit facilities and proceeds from the issuance of our ordinary shares to fund such capital expenditures.

#### **Anticipated Future Resources and Uses of Cash**

The Company has historically funded its working capital and capital expenditure needs from operations, available bank credit facilities and proceeds from the issuances of our ordinary shares and expects to continue funding its 2006 working capital requirements from operations, available bank credit facilities and proceeds from the issuances of our ordinary shares. The Company may use its funds to acquire other businesses, form strategic alliances with third parties, invest in product research and development, or expand its sales offices and retail shops or, with third parties, seek to acquire new products or businesses or form strategic alliances. The Company expects, but can make no assurances that its present cash reserves, cash from operations and existing available bank credit facilities would be sufficient to fund its future cash requirements.



## **Inflation**

The Company believes generally declining rates of inflation in the PRC have had a positive effect on its results from operations. The Company believes, although no assurance can be given, that as credit restrictions are gradually lifted, Far East will be able to increase prices in the market for its products and thus realize increased profit margins.

## **Critical Accounting Policies**

### ***Revenue Recognition***

Pursuant to the revenue recognition criteria set forth in Securities and Exchange Commission's Staff Accounting Bulletin (SAB) No. 104: Revenue Recognition, the Company recognizes revenue when it is realized or realizable and earned. The Company considers revenue realized or realizable and earned when it has persuasive evidence of an arrangement, the product has been delivered, the sales price is fixed or determinable and collectibility is reasonably assured. For certain products where installation is necessary, revenue is recognized upon completion of installation. Revenue earned from customer support, which represents a minor percentage of total revenues, is recognized when such services are provided.

Revenues and profits in long term fixed price contracts are recorded under the percentage of completion method. This approach relies on estimates of total expected direct costs of completion, which are compared to actual direct costs incurred to date to arrive at an estimate of revenue and profit earned to date. Recognized revenue and profit are subject to revisions as the contract progresses to completion. Revisions to profit estimate are reflected in income in the period in which the facts that give rise to the revision become known.

### ***Inventory Valuation***

The Company writes down its inventory for estimated obsolescence or unmarketable inventory equal to the difference between the cost of inventory and the estimated market value based upon assumptions about future demand and market conditions. If actual future demand or market conditions are less favorable than those projected by management, additional write-downs may be required.

### ***Deferred Taxes***

As part of the process of preparing its consolidated financial statements, the Company is required to estimate its income taxes and tax bases of assets and liabilities in each of the jurisdictions in which it operates. This process involves the Company estimating its current tax exposure together with assessing temporary differences resulting from its differing treatment of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included in the Company's consolidated balance sheet. The Company must then assess the likelihood that its deferred tax assets will be recovered from future taxable income, and, to the extent the Company believes that recovery is more unlikely than likely, it must establish a valuation

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allowance. To the extent the Company establishes a valuation allowance or increases this allowance in a period, it must include an expense within the tax provision in the statement of operations.

*Recent Accounting Pronouncements*

In November 2004, the FASB issued SFAS N. 151, *Inventory Costs*, an amendment of ARB No. 43, Chapter 4. SFAS No. 151 requires that abnormally high vacancy, wasted material, freight and processing costs not be part of recognizable production costs. Such cost must instead be expensed as incurred. Accordingly fixed costs shall henceforth be allocated to inventory based on normal production capacity. The standard is effective for the fiscal year beginning January 1, 2006. It is not expected that SFAS No., 151 will have a material effect on the Company's consolidated financial statement.

In December 2004, the FASB issued SFAS No. 123 (Revised 2004) *Share-Based Payment* that will require the Company to expense costs related to share-based payment transactions with employees. With limited exception, SFAS No. 123 (R) requires that the fair value of share-based payments to employees be expensed over the period service is received. SFAS No. 123 (R) becomes mandatory effective for the Company on July 1, 2005. The Company intends to adopt this standard using the modified retrospective method of transition, effective as of January 1, 2006.

SFAS No. 123 (R) allows the use of both closed form models (e.g., Black-Scholes Model) and open form models (e.g., lattice models) to measure the fair value of the share-based payment as long as that model is capable of incorporating all of the substantive characteristics unique to share-based awards. In accordance with the transition provisions of SFAS No. 123 (R), the expense attributable to an award will be measured in accordance with the Company's measurement model at that award's date of grant.

The Company believes that the total expense recorded in future periods will depend on several variables, including the number of share-based awards that vest and the fair value of those vested awards.

In March 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections* (SFAS 154), which was a replacement of APB Opinion No. 20 and FAS No. 3 effective for accounting changes made in fiscal periods beginning after December 15, 2005. SFAS 154 requires retrospective application to prior periods' financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. It also requires that retrospective application of a change in accounting principle be limited to the direct effects of the change. SFAS also requires that a change in depreciation, amortization, or depletion method for long-lived, nonfinancial assets be accounted for as a change in accounting estimate effected by a change in accounting principle. The Group is currently assessing the impact of this statement on our results of operations, financial position and cash flows upon adoption and has not yet completed that assessment.

In February 2006, FASB issued SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments*. SFAS No. 155 amends SFAS No 133, *Accounting for Derivative Instruments* and

Hedging Activities , and SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities . SFAS No. 155, permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, clarifies which interest-only strips and principal-only strips are not subject to the requirements of SFAS No. 133, establishes a requirement to evaluate interest in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation, clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives, and amends SFAS No. 140 to eliminate the prohibition on the qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. This statement is effective for all financial instruments acquired or issued after the beginning of the Group s first fiscal year that begins after September 15, 2006. The Group management has not evaluated the impact of this pronouncement on the Group s financial statements.

In March 2006 FASB issued SFAS 156 Accounting for Servicing of Financial Assets this Statement amends FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, with respect to the accounting for separately recognized servicing assets and servicing liabilities. This Statement:

Requires an entity to recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract. Requires all separately recognized servicing assets and servicing liabilities to be initially measured at fair value, if practicable.

Permits an entity to choose Amortization method or Fair value measurement method for each class of separately recognized servicing assets and servicing liabilities. At its initial adoption, permits a one-time reclassification of available-for-sale securities to trading securities by entities with recognized servicing rights, without calling into question the treatment of other available-for-sale securities under Statement 115, provided that the available-for-sale securities are identified in some manner as offsetting the entity s exposure to changes in fair value of servicing assets or servicing liabilities that a servicer elects to subsequently measure at fair value. Requires separate presentation of servicing assets and servicing liabilities subsequently measured at fair value in the statement of financial position and additional disclosures for all separately recognized servicing assets and servicing liabilities. An entity should adopt this Statement as of the beginning of its first fiscal year that begins after September 15, 2006.

The Group s management believes that this statement will not have a significant impact on the Group s financial statement.

In June 2005, the FASB ratified the Emerging Issues Task Force ( EITF ) consensus to amend EITF No. 96-16, Investor s Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholders Have Certain Approval or Veto Rights . The EITF agreed to amend the Protective Rights section of this consensus, as well as Example of Exhibit 96-16A, to be consistent with the consensus reached in Issue No. 04-5, Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or

Similarly Entity When the Limited Partners Have Certain Rights. The provisions of this amendment should be applied prospectively to new investments and to investment agreements that are modified after June 29, 2005. The Group's management believes the adoption of this pronouncement will not have a material effect on the Group's consolidated financial statements. In June 2005, the EITF reached consensus on Issue No. 05-6, Determining the Amortization Period for Leasehold Improvements ( EITF 05-6. ) EITF 05-6 provides guidance on determining the amortization period for leasehold improvements acquired in a business combination or acquired subsequent to lease inception. The guidance in EITF 05-6 will be applied prospectively and is effective for periods beginning after June 29, 2005. EITF 05-6 is not expected to have a material effect on the Group's consolidated financial position or results of operations.

*Item 5C.*

## ***Research and Development, Patents and Licenses***

During Fiscal 2005, Fiscal 2004 and Fiscal 2003, the Company expensed approximately US\$48,000, US\$56,000 and US\$12,000, respectively, on the development of its products. See Item 4B. Business Overview. It is anticipated that an additional US\$250,000 in research and development costs will be expended on similar projects and potential research and development projects for the development of on line water testing equipment during Fiscal 2006.

*Item 5D.*

### ***Trend Information***

There are increasing demands in the PRC for clean water, greater industrial pollution controls, waste management and electricity. We also see additional distributors competing with us. However, given the political situation in the PRC, trends could quickly disappear and we do not know if they will continue in the future. We note that, as evidenced by our recent acquisition of Pact-Yixing, we are placing greater emphasis on developing our engineering solution business in an effort to capitalize on these increased demands (clean water, pollution controls and waste management).

**The Company believes that the expenses incurred in product development may result in increases in revenue but such increases are unlikely to allow for a recovery of the expenses for approximately the next two years.**

*Item 5E.*

### ***Off Balance Sheet Arrangements***

Not applicable.

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Item 5F.

**Tabular Disclosure of Contractual Obligations**

<b>Contractual Obligations</b>	<b>Total</b>	<b>Less than 1 Year</b>	<b>1-3 Years</b>	<b>4-5 Years</b>	<b>After 5 Years</b>
Operating Leases	US\$423,000	US\$283,000	US\$140,000		
Total Contractual Cash Obligations	US\$423,000	US\$283,000	US\$140,000		

**ITEM 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES**

Item 6A.

**Directors and Senior Management**

Information concerning the Directors and Executive Officers of the Company are as follows:

<b>Name</b>	<b>Age</b>	<b>Position</b>
T.C. Leung	62	Chairman of the Board of Directors and Chief Executive Officer
Jerry Wong	47	Director and Chief Financial Officer
Nancy Wong	57	Director
C.P. Kwan	47	Director
Alex Sham	42	Director
Y.K. Liang	76	Director
Ka Chong Cheang	77	Director
Xu Hong Wang	38	Director
Li Da Weng	61	Director

Set forth below is a brief background of the executive officers and directors based upon the information supplied by them to the Company:

**T.C. Leung** has been Chief Executive Officer and Chairman of the Board of Directors of both the Company and Far East since their inception. Before establishing Far East, Mr. Leung was an engineer for English Electric in England, from 1965 to 1968, and Lockheed Aircraft in Hong Kong, from 1968 to 1970. Mr. Leung also served as managing director of Eurotherm (Far East) Ltd.

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between 1971 and 1992. Since 1988, Mr. Leung has also served as managing director of Eurotherm Hong Kong. Mr. Leung received a Masters degree in Business Administration from the University of East Asia, Macau in 1986 and is a Chartered Engineer, a title bestowed upon a member of the Council of Engineering Institutions in the United Kingdom.

**Jerry Wong** has served as Director and Chief Financial Officer of Far East since 1994 and has been with Far East since 1987. Mr. Wong has been the Chief Financial Officer and a Director of the Company since its inception. From 1985 until 1987, Mr. Wong worked for MUA Agencies Ltd., a subsidiary of a Hong Kong publicly listed company engaged in the insurance business, as deputy manager of its secretarial, legal and accounting department. From 1981 until 1985, Mr. Wong served as a senior accountant in Price Waterhouse-Hong Kong. He is a Fellow of the Association of Chartered Certified Accountants in the United Kingdom and a Certified Public Accountant in Hong Kong.

**Nancy Wong** has been a Director of the Company since its inception and a Director of Far East, and its Personnel Manager, since 1994. Ms. Wong has been with Far East since 1971. Ms. Wong is also Far East's Chief Representative in China. Ms. Wong received a Bachelor of Science degree in Business Administration from the University of East Asia, Macau in 1989.

**C.P. Kwan** joined Far East in 1984 and has served as a Director and Manager of its Process Equipment Department since 1991. Mr. Kwan has been a Director of the Company since its inception. Before joining Far East, he was employed by Haven Automation (H.K.) Ltd., a company involved in the water treatment and process control business between 1981 and 1984. Mr. Kwan received a Masters Degree in Business Administration from the Open University of Hong Kong in 2001.

**Alex Sham** has been a Director of the Company since its inception. Mr. Sham joined Far East in 1988 and has been its Sales Manager since 1993 and became a Director of Far East in 1996. Mr. Sham received a Bachelor of Science in Applied Chemistry from Hong Kong Baptist University in 1990. Prior to joining Far East, Mr. Sham was employed by the Environmental Protection Department of the Hong Kong Government from 1986 until 1988. Mr. Sham received a Master's Degree in Business Administration from the University of Adelaide in 2003.

**Y.K. Liang** has been a Director of the Company since February 1998. Mr. Liang is a director of Wong Liang Consultants Ltd. (Consultants) and a member of the certified public accounting firm of Y.K. Liang & Co. (LCO). Mr. Liang has been associated with both Consultants and LCO for more than the past five years. Consultants is a general business consulting firm.

**Ka Chong Cheang** has been a Director of the Company since December 2005. From 1952 until 1977, he had been shipping manager for John Swine & Sons (Hong Kong) Ltd., a firm engaged in the importing and exporting shipping industry. For more than the past five years, Mr. Chong has been a business consultant.

**Xu Hong Wang** has been a director of the Company since August 2002. Mr. Wang is the East China sales manager of Euro Tech (Far East) Limited, a wholly-owned subsidiary of the

Company, since mid 1994. From mid 1997 until joining Euro Tech, he was employed as a Research Associate and Lecturer at the Analysis and Research Center of Shanghai's Tongji University. Wang Xu Hong received Bachelor's and Master's degrees in Science from Fudan University in 1984 and 1988, respectively.

**Li Da Weng**, from 1993 until January 2005, was the General Director of the Yangtze Valley Water Resources Protection Bureau ( YVWRPB ). He was employed by the YVWRPB in various positions, for more than 25 years, before he became the General Director in 1993. Since 2005, he has been the Secretary General of Yangtze Forum, a group of governments, businesses, universities and research institutes meeting on occasion to discuss issues on protecting and developing the Yangtze River, and since 1994 he has been a member of the Science and Technical Committee of Changjiang Water Resources Commission. Mr. Li Da Weng graduated from Hengyang Mining and Metallurgy College (now known as Nanhua University) in 1965 with a Bachelor's Degree in Analytical Chemistry. From December 1981 to December 1983, he was a visiting scholar at the Canada's Centre for Inland Waters, National Water Research Institute .

Directors of the Company serve until the next annual meeting of shareholders of the Company and until their successors are elected and duly qualified. Officers of the Company are elected annually by the Board of Directors and serve at the discretion of the Board of Directors.

None of the Company's directors, officers or beneficial owners of ten percent or more of its Common Stock are required to file any reports pursuant to Section 16(a) of the Securities Exchange Act of 1934, as amended (the "1934 Act").

The Company had two meetings of its Board of Directors during Fiscal 2005, while its Audit Committee had six meetings during Fiscal 2005.

Mr. Choi Chiu Ho and Mr. Siu Hung Lau resigned as directors in December 2005 and June 2006, respectively.

There are no material legal proceedings involving any director, officer or affiliate of the Company, owner of record or beneficially of more than five percent of the Company's Common Stock or any associate of any of the foregoing.

#### **Key Employees**

**George Hayek**, Managing Director. He is the founder of Pact and Yixing and is a civil engineer (1967) and post-graduate certificate holder in sanitary engineering and environmental management from the American University of Beirut and the University of California at Irvine (in 1971 and 1988, respectively). Since 1971, he has occupied several key posts in water and wastewater treatment companies in the USA, the UK, Spain, Cyprus, The Middle East, Southeast Asia and the last 12 years in the PRC. From 1998 to date, he has been the managing director of Pact. His international experience helped Pact in securing most of the contracts with European and American multinational industries in the PRC.



With the introduction of the Mandatory Provident Fund Scheme, a defined contribution scheme managed by an independent trustee on December 1, 2000, each of the Company and its employees who joined the Company subsequently makes monthly contributions to the scheme at 5% of the employee's cash income as defined under the Mandatory Provident Fund legislation. Contributions of both the Company and its employees are subject to a maximum of HK\$1,000 per month and thereafter contributions are voluntary and are not subject to any limitation. The Company and its employees made their first contributions in December 2000.

As stipulated by the rules and regulations in the PRC, the Company contributes to state-sponsored retirement plans for its employees in the PRC. The Company contributes approximately 10% to 22% of the basic salaries of its employees, and has no further obligations for the actual payment of pension or post-retirement benefits beyond the annual contributions. The state-sponsored retirement plans are responsible for the entire pension obligations payable to retired employees.

During the years ended December 31, 2005, 2004 and 2003, the aggregate contributions of the Company to the aforementioned pension plans and retirement benefit schemes were approximately US\$191,000, US\$166,000 and US\$137,000, respectively.

**Management Option Plan.** The Company had authorized the issuance of Options to purchase up to an aggregate of 4,586,400 Ordinary Shares (the "Management Options") to its officers, directors and employees as the Company's Chairman of the Board and Chief Executive Officer may direct. The Management Options became exercisable on March 14, 1998 and will expire on March 14, 2007.

The exercise price and the number of Ordinary Shares purchasable upon exercise of any Management Options are subject to adjustment upon the occurrence of certain events, including stock dividends, reclassification, reorganizations, consolidations, mergers, and certain issuances and redemptions of Ordinary Shares and securities convertible into or exchangeable for Ordinary Shares excluding certain issuances of shares. No adjustments in the exercise price will be required to be made with respect to the Management Options until cumulative adjustments amount to US\$0.05.

In the event of any capital reorganization, certain reclassifications of the Ordinary Shares, any consolidation or merger involving the Company (other than (i) a consolidation or merger which does not result in any reclassification or change in the outstanding Ordinary Shares, or (ii) sale of the properties and assets of the Company, as, or substantially as, an entirety to any other corporation), Management Options will thereupon become exercisable only for the number of shares of stock or other securities, assets, or cash to which a holder of the number of Ordinary Shares of the Company purchasable (at the time of such reorganization, reclassification, consolidation, merger, or sale) upon exercise of such Management Options would have been entitled upon such reorganization, reclassification, consolidation, merger, or sale.

The table below shows, as to each of the executive officers and directors of the Company and as to all executive officers and directors of the Company as a group, the following

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information with respect to Management Options: (i) the aggregate amounts of Ordinary Shares subject to Management Options; and (ii) the per share exercise price for the Management Options granted to these individuals at June 2, 2006.

Each of the following persons also received options under the Company's 2000 and 2002 Officers and Directors Plans.

Name of Executive Officers and Directors	Shares Subject To Remaining (Unexercised) Management Options	Per Share Exercise Price	
		(US\$)	(1)
T.C. Leung	2,350,000	1.6789	
Alex Sham	125,444	1.6789	
	65,520	1.221	
Jerry Wong	124,064	1.6789	
Nancy Wong	92,820	1.6789	
	24,570	1.221	
C.P. Kwan	73,710	1.6789	
	24,570	1.221	
Xu Hong Wang	27,294	1.6789	
All Executive Officers and Directors as a group (9 persons)	2,907,992	1.221	1.6789 (1)

(1) Price range.

Other officers and/or employees of the Company have been or will be granted management options to purchase an aggregate of 282,984 Management Options, all of which will be exercisable at US\$1.6789 per share.

As of June 2, 2006, Mr. Leung has exercised 1,253,600 Management Options (1,146,000 options at US\$1.221 per share and 107,000 options at US\$1.6789 per share).

**Company Option Plans.** The Company's 2000 Officers and Directors Plan and 2002 Officers and Directors Plan (collectively referred to as the Officers Plans) provide for the grant of options to acquire Ordinary Shares to the Company's executive officers and directors and persons holding the same positions with the Company's subsidiaries. The 2000 Employees Plan and 2002 Employees Plan (collectively referred to as the Employees Plan) provides for the

grant of options to acquire Ordinary Shares to key employees of the Company and its subsidiaries. All four plans are collectively referred to as the Plans .

692,580 and 1,637,160 shares had been originally authorized for issuance under the Employees Plan and the Officers Plans, respectively.

The Board of Directors or a committee (the Committee ) appointed by the Board of Directors administers the Plans. The Board of Directors or the Committee has the authority to interpret the Plans, prescribe, amend and rescind rules and regulations relating to them, determine the terms and provisions of options granted under the Plans (which need not be identical), and make other determinations as it deems necessary and advisable for the administration of the Plans. The Board of Directors or the Committee also has the authority to delegate decisions with respect to Options granted to key employees under the Employees Plan who are not elected officers or directors of the Company or its subsidiaries and to delegate decisions with respect to key employees to the Chief Executive Officer.

Any decision by the Committee or the Chief Executive Officer to grant an award under the Plans is subject to ratification by the Board of Directors of the Company. The Board is also to ratify any decision that effects the terms or conditions of options awarded to elected officers or directors of the Company or its subsidiaries.

In the event that the Ordinary Shares of the Company are subdivided or consolidated as a result of a reorganization, stock split, payment of a stock dividend, reverse stock split or other change in the Company's capitalization, the Committee or the Board of Directors has the authority to make appropriate adjustments in the Ordinary Shares available for issuance under the Plans, the number of shares subject to options that may have been or may be awarded to any participant in any 12 month period, the price, number of Ordinary Shares or kind of securities subject to outstanding options, or the terms of such options in order to prevent dilution or enlargement of rights under the options. In addition, the Board may also change the kind of securities available for grant under the Plans to reflect any such corporate changes.

The Committee or the Chief Executive Officer has the discretion to determine which employees constitute key employees to whom options will be awarded under the Employees Plan.

The Committee or Chief Executive Officer, as the case may be, determines the number of Ordinary Shares subject to options to be granted.

The purchase price per share of the Ordinary Shares to be paid upon the exercise of the option must be at least 100% of the fair market value of an Ordinary Shares on the date on which the option was granted. Under the Plans, if the Ordinary Shares are principally traded on a national securities exchange or the Nasdaq Stock Market's National Market or Small Cap Market at the time of grant, the Company is required to use, as fair market value, the average of the closing prices of the Ordinary Shares for the ten consecutive trading days immediately before the date of grant. If the Ordinary Shares are traded on a national securities exchange or the Nasdaq Stock Market's National Market or Small Cap Market, but no closing prices are reported for such ten-day period, or if the Ordinary Shares are principally traded in the over-the-counter market, the Company is required to use, as fair market value, the average of the mean between the bid and asked prices reported for the Company's Ordinary Shares at the close of trading during such

ten-day period before the date of grant. If the Ordinary Shares are traded neither on a national securities exchange, the Nasdaq Stock Market's National Market, Small Cap Market nor in the over-the-counter market or if bid and asked prices are otherwise not available, the fair market value of the Ordinary Shares on the date of grant will be determined in good faith by the Committee or the Board of Directors, as the case may be.

The Board of Directors or the Committee, as the case may be, or, to the extent that such authority has been delegated to the Chief Executive Officer, the Chief Executive Officer determines, at the time of grant, when each option granted under the Plans will become exercisable. Notwithstanding the foregoing, all options held by a key employee of the Company or its subsidiaries become immediately exercisable, whether or not exercisable at the time, upon the death or disability.

No option is to be exercisable more than ten years from the date the option is granted.

Payment of Exercise Price for Options. Under the Plans, payment for shares purchased upon exercise of an option may be made by any of the following methods, subject to certain requirements: (1) in cash, paid by either the optionholder or a broker to whom the optionee has tendered the option; (2) in Ordinary Shares valued at the fair market value of such shares on the date of exercise, provided that such shares were held by the optionholder for not less than six months prior to the date of exercise of the option; (3) by any other medium of payment that the Board, Committee or the Chief Executive Officer, as applicable, has authorized at the time of grant (other than the withholding of shares issuable upon the exercise of options); or (4) by any combination of the preceding methods.

Transfer Of Options. Under the Plans, an option may not be sold, assigned or otherwise transferred except to:

- the spouse or lineal descendant of a plan participant;
- the trustee of a trust for the primary benefit of a plan participant's spouse or lineal descendant;
- a partnership of which a plan participant and lineal descendants are the only partners; or
- a charitable organization.

These assignments are only permitted if the assigning optionee does not receive any compensation in connection with the assignment and the assignment is expressly approved by the Board or Committee, as the case may be.

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The Company indemnifies the members of any Committee and its delegates and the Chief Executive Officer against (1) reasonable expenses incurred in connection with the defense of any action, suit or proceeding to which they may be a party by reason of any action taken or failure to act in connection with the Plans, and (2) all amounts paid by them in settlement of or satisfaction of a judgment entered in any such action, suit or proceeding, except in cases where such a person is adjudged liable for gross negligence or gross misconduct in the performance of his or her duties.

The Board may terminate, suspend, or amend the Plans at any time without the authorization of shareholders to the extent allowed by law or the rules of any market on which the Company's shares are then listed or quoted.

During Fiscal 2000 and in January 2002, the Company granted options to certain of its officers and directors pursuant to the 2000 Officers and Directors Plan and, in November 2002, options were granted to certain of its officers and directors pursuant to the 2002 Officers and Directors Plan. The table below shows, as to each of the executive officers and directors of the Company and as to all executive officers and directors of the Company as a group, the aggregate amounts of Ordinary Shares remaining (unexercised), subject to such options.

Names of Executive Officers and Directors	Shares Subject To the Officers Plans Options	Per Share Exercise Price (US\$)
T.C. Leung	567,000	(1)0.5857
	205,800	(2)0.8191
Alex Sham	84,000	(1)0.5857
	94,500	(2)0.8191
Nancy Wong	42,000	(1)0.5857
	21,840	(2)0.5787
	23,100	(2)0.8191
C.P. Kwan	42,000	(1)0.5857
	16,380	(2)0.5787
	22,680	(2)0.8191
Xu Hong Wang	42,000	(1)0.5857
	10,920	(3)0.5787
	31,500	(3)0.8191
All executive officers and Directors as a group	1,203,720	0.5787 0.8191 (4)

(1) Granted pursuant to the 2002 Officers and Directors Plan.

- (2) Granted pursuant to the 2000 Officers and Directors Plan.
- (3) Granted pursuant to the 2000 Employees Plan.
- (4) Price range.

The foregoing options will expire in August 2010.

Pursuant to its 2000 Employees Plan, the Company had originally granted options to 32 of its non-officer/director employees to purchase an aggregate of 398,580 of its Ordinary Shares exercisable at a price of US\$0.5787 per share for a ten year term expiring in February 2011.

Pursuant to its 2002 Employees Plan, the Company had originally granted options to 32 of its non-officer/director employees to purchase an aggregate of 294,000 of its Ordinary Shares exercisable at a price of US\$0.7618 per share for a ten year term expiring in April 2012.

As of June 2, 2006, 451,080 options had been exercised, including 300,300 options exercised by Mr. Leung at a price of US\$0.5857 per share.

The Company has set forth in this Report all required disclosure of additional compensation to its executive officers and directors including personal benefits and securities or properties paid or distributed which was not offered on the same terms to all full time employees during Fiscal 2005.

Changes in outstanding options under various plans mentioned above were as follows:

	As of December 31, 2005		2004		2003	
	Number of Options	Weighted average exercise price	Number of options	Weighted average exercise price US\$	Number of Options	Weighted average exercise price US\$
Outstanding, beginning of year	6,724,042	1.26	6,862,632	1.24	6,862,632	1.24
Granted			46,000	1.68		
Cancelled	(104,706 )	(1.16 )	(184,590 )	(0.93 )		
Exercised	(604,530 )	(0.78 )				
Outstanding, end of year	5,978,806	1.31	6,724,042	1.26	6,862,632	1.24
Exercisable, end of year	5,978,806	1.31	6,724,042	1.26	6,862,632	1.24

As of December 31, 2005, the options outstanding and exercisable had exercise prices in the range of US\$0.5787 to US\$1.6789 and a weighted average unexpired life of approximately 2.5 years.

The Company accounts for stock-based compensation using the intrinsic value method prescribed by APB Opinion No. 25, under which no compensation cost is recognized as all stock options granted under the Management Options, the 2000 Stock Options, the 2002 Employee Stock Option and the 2002 D&O Stock Options have exercise prices at or above the fair market value of the underlying stock at the date of grant.

Pro forma information regarding net income and earnings per share is required by SFAS No. 123, and has been determined as if the Company had accounted for its employee stock options under the fair value method of SFAS No. 123. The weighted average fair values of stock options at date of grant of US\$1.44 per option for the year ended December 31, 2004, were estimated using the Black-Scholes option pricing model with the following assumptions. There were no options granted during the years ended December 31, 2003 and 2005.

	2005	2004	2003
Risk-free interest rate		2.88	%
Expected dividend yield		0	%
Expected option life		2.3 years	
Expected stock price volatility		208	%

The Black-Scholes option-pricing model requires the input of subjective assumptions, including the expected volatility of stock price. Because changes in subjective input assumptions can materially effect the fair value estimate, in directors' opinion, the existing model may not necessarily provide a realizable measure of the fair value of the stock options.

Had compensation expense for the Company's stock-based compensation plan been recognized based on the fair value of the options on the grant date in accordance with SFAS No. 123, the Company's pro forma net income and earnings per common share would have been as follows:

	As of December 31,		
	2005	2004	2003
	US\$	US\$	US\$
	(amounts expressed in thousands, except share and per share data)		
Net income as reported	733	594	531
Less: Stock compensation expense determined under the fair value method, net of tax	(39)	(27)	(216)
Pro forma net income/(loss)	694	567	315
Income/(loss) per share:			
Basic, as reported	US\$0.11	US\$0.09	US\$0.08
Diluted, as reported	US\$0.07	US\$0.06	US\$0.08
Basic, pro forma	US\$0.11	US\$0.09	US\$0.05
Diluted, pro forma	US\$0.07	US\$0.06	US\$0.05



*Item 6C.*

***Board Practices***

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The term of each of the Company's directors expires at the election and qualification of their successors at the next annual meeting of the Company's shareholders, anticipated to be held in August of this year. Of the Company's nine directors, seven were elected at the Company's last annual meeting of shareholders in August 2005 and the eighth and ninth members were appointed to the Board in December 2005 and June 2006.

The Board has a standing Audit Committee to assist the Board in carrying out its duties. The Audit Committee has a written charter approved by the Board. The chair of the Audit Committee determines the meeting agenda of the Audit Committee. The Audit Committee members receive materials in advance of Committee meetings allowing them to prepare for the meeting.

During Fiscal 2005, the Audit Committee met six times, being attended by all members.

The Audit Committee assists the Board in monitoring the Company's financial accounting, controls, planning and reporting. Among its duties, the Audit Committee:

- reviews the Company's auditing, accounting and financial reporting process;

- reviews the adequacy of the Company's internal controls;

- reviews the independence, fee arrangements, audit scope, and performance of the Company's independent auditors, and recommends the appointment or replacement of independent auditors to the Board of Directors;

- reviews and approves all non-audit work, if any, to be performed by the auditors;

- reviews the scope of our internal auditing and the adequacy of the organizational structure and qualifications of the internal auditing staff;

- reviews, before release, the audited financial statements and operating and financial review and prospects contained in the Company's Annual Report on Form 20-F, and recommends that the Board of Directors submit these items to the shareholders' meeting for approval;

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provide an open avenue of communication among the Company's independent auditors, financial and senior management, the internal audit function and the Board of Directors;

review and update the Company's Code of Business Conduct and Ethics and ensure that there is a system to enforce same and that this Code complies with all applicable rules and regulations;

ensure that the Company's management and auditors assess current financial reporting issues and practices;  
and

review and pre-approve both audit and non-audit services to be provided by the Company's auditors.

The Audit Committee is currently composed of Y.K. Liang, Ka Chong Cheang and Li Da Weng. The Audit Committee's financial expert is Y.K. Liang. The Board has determined that the membership of the Audit Committee meets the current independence requirements of the NASDAQ listing standards as same applies to private foreign issuers and the applicable rules and regulations of the SEC.

*Item 6D.*

## ***Employees***

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The Company (exclusive of Pact-Yixing) has approximately 180 full-time employees. At December 31, 2005, 2004 and 2003, staffing levels were approximately as follows:

	2005*	2004*	2003*
Marketing and sales	76	72	62
Administrative	59	53	40
Technical	45	37	23
Total full time employees	180	162	125

\* For 2003 does not include, but for 2004 and 2005 does include, employees situated in our retail shops and their representative offices.

Pact and Yixing had approximately 30 full-time employees at December 31, 2005, including 21 engineers and 9 administrative employees.

The Company's management consists of its officers and directors.

The Company is not subject to any collective bargaining agreement and believes that its relations with its employees are good.

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*Item 6E.*

### ***Share Ownership***

With respect to the share ownership of the directors and senior management of the Company, reference is made to Item 7. Major Shareholders and Related Party Transactions.

ITEM 7.

## **MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS**

*Item 7A.*

### ***Major Shareholders***

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The following table sets forth, as of June 1, 2006, certain information concerning beneficial ownership of the Company's Ordinary Shares with respect to (i) each person known to the Company to own 5% or more of the outstanding Ordinary Shares, (ii) each director and executive officer of the Company, and (iii) all officers and directors of the Company as a group:

	<b>Amount and Nature of Beneficial Ownership(3)</b>	<b>Approximate Percentage Of Ordinary Shares Owned</b>	
T.C. Leung (1)(2)	7,222,645	63.8	%
Pearl Venture Ltd.(1)(2)	2,536,445	30.9	%
Alex Sham(1)(3)	402,224	4.7	%
Jerry Wong(1)(3)	297,704	3.6	%
Nancy Wong(1)(3)	204,330	2.4	%
C.P. Kwan(1)(3)	238,316	2.8	%
Y.K. Liang(1)	*	*	
Xu Hong Wang(1)(3)	111,714	1.3	%
Ka Chong Cheang(1)	*	*	%
Li Da Weng(1)	*	*	%
All Executive Officers And Directors of the Company as a group (9 persons)(2) (3)	8,476,933	68.9	%

\* Denotes Nil.

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(1) The address for the Company's officers and directors is c/o Euro Tech (Far East) Ltd., 18/F Gee Chang Hong Centre, 65 Wong Chuk Hang Road, Hong Kong. The address for Pearl is Columbus Centre Building, Wichhams Cay, Road Town, Tortola, British Virgin Islands.

(2) Includes shares of the Company's Common Stock owned of record by Pearl, which is a trust established for the benefit of Mr. Leung. Also includes those Company Ordinary Shares owned of record by Regent, of which Pearl is the majority shareholder.

(3) Gives effect to the exercise of Management Options and 2000 Officers and Directors Plan, 2000 Employees Plan and 2002 Officers and Directors Plan Options owned of record by such persons and which have vested or will vest within six (6) months of the date of this Report. See Item 6B. Compensation.

*Item 7B.*

### ***Related Party Transactions***

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The related companies with which the Company has engaged in material transactions are Eurotherm and Armtison Limited ( Armtison ) and Patwin Inc. ( Patwin ).

During Fiscal 2005, 2004 and 2003, the Company made sales to Eurotherm of approximately US\$Nil, US\$27,000 and US\$43,000, respectively. During Fiscal 2005, 2004 and 2003, the Company made purchases from Armtison of approximately US\$Nil, US\$Nil and US\$4,000, respectively. During Fiscal 2005, 2004 and 2003, the Company made purchases from Eurotherm of approximately US\$242,000, US\$7,503,000 and US\$7,219,000, respectively. Additionally, during Fiscal 2005, 2004 and 2003, the Company paid approximately US\$11,000, US\$25,000 and US\$33,000, respectively to Armtison for office space rentals, and for Fiscal 2005, 2004 and 2003, paid Eurotherm approximately US\$4,000, US\$29,000 and US\$29,000 in management fees to assist in the management of some of the Company's PRC offices while the Company earned approximately US\$2,000, US\$30,000 and US\$34,000 from Eurotherm for office space rentals during Fiscal 2005, 2004 and 2003, respectively. The payments to Armtison and Eurotherm were based on actual office space usage and the time cost of personnel used, respectively. During Fiscal 2005 and 2004, the Company received management fees of US\$2,000 and US\$9,000 from Armtison for accounting and administrative services. The Company also paid approximately US\$18,000, US\$30,000 and US\$30,000 in management fees to Patwin to represent the Company in the United States for each of Fiscal 2005, 2004 and 2003, respectively. At the end of Fiscal 2004 and 2003, the Company was obligated to Eurotherm for approximately US\$1,265,000 and US\$1,330,000, respectively, for normal trade indebtedness. This indebtedness is repayable on normal trading terms, is unsecured and does not bear interest. T.C. Leung, the Company's Chairman of the Board and Chief Executive Officer was also a director of Eurotherm as at December 31, 2004 and 2003 and retired in February 2005. Patwin is beneficially owned by the brother of T.C. Leung.

As of December 31, 2003, approximately US\$261,000 of other current assets represent to certain PRC employees of the Company. The advances are provided to those PRC employees in order for them to finance the operations of certain retail shops established in PRC by the employees to sell the Company's products. The advances are unsecured, bear interest at a nominal rate and have no fixed repayment terms. During Fiscal 2003, an allowance for doubtful debt in respect of such advances of US\$45,000 was made. The Company does not account for the related sales to these retail shops until the inventories are sold to third parties. As at

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December 31, 2005 and 2004, the Company has included the financial results of these retail shops with the application of FIN 46 Consolidation of Variable Interest Entities . All material intercompany balances and transactions have been eliminated in consolidation.

*Item 7C.*

### ***Interest of Experts and Counsel***

Not applicable.

ITEM 8. **FINANCIAL INFORMATION**

*Item 8A.* ***Consolidated Statements and Other Financial Information***

Item 8A.1 See Item 18.

Item 8A.2 See Item 18.

Item 8A.3 See Reports of Independent Registered Public Accounting Firms, pages F-2 and F-3.

Item 8A.4 We have complied with this requirement.

Item 8A.5 Not applicable.

Item 8A.6 Not applicable.

Item 8A.7 Legal Proceedings.

The Company is not a party to any material legal proceedings.

Item 8A.8 Dividend Policy.

The Company has not paid cash dividends to date. The payment of cash dividends, if any, in the future is within the discretion of the Board of Directors. The payment of cash dividends, if any, in the future will depend upon the Company's earnings, capital requirements and financial conditions and other relevant factors. The Company's Board of Directors does not presently intend to declare any cash dividends in the foreseeable future, but instead intends to retain all earnings, if any, for use in the Company and Far East's business operations.

*Item 8B.* **Significant Changes**

There has not been any significant change since the date of the annual financial statements included in this Report.

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## ITEM 9.

**THE OFFERING AND LISTING***Item 9A.* Listing Details

The Company has one class of securities presently registered: Ordinary Shares. These securities are presently traded on the NASDAQ SmallCap Market under the trading symbols CLWT, and have so traded since the Company's Public Offering in March 1997.

The following prices are not adjusted to reflect stock dividends of 20%, 30%, 40% and 50% issued in September 1999, August 2001, September 2003 and August 2004, respectively.

The high and low prices for the Ordinary Shares in the periods indicated, as reported by NASDAQ, are set forth below:

Years Ended December 31,	Low US\$	High US\$
2001	0.4293	1.6857
2002	0.5786	1.3707
2003	0.650	3.7143
2004	0.933	7.327
2005	2.700	6.590

Quarters Ended	Low US\$	High US\$
June 30, 2004	1.700	5.280
September 30, 2004	2.074	5.447
December 31, 2004	2.360	6.940
March 31, 2005	3.000	4.680
June 30, 2005	2.700	4.900
September 30, 2005	3.300	6.590
December 31, 2005	3.050	4.850
March 31, 2006	3.250	3.800

The Following Months	Low US\$	High US\$
January 2006	3.020	3.600
February 2006	3.200	4.440
March 2006	3.340	4.240
April 2006	3.300	3.740
May 2006	3.250	3.460

The Ordinary Shares were held by approximately 41 holders of record as of June 2, 2006. Based upon information received from broker-dealers, clearing firms and others, the Company believes that it has approximately at least 1,700 beneficial shareholders of its Ordinary Shares.

*Item 9B.***Plan of Distribution**



Not Applicable.

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*Item 9C. Markets*

See Item 9A. Listing Details.

*Item 9D. Selling Shareholders*

Not Applicable.

*Item 9E. Dilution*

Not Applicable.

*Item 9F. Expenses Of The Issue*

Not Applicable.

ITEM 10. **ADDITIONAL INFORMATION**

*Item 10A.* ***Share Capital***

**Authorized Capital.** The authorized capital of the Company is US\$250,000 comprised of 20,000,000 Ordinary Shares and 5,000,000 shares of Preferred Stock. As of December 31, 2005, there were 7,022,351 Ordinary Shares and no shares of Preferred Stock, issued and outstanding. An additional approximately 341,000 Ordinary Shares were repurchased by the Company as treasury stock and are non-voting. All of the Company's shares of capital stock have a par value of US\$0.01 per share.

Holders of the Company's Ordinary Shares are entitled to one vote for each whole share on all matters to be voted upon by shareholders, including the election of directors. Holders of Ordinary Shares do not have cumulative voting rights in the election of directors. All shares of Ordinary Shares are equal to each other with respect to liquidation and dividend rights. Holders of Ordinary Shares are entitled to receive dividends if and when declared by the Company's Board of Directors out of funds legally available under British Virgin Islands law. In the event of the liquidation of the Company, all assets available for distribution to the holders of Ordinary Shares are distributable among them according to their respective share holdings. Holders of Ordinary Shares have no preemptive rights to purchase any additional, unissued shares of Ordinary Shares. All of the outstanding shares of Ordinary Shares of the Company are duly authorized, validly issued, fully paid and non-assessable.

Pursuant to the Company's Memorandum and Articles of Association and pursuant to the laws of the British Virgin Islands, the Company's Memorandum and Articles of Association may be amended by a resolution of the Board of Directors without shareholder approval. This includes amendments to increase or reduce the authorized capital stock of the Company or to increase or reduce the par value of its shares. The ability of the Company to amend its

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Memorandum and Articles of Association without shareholder approval could have the effect of delaying, deterring or preventing a change in control of the Company without any further action by the shareholders including but not limited to, a tender offer to purchase the Common Stock at a premium over then current market prices.

Under United States law, majority and controlling shareholders generally have certain fiduciary responsibilities to the minority shareholders. Shareholder action must be taken in good faith and actions by controlling shareholders which are obviously unreasonable may be declared null and void. The British Virgin Islands law protecting the interests of the minority shareholders is not as protective in all circumstances as the law protecting minority shareholders in United States jurisdictions. While British Virgin Islands law does not permit a shareholder of a British Virgin Islands company to sue its directors derivatively, *i.e.*, in the name of and for the benefit of the Company, and to sue the Company and its directors for his benefit and the benefit of others similarly situated, the circumstances in which any such action may be brought that may be available in respect of any such action may result in the rights of shareholders of a British Virgin Island company being more limited than those rights of shareholders in a United States company.

The Board of Directors of the Company, without further shareholder action, may issue shares of Preferred Stock in any number of series and may establish as to each such series the designation and number of shares to be issued and the relative rights and preferences of the shares of each series, including provisions regarding voting powers, redemption, dividend rights, rights upon liquidation and conversion rights. The issuance of shares of Preferred Stock by the Board of Directors could adversely effect the rights of holders of Ordinary Shares by, among other matters, establishing preferential dividends, liquidation rights and voting power. The Company has not issued any shares of Preferred Stock and has no present intention to issue shares of Preferred Stock. The issuance thereof could discourage or defeat efforts to acquire control of the Company through acquisition of Ordinary Shares.

*Item 10B.*                    **Memorandum and Articles of Association**

Set forth below is a summary of the material provisions of our Memorandum and Articles of Association (the Articles) and the British Virgin Islands ( BVI ) International Business Companies Act of 1984 relating to the shares. This description does not purport to be complete and is qualified in its entirety by reference to BVI statutory law and to the Articles.

**Share Register and Voting Restrictions.** The Company maintains a share register at its registered office in the BVI. The Company's registered number is 200960. The objects of the Company are to engage in any act or activity that is not prohibited under any law of the BVI. See Regulation 4(1) of the Articles. Under the Articles, the Company is not required to treat the holder of a registered share in the Company as a shareholder until that person's name has been entered in the share register. The holders of Ordinary Shares have one vote for each Ordinary Share held of record. The holders of Preferred Shares have such voting powers, full or limited, or no voting powers and such restrictions as may be stated and expressed in the resolution providing for the issuance of the Preferred Shares.

**Shareholders Meeting.** The directors of the Company may convene meetings of the shareholders of the Company at such times and in such manner and places within or outside the BVI as the directors consider necessary or desirable. Upon the written request of the shareholders holding ten (10%) percent or more of the outstanding voting shares in the Company the directors must convene a meeting of shareholders. The directors must give not less than seven days notice of meetings of shareholders to those persons whose names on the date of the notice is given appear as shareholders in the share register of the Company and are entitled to vote at the meeting. The directors may fix the date notice is given of a meeting of shareholders as the record date for determining those shares that are entitled to vote at the meeting.

The inadvertent failure of the directors to give notice of a meeting to a shareholder, or the fact that a shareholder has not received notice, does not invalidate the meeting. A shareholder may be represented at a meeting of shareholders by a proxy who may speak and vote on behalf of the shareholder.

A shareholder may participate at a meeting of shareholders by telephone or other electronic means, as long as all shareholders participating in the meeting are able to hear each other.

A meeting of shareholders is duly constituted if, at the commencement of the meeting, there are present in person or by proxy not less than fifty (50%) percent of the votes of the shares or class series of shares entitled to vote on resolutions of shareholders to be considered at the meeting.

If a quorum is not present, the meeting, if convened upon the requisition of shareholders, shall be dissolved; in any other case it shall stand adjourned to the next business day at the same time and place or to such other time and place as the directors may determine, and if at the adjourned meeting there are present in person or by proxy not less than one third of the votes of the shares or each class or series of shares entitled to vote on the resolutions to be considered by the meeting, those present shall constitute a quorum but otherwise the meeting shall be dissolved.

At every meeting of shareholders, the chairman of the board of directors shall preside as chairman of the meeting.

The chairman may, with the consent of the meeting, adjourn any meeting from time to time, and from place to place, but no business shall be transacted at any adjourned meeting other than the business left unfinished at the meeting from which the adjournment took place.

At any meeting of the shareholders the chairman shall be responsible for deciding in such manner as he shall consider appropriate whether any resolution has been carried or not and the result of his decision shall be announced to the meeting and recorded in the minutes thereof.

Any action that may be taken by the shareholders at a meeting may also be taken by a resolution of shareholders consented to in writing or by written electronic communication, without the need for any notice, but if not a unanimous writing, a copy of such resolution shall be sent to all non-consenting shareholders.

**Net Profits and Dividends.** Under BVI law, dividends may only be declared and paid by an International Business Company (which the Company is classified as under BVI law) out of surplus, such that after payment of dividends such company must be able to satisfy its liabilities as they become due in the ordinary course of business and the realizable value of the assets of such company must not be less than the sum of its liabilities (other than deferred taxes and capital). There are no other BVI restrictions regarding dividends.

**Pre-emptive Rights.** The holders of Ordinary Shares and Preferred Shares are not entitled to any pre-emptive or similar rights.

**Borrowing Power.** The directors may exercise all the powers of the Company to borrow money and to mortgage or charge its undertakings and property or any part thereof, to issue debentures, debenture stock and other securities whenever money is borrowed or as security for any debt, liability or obligation of the Company or of any third party.

**Conflict of Interests.** No agreement or transaction between the Company and one or more of its directors or any person in which any director has a financial interest or to whom any director is related, including as a director of that other person, is void and avoidable for this reason only, or by reason only that the director is present at the meeting of directors, or at the meeting of the committee of directors that approves the agreement or transaction, or that the vote or consent of the director is counted for that purpose, if the material facts of the interest of each director in the agreement or transaction and his interest in or relationship to any other party to the agreement or transaction are disclosed in good faith, or are known by the other directors. A director who has an interest in any particular business to be considered at a meeting of directors or shareholders may be counted for purposes of determining whether the meeting is duly constituted.

**Repurchase of Shares.** The Company may purchase, redeem or otherwise acquire and hold its own shares, but only out of surplus or in exchange for newly issued shares of equal value. Subject to provisions to the contrary in:

- (a) the designations, powers, preferences, rights, qualifications, limitations and restrictions with which the shares were issued; or
- (b) the subscription agreement for the issue of the shares,

the Company may not purchase, redeem or otherwise acquire its own shares without the consent of shareholders whose shares are to be purchased, redeemed or otherwise acquired.

Generally, no purchase, redemption or other acquisition of shares shall be made unless the directors determine that immediately after purchase, redemption or other acquisition the Company will be able to satisfy its liabilities as they become due in the ordinary course of its business and the realizable value of the assets of the Company will not be less than the sum of its total liabilities, other than deferred taxes, as shown in the books of account, and its capital and, in

the absence of fraud, the decision of the directors as to the realizable value of the assets of the Company is conclusive, unless a question of law is involved.

**Notices.** Any notice, information or written statement to be given by the Company to shareholders may be served, in the case of shareholders holding registered shares in any way by which it can reasonably be expected to reach each shareholder or by mail addressed to each shareholder at the address shown in the share register and in the case of shareholders holding shares issued to bearer, in the manner provided in the Memorandum of Association.

**Purpose, Duration, Liquidation, Merger.** The Company is empowered under BVI law and its Memorandum of Association to engage in any act or activity that is not prohibited under any law in the BVI. The Company shall continue until wound-up and dissolved by a resolution of shareholders, or under the terms of any insolvency or liquidation laws in force in the BVI. Under BVI law the Company may merge with another company, including a parent company or subsidiary, incorporated in the BVI, or in a jurisdiction outside of the BVI where the laws of that jurisdiction permit the merger. A merger must be authorized by the directors of the Company and approved by the shareholders.

**Disclosure of Principal Shareholders.** Under the laws of the BVI the identity of the shareholders of the Company is confidential and is not disclosed in any public document.

**Board of Directors.** The business and affairs of the Company are managed by the directors who may exercise all such powers of the Company as are not by BVI law or by the Company's Articles reserved to the shareholders of the Company.

*Item 10C.*                    **Material Contracts**

During Fiscal 2005, the Company agreed to and did acquire 21% of the capital stock of each of Pact and Yixing from Tamworth. As part of the agreements with Tamworth, Tamworth and Far East each granted to the other a right of first refusal should either elect to sell some or all of their shares to a third party at the same price and with the same conditions as that offered by the third party.

Far East also granted Tamworth a three-year put option requiring Far East to acquire part of all of the remaining shares of Pact owned by Tamworth. The acquisition price for each remaining share is to be based on the following formula:

$$\frac{5.2 \text{ times the Average Net Profit of the latest 3 years of Pact}}{[\textit{Divided By}]}$$

The Total Number of Shares Outstanding

Similarly, Far East also granted Tamworth a three-year put option requiring Far East to acquire all remaining securities of Yixing held by Tamworth at 5.2 times of Yixing's net profit for the three prior fiscal years.

As part of the foregoing agreements, Mr. George Hayek is to continue his employment relationship with Pact and Yixing. See Item 11, Executive Compensation. Mr. Hayek is the majority shareholder of Tamworth. Also, as a substantial portion of Yixing's income is derived from sales to a Middle East company that Mr. Hayek owns a beneficial interest in, Mr. Hayek is required to, and did, disclose the pricing policy for sales to that Middle East company and this policy has been adopted for future sales to the Middle East company.

***Item 10D. Exchange Controls***

There are no exchange control restrictions on payment of dividends on the Company's Ordinary Shares or on the conduct of the Company's operations either in Hong Kong, where the Company's principal executive offices are located, or the British Virgin Islands, where the Company is incorporated. There are no British Virgin Islands laws which impose foreign exchange controls on the Company or that effect the payment of dividends, interest, or other payments to non-resident holders of the Company's securities. British Virgin Islands laws and the Company's Memorandum and Articles of Association impose no limitations on the right of non-resident or foreign owners to hold the Company's securities or vote the Company's Ordinary Shares. The PRC government has established a unified exchange rate system and system of exchange controls to which the Company is subject.

***Item 10E. Taxation***



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The Company is exempted from taxation in the British Virgin Islands.

The Company's subsidiaries organized in Hong Kong, Far East, Euro Tech (China) Limited and ChinaH2O.com Limited, provide for Hong Kong profits tax at a rate of 17.5% on the basis of their income for financial reporting purposes, adjusting for income and expense items which are not assessable or deductible for profits tax purposes. Hong Kong levies no capital gains or dividends tax.

Euro Tech Trading (Shanghai) Limited, a subsidiary of the Company, provides for PRC Enterprise Income Tax at a rate of 15%, after offsetting losses brought forward, if any, on the basis of its income for financial reporting purposes, adjusting for income and expense items which are not assessable or deductible for PRC Enterprise Income Tax purposes.

In accordance with the relevant income tax laws and regulations applicable to foreign investment enterprises in the PRC, Shanghai Euro Tech Limited ( SET ), a subsidiary of the Company, is exempt from PRC Enterprise Income Tax of 15% for two years starting from its first profit-making year, after offsetting losses brought forward, if any, followed by a 50% reduction for the next three years thereafter. As of December 31, 2005, SET remained exempt from the PRC enterprise income tax.

VIEs of the Group provide for PRC Enterprise Income Tax at a rate of 33%, after offsetting losses brought forward, if any, on the basis of its income for financial reporting purposes, adjusting

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for income and expense items which are not assessable or deductible for PRC Enterprise Income Tax purposes.

As of December 31, 2005, certain VIEs had aggregated assessable losses carried forward of US\$128,591 as agreed by the local tax authority.

The Company's effective tax rates for Fiscal 2005, Fiscal 2004 and Fiscal 2003 were 24.2%, 29.3% and 19.7%, respectively. Weighted average statutory tax rates of 23%, 20.8% and 20.1% were in effect for Fiscal 2005, Fiscal 2004 and Fiscal 2003, respectively. Principal adjustments to this statutory tax rate were valuation allowances of 0.3%, 7.0% and (0.8%) during Fiscal 2005, Fiscal 2004 and Fiscal 2003, respectively.

In 2003, Hong Kong changed the profits tax rate from 16% to 17.5% for the fiscal year ended 2003/2004. PRC Enterprise Income Tax applied at 15% for Euro Tech Trading (Shanghai) Limited, a subsidiary incorporated in the PRC, for the year ended December 31, 2005. Accumulated tax losses of Shanghai Euro Tech Limited, another subsidiary incorporated in the PRC, available to offset against future profit were US\$208,525 and US\$226,550, respectively, during Fiscal 2005 and 2004.

*Item 10F.*                    **Dividends And Paying Agents**

Not applicable.

*Item 10G.*

***Statement By Experts***

Not applicable.

*Item 10H.*                    **Documents on Display**

The documents that are exhibits to or incorporated by reference in this annual report can be read at the U.S. Securities and Exchange Commission's public reference facilities at Room 1024, 450 Fifth Street, N.W., Washington, DC 20549 or on the Commission's website: [www.sec.gov](http://www.sec.gov).

*Item 10I.*                    **Subsidiary Information**

Not applicable.

ITEM 11. **QUANTITATIVE AND QUALITATIVE DISCLOSURES  
ABOUT MARKET RISK**

The Company's primary risk exposures arise from changes in interest rates and foreign currency exchanges rates.

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*Foreign Currency Risks*

The Company is exposed to risk from changing foreign currency exchange rates. The Company's sales are denominated either in HK dollar or RMB. The majority of the Company's expenses and cost of revenue are denominated in HK dollars, followed by RMB, US dollars, Japanese yen and the Euro. The Company is subject to a variety of risks associated with changes among the relative value of the US dollar, HK dollar, RMB, Japanese yen and the Euro. The Company does not currently adequately hedge its foreign exchange positions. Any material increase in the value of the HK dollar, RMB, Japanese yen and the Euro relative to the US dollar would increase the Company's expenses and cost of revenue and therefore would have a material adverse effect on the Company's business, financial condition and results of operations.

*Inflation*

The Company cannot accurately determine the precise effect of inflation on its operations, it does not believe inflation has had a material effect on sales or results of operations during the past several years.

The Company is currently not exposed to material future earnings or cash flow exposures from changes in interest rates on debt obligations as the Company had no bank indebtedness in Fiscal 2004. The Company does not currently anticipate entering into interest rate swaps and/or similar instruments.

ITEM 12. **DESCRIPTION OF SECURITIES OTHER THAN  
EQUITY SECURITIES**

Not applicable

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PART II

**ITEM 13. DEFAULTS, DIVIDENDS, ARREARAGES AND DELINQUENCIES**

None.

**ITEM 14. MATERIAL MODIFICATION TO THE RIGHTS OF SECURITY HOLDERS AND USE OF PROCEEDS**

Not Applicable.

**ITEM 15. CONTROLS AND PROCEDURES**

(a) Evaluation of Disclosure Controls and Procedures

Our Chief Executive Officer and Chief Financial Officer have evaluated the effectiveness of our disclosure controls and procedures, as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, as of the end of the period covered by this report (the Evaluation Date ). Based on such evaluation, such officers have concluded that, as of the Evaluation Date, our disclosure controls and procedures are effective in relating to us, including our consolidated subsidiaries, that is required to be included in our reports filed or submitted under the Exchange Act.

The Company's management, including the Chief Executive Executive Officer and Chief Financial Officer, does not expect that our disclosure controls and procedures or our internal controls will prevent all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs.

(b) Changes in Internal Controls

No significant changes in our internal controls or in other factors that could significantly effect these controls subsequent to the date of the evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses, were made as a result of the evaluation.

**ITEM 16. [RESERVED]**

*Item 16A. Audit Committee Financial Expert*

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The Committee includes one non-employee director who meets the independence and financial expert requirements and two other members who meet the independence requirements of the NASDAQ listing standards and the rules and regulations of U.S. Securities

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and Exchange Commission. The Committee includes Messrs. Y.K. Liang and Ka Chong Cheang and Li Da Weng. Mr. Y.K. Liang is the financial expert on that committee.

*Item 16B.*

***Code Of Ethics***

Our board of directors has adopted a code of business conduct and ethics that applies to our directors, officers and employees, including certain provisions that specifically apply to our chief executive officer, chief financial officer and any other persons who perform similar functions for us. The Company agrees to undertake to provide to any person without charge, a copy of our code of business conduct and ethics within ten working days after we receive such person's written request.

*Item 16C.*

***Principal Accountant Fees And Services***

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The following table sets forth the aggregate fees by categories specified below in connection with certain professional services rendered by PricewaterhouseCoopers who were our principal external auditors for 2003 and 2004 and BDO McCabe Lo Limited for 2005.

	<b>For the Year Ended December, 31</b>		
	<b>2003</b>	<b>2004</b>	<b>2005</b>
	<b>US\$</b>	<b>US\$</b>	<b>US\$</b>
Audit fees(1)	88,000	109,000	103,500
Audit-related fees(2)	NIL	NIL	Nil
Tax fees(3)	3,800	6,000	6,000
All other fees	NIL	NIL	NIL

Our Audit Committee has adopted a pre-approval policy for the engagement of our independent accountant to perform permitted audit and non-audit services. Under this policy, which is designed to assure that such engagements do not impair the independence of our auditors, the Audit Committee pre-approves annually a range of specific audit and non-audit services in the categories of Audit Service, Audit-Related Services, Tax Services and other services that may be performed by our independent accountants, and the maximum pre-approved fees that may be paid as compensation for each pre-approved service in those categories. Any proposed services exceeding the maximum pre-approved fees require specific approval by the Audit Committee.

(1) **Audit fees** means the aggregate fees billed in each of the fiscal years listed for professional services rendered by our principal auditors for the audit of our annual financial statements.

(2) **Audit-related fees** means the aggregate fees billed in each of the fiscal years listed for assurance and related

services by our principal auditors that are reasonably related to the performance of the audit or review of our financial statements and are not reported under Audit fees. Services comprising the fees disclosed under the category of Audit-related fees involve principally the performance of certain agreed upon procedures for the years ended December 31, 2003, 2004 and 2005, respectively.

(3) Tax fees means the aggregated fees billed in each of the years listed for professional services rendered by our principal auditors for tax compliance, tax advice and tax planning.

*Item 16D.*                    **Exemptions From Listing Standards**

The Company is a Controlled Company as defined in NASDAQ's corporate governance rules as a majority of our shares are owned by a control group consisting of T.C. Leung, Pearl Venture Ltd. and Regent Earnings Limited, who have disclosed their control group status in their filings with the Commission. So long as that controlled company status remains in effect, the Company will be exempt from certain of NASDAQ corporate governance rules that, including among other things, would require: (a) a majority of our directors be independent; (b) the compensation of our chief executive officer be determined or recommended by independent directors; and (c) director nominations be determined or recommended by independent directors.

The Company believes it is in compliance with NASDAQ's corporate governance rules as in effect and intends to comply with the changes to said rules no later than the date that they become effective.

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**PART III**

ITEM 17.

## FINANCIAL STATEMENTS

Not applicable.

ITEM 18.

## FINANCIAL STATEMENTS

The following financial statements are filed as part of this annual report on Form 20-F.

Index to consolidated financial statements

Reports of Independent Registered Public Accounting Firms

Consolidated balance sheets

Consolidated income statements

Consolidated cash flow statements

Consolidated statement of changes in shareholders' equity

Notes to the consolidated financial statements

ITEM 19.

## EXHIBITS

Lists of Exhibits

<b>Exhibit No.</b>	<b>Description</b>
1.1	Amended and Restated Memorandum and Articles of Association (1)
1.2	Amendments to Exhibit 3.1 adopted by shareholders on August 15, 2000 (3)
4.2	Management Stock Option Plan (1)
4.3	Agreement with Shanghai Institute of Optics Instruments (2)
4.4	Agreement with Hach Company, Inc. (2)
4.5	2000 Officers and Directors Stock Option and Incentive Plan (3)
4.6	2000 Employees' Stock Option and Incentive Plan (3)
4.7	Equity Interest Transfer Agreement between Tamworth Industrial Ltd. ( Tamworth ) and Registrant (4)

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- 4.8 Equity Interest Transfer and Shareholders Agreement among Tamworth, Registrant and Pact Asia Pacific Limited (4)
- 4.10 2002 Officers and Directors Stock Option Plan (6)
- 4.11 Registrant's Audit Committee Charter (7)
- 8.1 List of Subsidiaries (8)
- 10.1 Share Sale and Purchase Agreement between Tamworth Industrial Ltd. And Registrant's subsidiary (5)
- 10.2 Equity Interest Transfer Agreement between Tamworth Industrial Ltd. And the Registrant's subsidiary (5)
- 12.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (8)
- 12.2 Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (8)
- 13.1 Certification of the Chief Executive Officer pursuant to 18 U.S.C. Section 1350 as Oxley Act of 2002 (8)
- 13.2 Certification of the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (8)

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- (1) Incorporated by reference, previously filed as an Exhibit to Registration Statement, SEC File No. 333-16277 and is incorporated by reference herein.
  - (2) Incorporated by reference, previously filed as an Exhibit to Registrant's Report on Form 20-F for its year ended December 31, 1999.
  - (3) Incorporated by reference, previously filed as an Exhibit to Registrant's Report on Form 20-F for its year ended December 31, 2000.
  - (4) Incorporated by reference, previously filed as an Exhibit to Registrant's Report on Form 6-K filed on February 11, 2002.
  - (5) Incorporated by reference, previously filed as an Exhibit to Registrant's Report on Form 6-K, filed on December 8, 2005.
  - (6) Incorporated by reference, previously filed as an Exhibit to Registrant's Report on Form 6-K filed on July 24, 2002.
  - (7) Incorporated by reference, previously filed as an Exhibit to Registrant's Report on Form 6-K filed on August 19, 2002.
  - (8) Filed herewith.





**SIGNATURES**

Pursuant to the requirements of Section 12 of the Securities Exchange Act of 1934, the registrant certifies that it meets all of the requirements for filing on Form 20-F and has duly caused this annual report to be signed on its behalf by the undersigned, thereunto duly authorized.

**EURO TECH HOLDINGS COMPANY LIMITED**  
(Registrant)

/s/ T.C. Leung  
T.C. Leung,  
Chief Executive Officer and Chairman of the Board

Dated: June 29, 2006

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**EURO TECH HOLDINGS COMPANY LIMITED**  
**AUDITED CONSOLIDATED BALANCE SHEETS**  
**AS OF DECEMBER 31, 2005 AND 2004 AND**  
**CONSOLIDATED STATEMENTS OF INCOME,**  
**CASH FLOWS AND CHANGES IN SHAREHOLDERS' EQUITY**  
**FOR THE YEARS ENDED DECEMBER 31, 2005, 2004 AND 2003**  
**TOGETHER WITH REPORT OF INDEPENDENT REGISTERED**  
**PUBLIC ACCOUNTING FIRM**

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**Report of Independent Registered Public Accounting Firm**

To the Board of Directors and shareholders of  
Euro Tech Holdings Company Limited

We have audited the accompanying consolidated balance sheet of Euro Tech Holdings Company Limited as of December 31, 2005 and the related consolidated statement of operations, shareholders' equity and cash flows for the year ended December 31, 2005. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. The audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Euro Tech Holdings Company Limited as of December 31, 2005 and the results of its consolidated operations and cash flows for the year ended December 31, 2005, in conformity with generally accepted accounting principles in the United States of America.

/s/ BDO McCabe Lo Limited

Hong Kong, June 27, 2006

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

**TO THE SHAREHOLDERS AND DIRECTORS OF  
EURO TECH HOLDINGS COMPANY LIMITED**

In our opinion, the accompanying consolidated balance sheet as of December 31, 2004 and the related consolidated statements of income, of shareholders' equity and of cash flows for each of two years in the period ended 31 December 2004 present fairly, in all material respects, the financial position of Euro Tech Holdings Company Limited and its subsidiaries at 31 December 2004, and the results of their operations and their cash flows for each of the two years in the period ended 31 December 2004, in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

/s/ PricewaterhouseCoopers

PricewaterhouseCoopers

Hong Kong, July 14, 2005

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## EURO TECH HOLDINGS COMPANY LIMITED

CONSOLIDATED BALANCE SHEETS  
AS OF DECEMBER 31

	Note	2005 US\$ 000	2004 US\$ 000
<b>Assets</b>			
<b>Current assets:</b>			
Cash and cash equivalents		5,362	5,242
Restricted cash		304	
Accounts receivable, net	6	5,467	4,139
Prepayments and other current assets		643	367
Inventories, net	7	2,732	3,564
Taxation recoverable		42	7
Total current assets		14,550	13,319
Property, plant and equipment, net	8 & 22(iii)	1,735	1,766
Investments in affiliates	9		571
Goodwill	13	1,060	
Deferred tax assets	4	32	43
Total assets		17,377	15,699
<b>Liabilities and shareholders' equity</b>			
<b>Current liabilities:</b>			
Accounts payable	10	4,627	4,704
Amounts due to related companies	19		1,266
Other payables and accrued expenses	11	2,570	1,791
Taxation payable		422	101
Total current liabilities		7,619	7,862
Deferred tax liabilities		4	
Commitments and contingencies	20		
<b>Shareholders' equity:</b>			
Ordinary share, par value US\$0.01 each, 20,000,000 (2004: 20,000,000) shares authorized; 7,363,002 (2004: 6,775,318) shares issued and outstanding	12	74	68
Additional paid-in capital		2,800	2,500
Treasury stock, 340,651 (2004: 340,651) shares at cost	14	(237)	(237)
PRC statutory reserve	15	72	69
Accumulated other comprehensive losses		(10)	(26)
Retained earnings		6,193	5,463
Total shareholders' equity		8,892	7,837
Minority interest		862	

Total equity	9,754	7,837
Total liabilities and shareholders' equity	17,377	15,699

The accompanying notes are an integral part of these consolidated financial statements.

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## EURO TECH HOLDINGS COMPANY LIMITED

**CONSOLIDATED STATEMENTS OF INCOME  
FOR THE YEARS ENDED DECEMBER 31, 2005, 2004 AND 2003**

	Note	2005 US\$ 000	2004 US\$ 000	2003 US\$ 000
Revenue	22(i) & (ii)	31,250	32,282	27,442
Cost of revenue		(24,681)	(27,033)	(22,805)
Gross profit		6,569	5,249	4,637
Selling and administrative expenses		(5,418)	(4,801)	(4,108)
Operating income		1,151	448	529
Interest income		35	17	13
Other income, net	3	172	104	6
Income before income taxes		1,358	569	548
Income taxes	4	(328)	(167)	(108)
Equity in profit of affiliates, net of taxes		21	192	91
Net income		1,051	594	531
Minority interest		(318)		
Profit attributable to the shareholders of the company		733	594	531
Net income per ordinary share				
Basic		US\$0.11	US\$0.09	US\$0.08
Diluted		US\$0.07	US\$0.06	US\$0.08
Weighted average number of ordinary shares outstanding				
Basic	6	6,598,201	6,434,667	6,434,667
Diluted	6	10,689,482	10,034,687	6,434,667

The accompanying notes are an integral part of these consolidated financial statements.

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## EURO TECH HOLDINGS COMPANY LIMITED

**CONSOLIDATED STATEMENTS OF CASH FLOWS  
FOR THE YEARS ENDED DECEMBER 31, 2005, 2004 AND 2003**

	2005 US\$ 000	2004 US\$ 000	2003 US\$ 000
<b>Cash flows from operating activities:</b>			
Net income	1,051	594	531
<b>Adjustments to reconcile net income to net cash provided by (used in) operating activities:</b>			
Depreciation of property, plant and equipment	181	184	190
(Gain) loss on disposal of property, plant and equipment	1		(1 )
Equity in profit of affiliates, net of taxes	(21 )	(192 )	(91 )
Deferred tax assets	11	3	(3 )
Deferred tax liabilities	4		
Translation reserve	16		
<b>(Increase) decrease in current assets:</b>			
Accounts receivable, net	(1,237 )	1,212	(573 )
Prepayments and other current assets	327	248	(153 )
Inventories, net	2,387	(1,318 )	(282 )
Taxation recoverable	(35 )	8	(15 )
Amount due from a related company			2
<b>Increase (decrease) in current liabilities:</b>			
Accounts payable	(148 )	1,170	(1,143 )
Amounts due to related companies	(1,267 )	(64 )	664
Other payables and accrued expenses	(1,665 )	618	534
Taxation payable	137	73	(7 )
<b>Net cash (used in)/provided by operating activities</b>	<b>(258 )</b>	<b>2,536</b>	<b>(347 )</b>
<b>Cash flows from investing activities:</b>			
Sales proceeds on disposal of property, plant and equipment			1
Purchase of property, plant and equipment	(110 )	(101 )	(74 )
Cash flow on business combination, net of cash acquired	486		
Restricted cash for issuance of bank guarantees	(304 )		
Dividend income		55	
<b>Net cash provided by/(used) in investing activities</b>	<b>72</b>	<b>(46 )</b>	<b>(73 )</b>
<b>Cash flows from financing activities:</b>			
Issuance of ordinary shares on exercise of options	306		
<b>Net cash provided by financing activities</b>	<b>306</b>		
Effect of exchange rate changes on cash and cash equivalents			(1 )
<b>Net increase/(decrease) in cash and cash equivalents</b>	<b>120</b>	<b>2,490</b>	<b>(421 )</b>
Cash and cash equivalents, beginning of year	5,242	2,752	3,173
<b>Cash and cash equivalents, end of year</b>	<b>5,362</b>	<b>5,242</b>	<b>2,752</b>
<b>Supplementary information</b>			
Interest received	35	17	13
Interest paid			
Income taxes paid	121	121	134
Shares surrendered for exercise of stock options	195		



The accompanying notes are an integral part of these consolidated financial statements.

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## EURO TECH HOLDINGS COMPANY LIMITED

**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY  
FOR THE YEARS ENDED DECEMBER 31, 2005, 2004 AND 2003**

	Number of Ordinary share	Ordinary share US\$ 000	Additional paid-in capital US\$ 000	Warrants US\$ 000	Treasury stock US\$ 000	Accumulated other comprehensive income (loss) US\$ 000	PRC statutory reserve US\$ 000	Retained earnings US\$ 000	Total US\$ 000
Balance as of									
January 1, 2003	6,775,318	32	2,370	166	(237)	(24)		4,407	6,714
Comprehensive income:									
Net income								531	531
Other comprehensive income: Foreign exchange translation adjustment						(2)			(2)
Total comprehensive income									529
Stock split effect in the form of a dividend		13	(13)						
Expiration of warrants			166	(166)					
Balance as of									
December 31, 2003	6,775,318	45	2,523		(237)	(26)		4,938	7,243
Net income								594	594
Stock split effect in the form of a dividend		23	(23)						
Transfer of reserve							69	(69)	
Balance as of									
December 31, 2004	6,775,318	68	2,500		(237)	(26)	69	5,463	7,837
Comprehensive income:									
Net income								733	733
Other comprehensive income: Foreign exchange translation adjustment						16			16
Total comprehensive income									749
Shares surrendered for exercise of stock options	(52,846)	(1)	(194)						(195)
Exercise of stock options	640,530	7	494						501
Transfer of reserve							3	(3)	
Balance as of									
December 31, 2005	7,363,002	74	2,800		(237)	(10)	72	6,193	8,892

The accompanying notes are an integral part of these consolidated financial statements.



**EURO TECH HOLDINGS COMPANY LIMITED****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****1 Organization and principal activities**

Euro Tech Holdings Company Limited (the Company) was incorporated in the British Virgin Islands on September 30, 1996.

Euro Tech (Far East) Limited (Far East) is the principal operating subsidiary of the Company. It is principally engaged in the marketing and trading of water and waste water related process control, analytical and testing instruments, disinfection equipment, supplies and related automation systems in Hong Kong and in the People's Republic of China (the PRC).

Details of the Company's subsidiaries and affiliates are summarized as follows:

Name	Percentage of equity ownership	Place of incorporation	Principal activities
Subsidiaries:			
Euro Tech (Far East) Limited	100%	Hong Kong	Marketing and trading of water and waste water related process control, analytical and testing instruments, disinfection equipment, supplies and related automation systems
Euro Tech (China) Limited	100%	Hong Kong	Inactive
ChinaH2O.com Limited	100%	Hong Kong	Internet content provider and provision of marketing services for environmental industry to the Company and its subsidiaries
Euro Tech Trading (Shanghai) Limited	100%	The PRC	Marketing and trading of water and waste water related process control, analytical and testing instruments, disinfection equipment, supplies and related automation systems
Shanghai Euro Tech Limited	100%	The PRC	Manufacturing of analytical and testing equipment
Yixing Pact Environmental Technology Co., Ltd	51%*	The PRC	Design, manufacturing and operation of water and waste water treatment machinery and equipment
Pact Asia Pacific Limited	51%*	The British Virgin Islands	Producing and selling of environment protection equipment, undertaking environment protection projects and providing relevant technology advice, training and services

\* In the year 2004, these two companies are affiliates of the Company, with 30% of equity ownership by the Company. The Company acquired additional 21% of equity interest of each of the affiliate in October 18, 2005. (See also note 9).

**2 Summary of significant accounting policies**

**(a) Basis of Consolidation**

The consolidated financial statements include the accounts of Euro Tech Holdings Company Limited and its subsidiaries (the Group). The financial statements of variable interest entities (VIEs) as defined by the Financial Accounting Standards Board (FASB) Interpretation No. 46 (R) (FIN46(R)), are included in the consolidated financial statements, if applicable. In January 2003, the FASB issued FASB Interpretation No. 46 (FIN46), Consolidation of Variable Interest Entities and amended it by issuing FIN 46(R) in December 2003. FIN 46 (R) addresses consolidation by business enterprises of VIEs that either: (1) do not have sufficient equity investment at risk to permit the entity to finance its activities without additional subordinated financial support, or (2) have equity investors that lack an essential characteristic of a controlling financial interest.

The Group identified that certain retail shops established in the PRC qualified as variable interest entities as defined in FIN46(R). The retail shops are principally engaged in the retailing business of water and waste water related process control, analytical and testing instruments, disinfection equipment, supplies and related automation systems. The Company is the primary beneficiary of these retail shops and, accordingly, consolidated their financial statements effective December 31, 2004. The Company has a controlling financial interest in these retail shops and is subject to a majority of the risk of loss from the retailing activities, and is entitled to receive a majority of the retail shops' residual returns. Total assets and liabilities of these consolidated VIEs total US\$464,415 and US\$151,217, respectively, as of December 31, 2005. The cumulative losses on consolidating these VIEs in the Group's consolidated statement of income in 2005 were US\$174,902, including taxes of US\$658. The assets of the entities consist mainly of cash and bank balances, trade and other receivables, inventories and property, plant and equipment. The creditors of these entities do not have recourse to the general credit of the Group.

Investments in business entities in which the Company does not have control, but has the ability to exercise significant influence over operating and financial policies (generally 20-50 percent ownership), are accounted for using the equity method of accounting. All material intercompany balances and transactions have been eliminated on consolidation.

**(b) Subsidiaries**

A subsidiary is a company in which the Company holds, directly or indirectly, more than 50% of its outstanding voting share capital and over which it is able to exercise control.

**(c) Revenue Recognition**

The Group's main source of revenue is the sale of water and waste water related process control, analytical and testing instruments, disinfection equipment, supplies and related automation systems. The Company recognizes revenue when the product is delivered and the title is transferred. For certain products where installation is necessary, revenue is recognized upon completion of installation. Revenue earned from customer support services, which represents a minor percentage of total revenues, is recognized when such services are provided.

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Revenues and profits in long term fixed price contracts are recorded under the percentage of completion method. This approach relies on estimates of total expected direct costs at completion, which are compared to actual direct costs incurred to date to arrive at an estimate of revenue and profit earned to date. Recognized revenue and profit are subject to revisions as the contract progresses to completion. Revisions to profit estimates are reflected in income in the period in which the facts that give rise to the revision become known.

**(d) Research and Development Costs**

Research and development costs ( R&D costs) are expensed as incurred. The R&D costs amounted to approximately US\$48,000, US\$56,000 and US\$12,000 for the years December 31, 2005, 2004 and 2003 respectively and were included in Selling and Administrative expenses in the Group s consolidated statement of income.

**(e) Advertising and promotional expenses**

Advertising and promotional expenses ( A&P expenses) are expensed as incurred. The A&P expenses amounted to approximately US\$240,000, US\$247,000 and US\$260,000 for the years December 31, 2005, 2004 and 2003 respectively and were included in Selling and Administrative expenses in the Group s consolidated statement of income.

**(f) Taxation**

The Group accounts for income and deferred tax under the provision of Statement of Financial Accounting Standards ( SFAS ) No. 109: Accounting for Income Taxes , under which deferred taxes are recognized for all temporary differences between the applicable tax balance sheets and the consolidated balance sheet. Deferred tax assets and liabilities are recognized for the estimated future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. SFAS 109 also requires the recognition of the future tax benefits of net operating loss carry forwards. A valuation allowance is established when the deferred tax assets are not expected to be realized within a reasonable period of time.

Deferred tax assets and liabilities are measured using the enacted tax rates expected to be applicable for taxable income in the years in which temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income for the period that includes the enactment date.

Note 4 shows the applicable tax rates for individual subsidiary and variable interest entities, as well as the major temporary differences so recorded.

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**(g) Cash and Cash Equivalents**

Cash and cash equivalents include cash on hand, demand deposits with banks.

**(h) Receivables and Other Assets**

Receivables and other assets are recorded at their nominal values. Valuation allowances are provided for identified individual risks for these line items. If the loss of a certain part of the receivables is probable, valuation allowances are provided to cover the expected loss.

**(i) Inventories**

Inventories are stated at the lower of cost, on the first-in, first-out method, or net realizable value. Costs include purchase and related costs incurred in bringing each product to its present location and condition. Net realizable value is calculated based on the estimated normal selling price, less further costs expected to be incurred for disposal. Provision is made for obsolete, slow moving or defective items, where appropriate.

**(j) Property, Plant and Equipment**

Property, plant and equipment are stated at cost less accumulated depreciation. Gains or losses on disposal are reflected in current operations. Major expenditures for betterments and renewals are capitalized. All ordinary repair and maintenance costs are expensed as incurred. Depreciation of property, plant and equipment is computed using the straight-line method over the assets' estimated useful lives as follows:

Office premises	47 to 51 years
Leasehold improvements	over terms of the leases or the useful lives whichever is less
Furniture, fixtures and office equipment	3 to 5 years
Motor vehicles	4 years
Testing equipment	3 years

**(k) Impairment**

The Group has adopted SFAS No. 144: Accounting for Impairment or Disposal of Long-Lived Assets which requires impairment losses to be recorded for property, plant and equipment to be held and used in operations when indicators of impairment are present. Reviews are regularly performed to determine whether the carrying value of assets is impaired. The Group determines the existence of such impairment by measuring the expected future cash flows (undiscounted and without interest charges) and comparing such amount to the carrying amount of the assets. An impairment loss, if one exists, is then measured as the amount by which the carrying amount of the asset exceeds the discounted estimated future cash flows. Assets to be disposed of are reported at the lower of the carrying amount or fair value of such assets less costs to sell. There were no impairment losses recorded during each of the three years ended December 31, 2005.

**(l) Operating Leases**

Leases where substantially all the risks and rewards of ownership of the leased assets remain with the lessors are accounted for as operating leases. Rental payments under operating leases are charged to expense on the straight-line basis over the period of the relevant leases.

**(m) Goodwill**

The Group has adopted SFAS No.142: Goodwill and other intangible assets which assess the possible impairment of goodwill existing at the date of adoption and perform a subsequent impairment test on an annual basis.

**(n) Foreign Currency Translation**

The Company maintains its books and records in United States dollars. Its subsidiaries and affiliates maintain their books and records either in Hong Kong dollars or Chinese Renminbi ( functional currencies ). Foreign currency transactions during the year are translated into the respective functional currencies at the applicable rates of exchange at the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies are translated into the respective functional currencies using the exchange rates prevailing at the balance sheet dates. Gains or losses from foreign currency transactions are recognized in the consolidated statements of income during the year in which they occur. Translation adjustments on subsidiaries' equity are included as cumulative translation adjustments.

**(o) Derivative Instruments and Hedging Activities**

SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities ( SFAS 133 ), as amended by SFAS No. 137, Accounting for Derivative Instruments and Hedging Activities - Deferral of the Effective Date of FASB Statement No. 133 - an amendment of FASB Statement No. 133 , and SFAS No. 138, Accounting for Certain Derivative Instruments and Certain Hedging Activities - an amendment of FASB Statement No. 133 , as well as the interpretations of the Derivatives Implementation Group ( DIG ), are applied as amended by SFAS No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities . SFAS 133 contains accounting and reporting standards for hedging accounting and for derivative financial instruments, including certain derivative financial instruments embedded in other contracts.

SFAS 133 requires that all derivatives be recognized as either assets or liabilities in the consolidated balance sheet and measured at fair value. Depending on the documented designation of a derivative instrument, any change in fair value is recognized either in net income or shareholders equity (as a component of accumulated other comprehensive income).

Fair values of derivative instruments are classified as operating assets or liabilities. Changes in fair value of derivative instruments affecting income are classified as other operating income or expenses. Please see note 18 for additional information regarding the Company's use of derivative instruments.

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**(p) Comprehensive Income**

The Group has adopted SFAS No. 130: Reporting Comprehensive Income, which requires the Group to report all changes in equity during a period, except for those resulting from investment by owners and distribution to owners, in the financial statements for the period in which they are recognized. The Group has presented comprehensive income, which encompasses net income and foreign currency translation adjustments, in the consolidated statement of changes in shareholders' equity.

**(q) Ordinary share**

Ordinary share refers to the \$0.01 par value capital stock as designated in the Company's Certificate of Incorporation. Treasury stock is accounted for using the cost method. When treasury stock is reissued, the value is computed and recorded using a weighted-average basis.

**(r) Net income per Ordinary Share**

Net income per ordinary share is computed in accordance with SFAS No. 128 Earnings Per Share, by dividing the net income by the weighted average number of shares of ordinary share outstanding during the period. The Company reports both basic earnings per share, which is based on the weighted average number of ordinary shares outstanding, and diluted earnings per share, which is based on the weighted average number of ordinary shares outstanding and all dilutive potential ordinary shares outstanding. Outstanding stock options are the only dilutive potential shares of the Company. There was no difference between basic and diluted earnings per share as the exercise prices of the stock options outstanding were higher than the average market prices of the ordinary share for the year ended December 31, 2003 and therefore the effect of including such items in the calculation of earnings per share would have been anti-dilutive.

**(s) Stock-based Compensation**

In accordance with the provisions of SFAS No. 148, Accounting for Stock-Based Compensation - Transition and Disclosure, the Group has selected the disclosure only of provisions related to employee stock options and share purchases and follows the provisions of Accounting Principles Board Opinion No. 25: Accounting for Stock Issued to Employees (APB 25) and related interpretations in accounting for stock options and shares issued to employees. Under APB 25, compensation expense, if any, is recognized as the excess of the estimated fair value of the ordinary shares over the exercise price on the measurement date, which is typically the date of grant, and is expensed ratably over the service period, which is typically the vesting period. The Company accounts for share-based compensation using the intrinsic value method prescribed by APB Opinion No. 25, under which no compensation cost is recognized as all stock options granted under the Management Options, the 2000 Stock Options, the 2002 Employee Stock Options and the 2002 D&O Stock Options have exercise prices at or above the fair market value of the underlying stock at the date of grant.

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**(s) Stock-based Compensation (Continued)**

Had compensation expense for the Company's share-based compensation plan been recognized based on the fair value of the options on the grant date in accordance with SFAS No. 123, the Company's pro forma net income and earnings per ordinary share would have been as follows:

	2005 US\$ 000	2004 US\$ 000	2003 US\$ 000
Net income as reported	733	594	531
Less: Stock compensation expense determined under the fair value method, net of tax(1)	(39 )	(27 )	(216 )
Pro forma net income	694	567	315
<b>Income per share:</b>			
Basic, as reported	US\$0.11	US\$0.09	US\$0.08
Diluted, as reported	US\$0.07	US\$0.06	US\$0.08
Basic, pro forma	US\$0.11	US\$0.09	US\$0.05
Diluted, pro forma	US\$0.07	US\$0.06	US\$0.05

(1) For the years ended December 31, 2003, the pro forma stock compensation expense amounts have been adjusted to reflect lower calculated fair values for employee stock options which resulted in a decrease of approximately US\$116,000 in the pro forma net income for the year ended December 31, 2003. This adjustment was required as the restrictions on the employee stock options were not considered by the external valuer in prior years.

**(t) Use of Estimates**

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America ( GAAP ) requires management to make estimates and assumptions that affect the amounts that are reported in the consolidated financial statements and accompanying disclosures. Although these estimates are based on management's best knowledge of current events and actions that the Company may undertake in the future, actual results may be different from the estimates.

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**(u) Related Parties**

Entities are considered to be related to the Group if the parties, directly or indirectly, through one or more intermediaries, control, are controlled by, or are under common control with the Group. Related parties also include principal owners of the Group, its management, members of the immediate families of principal owners of the Group and its management and other parties with which the Group may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests. A party which can significantly influence the management or operating policies of the transacting parties or if it has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests is also a related party.

**(v) Segment Information**

The Company's segment reporting is prepared in accordance with SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information". The management approach required by SFAS 131 designates that the internal reporting structure that is used by management for making operating decisions and assessing performance should be used as the source for presenting the Company's reportable segments.

**(w) Recent Accounting Pronouncements**

In November 2004, the FASB issued SFAS No. 151, "Inventory Costs", an amendment of APB No. 43, Chapter 4. SFAS No. 151 requires that abnormally high vacancy, wasted material, freight and processing costs not be part of recognizable production costs. Such cost must instead be expensed as incurred. Accordingly fixed costs shall henceforth be allocated to inventory based on normal production capacity. The standard is effective for the fiscal year beginning January 1, 2006. It is not expected that SFAS No. 151 will have a material effect on the Company's consolidated financial statements.

In December 2004, the FASB issued SFAS No. 123 (Revised 2004) "Share-Based Payment" that will require the Company to expense costs related to share-based payment transactions with employees. With limited exception, SFAS No. 123 (R) requires that the fair value of share-based payments to employees be expensed over the period service is received. SFAS No. 123 (R) becomes mandatory effective for the Company on January 1, 2006. The Company intends to adopt this standard using the modified retrospective method of transition with effect from 1 January 2006.

SFAS No. 123 (R) allows the use of both closed form models (e.g., Black-Scholes Model) and open form models (e.g., lattice models) to measure the fair value of the share-based payment as long as that model is capable of incorporating all of the substantive characteristics unique to share-based awards. In accordance with the transition provisions of SFAS No. 123 (R), the expense attributable to an award will be measured in accordance with the Company's measurement model at that award's date of grant.

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(w) **Recent Accounting Pronouncements (Continued)**

The Company believes that the total expense recorded in future periods will depend on several variables, including the number of share-based awards that vest and the fair value of those vested awards.

In March 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections* (SFAS 154), which was a replacement of APB Opinion No. 20 and FAS No. 3 effective for accounting changes made in fiscal periods beginning after December 15, 2005. SFAS 154 requires retrospective application to prior periods' financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. It also requires that retrospective application of a change in accounting principle be limited to the direct effects of the change. SFAS also requires that a change in depreciation, amortization, or depletion method for long-lived, nonfinancial assets be accounted for as a change in accounting estimate effected by a change in accounting principle. The Group is currently assessing the impact of this statement on our results of operations, financial position and cash flows upon adoption and has not yet completed that assessment.

In February 2006, FASB issued SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments*. SFAS No. 155 amends SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. SFAS No. 155, permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, clarifies which interest-only strips and principal-only strips are not subject to the requirements of SFAS No. 133, establishes a requirement to evaluate interest in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation, clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives, and amends SFAS No. 140 to eliminate the prohibition on the qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. This statement is effective for all financial instruments acquired or issued after the beginning of the Group's first fiscal year that begins after September 15, 2006. The Group's management has not evaluated the impact of this pronouncement on the Group's financial statements.

In March 2006 FASB issued SFAS 156 *Accounting for Servicing of Financial Assets* this Statement amends FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, with respect to the accounting for separately recognized servicing assets and servicing liabilities. This Statement:

Requires an entity to recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract. Requires all separately recognized servicing assets and servicing liabilities to be initially measured at fair value, if practicable.

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**(w) Recent Accounting Pronouncements (Continued)**

Permits an entity to choose Amortization method or Fair value measurement method for each class of separately recognized servicing assets and servicing liabilities.

At its initial adoption, permits a one-time reclassification of available-for-sale securities to trading securities by entities with recognized servicing rights, without calling into question the treatment of other available-for-sale securities under Statement 115, provided that the available-for-sale securities are identified in some manner as offsetting the entity's exposure to changes in fair value of servicing assets or servicing liabilities that a servicer elects to subsequently measure at fair value.

Requires separate presentation of servicing assets and servicing liabilities subsequently measured at fair value in the statement of financial position and additional disclosures for all separately recognized servicing assets and servicing liabilities. An entity should adopt this Statement as of the beginning of its first fiscal year that begins after September 15, 2006.

The Group's management believes that this statement will not have a significant impact on the Group's financial statements.

In June 2005, the FASB ratified the Emerging Issues Task Force (EITF) consensus to amend EITF No. 96-16, Investor's Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholders Have Certain Approval or Veto Rights. The EITF agreed to amend the Protective Rights section of this consensus, as well as Example of Exhibit 96-16A, to be consistent with the consensus reached in Issue No. 04-5, Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similarly Entity When the Limited Partners Have Certain Rights. The provisions of this amendment should be applied prospectively to new investments and to investment agreements that are modified after June 29, 2005. The Group's management believes the adoption of this pronouncement will not have a material effect on the Group's consolidated financial statements. In June 2005, the EITF reached consensus on Issue No. 05-6, Determining the Amortization Period for Leasehold Improvements (EITF 05-6.) EITF 05-6 provides guidance on determining the amortization period for leasehold improvements acquired in a business combination or acquired subsequent to lease inception. The guidance in EITF 05-6 will be applied prospectively and is effective for periods beginning after June 29, 2005. EITF 05-6 is not expected to have a material effect on the Group's consolidated financial position or results of operations.

**3 Other income, net**

	2005	2004	2003
	US\$ 000	US\$ 000	US\$ 000
Gain /(loss) on disposal of property, plant and equipment	(1 )		1
Exchange gain/(loss), net	158	73	(35 )
Rental income	15	31	40
	172	104	6

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#### 4 **Income taxes**

The Company is exempt from taxation in the British Virgin Islands.

Euro Tech (Far East) Limited, Euro Tech (China) Limited and ChinaH2O.com Limited provided for Hong Kong profits tax at a rate of 17.5% in the year of 2005, 2004 and 2003 on the basis of their income for financial reporting purposes, adjusting for income and expense items which are not assessable or deductible for profits tax purposes.

Euro Tech Trading (Shanghai) Limited, a subsidiary of the Company, provides for PRC Enterprise Income Tax at a rate of 15%, after offsetting losses brought forward, if any, on the basis of its income for financial reporting purposes, adjusting for income and expense items which are not assessable or deductible for PRC Enterprise Income Tax purposes.

In accordance with the relevant income tax laws and regulations applicable to foreign investment enterprises in the PRC, Shanghai Euro Tech Limited ( SET ), a subsidiary of the Company, is exempt from the PRC Enterprise Income Tax of 15% for two years starting from its first profit-making year, after offsetting losses brought forward, if any, followed by a 50% reduction for the next three years thereafter. As of December 31, 2005, SET is still exempt from the PRC enterprise income tax as it had an assessable loss brought forward of US\$208,525 as agreed by the local tax authority to offset its profit for the coming year (2004: US\$226,550).

VIEs of the Group provide for PRC Enterprise Income Tax at a rate of 33%, after offsetting losses brought forward, if any, on the basis of its income for financial reporting purposes, adjusting for income and expense items which are not assessable or deductible for PRC Enterprise Income Tax purposes.

As of December 31, 2005, certain VIEs had aggregated assessable losses carried forward of US\$128,591 as agreed by the local tax authority (2004: US\$107,726).

Income before income taxes:

	2005 US\$ 000	2004 US\$ 000	2003 US\$ 000
Domestic			
Foreign	1,358	569	548
	1,358	569	548

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The provision for income taxes consists of:

	2005 US\$ 000	2004 US\$ 000	2003 US\$ 000
Current tax expenses:			
Domestic			
Foreign	313	164	111
Total current provision	313	164	111
Deferred tax expense / (benefit):			
Domestic			
Foreign	15	3	(3 )
Total deferred provision	15	3	(3 )

The reconciliation of the weighted average statutory income tax rate to the effective income tax rate as stated in the consolidated statements of income is as follows:

	2005	2004	2003
Weighted average statutory tax rate	23.0 %	20.8 %	20.1 %
Change in valuation allowances	0.3 %	7.0 %	(0.8 %)
Under/(Over)-provision for income tax in prior years	(0.2 %)	0.4 %	(1.7 %)
Others	1.1 %	1.1 %	2.1 %
Effective tax rate	24.2 %	29.3 %	19.7 %

The components of deferred tax assets are as follows:

	2005 US\$ 000	2004 US\$ 000
Deferred tax assets arising from tax losses	74	183
Deferred tax assets arising from temporary difference		1
Less: Valuation allowances	(42 )	(141 )
Net deferred tax assets	32	43

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## 5 Net income per ordinary share

The calculation of the basic and diluted net income per ordinary share is based on the following data:

	2005 US\$ 000	2004 US\$ 000	2003 US\$ 000
Number of shares			
Weighted average number of ordinary shares for the purposes of basic net income per share	6,598,201	6,434,667	6,434,667
Effect of dilutive potential ordinary shares:			
Stock options	4,091,281	3,600,020	
Weighted average number of ordinary shares for the purposes of diluted net income per share	10,689,482	10,034,687	6,434,667

## 6 Accounts receivable

	2005 US\$ 000	2004 US\$ 000
Trade receivables	5,589	4,197
Less: Allowance for doubtful debts	(122 )	(58 )
	5,467	4,139

	2005 US\$ 000	2004 US\$ 000
Allowance for doubtful debts		
Balance at beginning	58	19
Charged to costs and expenses	97	46
Write off	(33 )	(7 )
Balance at end	122	58

As of December 31, 2005, accounts receivables in the form of bills receivable through banks amounted to US\$242,000 (2004: US\$ 812,000).

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7 **Inventories, net**

	2005 US\$ 000	2004 US\$ 000
Raw materials	93	55
Work in progress	387	57
Finished goods	2,252	3,452
	2,732	3,564

Management continuously reviews obsolete and slow moving inventories and assesses the inventory valuation to determine if the provision is deemed appropriate. At December 31, 2005, 2004 and 2003, provision for obsolete and slow moving inventories amounted to US\$44,370, US\$86,341 and US\$10,171, respectively.

8 **Property, plant and equipment**

	2005 US\$ 000	2004 US\$ 000
Office premises	2,271	2,271
Leasehold improvements	96	93
Furniture, fixtures and office equipment	591	522
Motor vehicles	127	125
Testing equipment	68	67
	3,153	3,078
Less: Accumulated depreciation	(1,418 )	(1,312 )
	1,735	1,766

	2005 US\$ 000	2004 US\$ 000	2003 US\$ 000
Depreciation charge	181	184	190

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## 9 Investments in affiliates and acquisition of subsidiaries

During the year ended December 31, 2002, the Group acquired 30% equity interests in Yixing Pact Environmental Technology Co., Ltd, a company incorporated in the PRC, and Pact Asia Pacific Limited, a company incorporated in the British Virgin Islands, from an independent third party for a total consideration of US\$335,000. The Group believes that the business of these two investments was complementary to the Group's business as the Group continued to focus on sales and marketing of other products. The Group believes that by aligning itself with an engineering firm, such as these affiliates, it was able to gain a competitive advantage by offering customers and potential customers not only hardware but solutions to engineering problems as well. Details of these affiliates are disclosed in Note 1. Investments in these affiliates are accounted for using the equity method of accounting.

The excess of purchase price over the underlying fair value of equity in net assets of the investees was considered goodwill and amounted to US\$215,000. The Group did not recognize any separately identifiable intangible assets under the criteria prescribed in SFAS No. 141 Business Combinations pursuant to the acquisition. This equity method goodwill is not amortized, and the investment is tested annually for impairment. As of December 31, 2004 and 2003, management does not believe the investments were impaired.

A summary of the combined financial information of the affiliates is set forth below:

	2004 US\$ '000	2003 US\$ '000
<b>Balance Sheet:</b>		
Current assets	2,795	942
Non-current assets	39	44
Total assets	2,834	986
Current and total liabilities	(1,804 )	(414 )
Total shareholders' equity	1,030	572

	2004 US\$ '000	2003 US\$ '000
<b>Operating results:</b>		
Net sales	3,674	1,995
Operating profits	893	348
Net profits	641	304

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The above table represents the combined financial information of entities in which the Group has an investment accounted for using the equity method of accounting during the years ended December 31, 2004 and 2003. These amounts are not the amounts reflected on the Group's accompanying consolidated financial statements for the years ended December 31, 2004 and 2003.

During the year ended December 31, 2005, the Group acquired additional 21% equity interests in Yixing Pact Environmental Technology Co., Ltd and Pact Asia Pacific Limited for a total consideration of US\$1,000,000 and these two companies become subsidiaries of the Group. The acquisition has been accounted for as an asset purchase. Assets acquired and liabilities assumed were recorded on the Company's Consolidated Balance Sheet as of the acquisition date based upon their estimated fair values at such date. The results of operations have been included in the Consolidated Statements of Income since date of acquisition.

The aggregate purchase price was calculated as follows:

	US\$ '000
Cash consideration	1,000
Direct costs relating to the acquisition	34
<b>Total purchase consideration for 21% equity</b>	<b>1,034</b>
Investment in affiliates for 30% equity at December 31, 2004	571
Equity in profit of affiliates for the year	21
<b>Total consideration</b>	<b>1,626</b>

The purchase price has been allocated based on the estimated fair values of the assets acquired and liabilities assumed as of the date of acquisition. The following represents the allocation of the purchase price:

	US\$ '000
<b>Current assets</b>	<b>1,922</b>
Property, plant and equipment	21
Goodwill	1,060
<b>Total assets</b>	<b>3,003</b>
<b>Current liabilities</b>	<b>(1,377 )</b>
<b>Total liabilities</b>	<b>(1,377 )</b>
<b>Total consideration</b>	<b>1,626</b>

The value was based on an independent appraisal. The amount of goodwill allocated to the purchase was US\$1,060,000. The following table sets forth the unaudited pro forma results of operations of the Company as if the acquisition had occurred at the beginning of the fiscal year. These pro forma amounts do not purport to be indicative of the results that would have actually been obtained if the acquisition occurred as of the beginning of each of the periods presented or that not be obtained in the future.

## Unaudited Pro Forma Results

	2005 US\$ 000	2004 US\$ 000
Revenue	32,415	35,956
Net income	1,101	1,043
Basic earnings per share	US\$0.11	US\$0.11
Diluted earnings per share	US\$0.07	US\$0.07

The Group granted The minority shareholder of Yixing Pact Environmental Technology Co., Ltd and Pact Asia Pacific Limited a three-year put option requiring the Group to acquire all remaining securities of these two companies at 5.2 times of their average net income for the three prior fiscal years.

**10 Accounts payable**

As of December 31, 2005, accounts payable in the form of bills payable through banks amounted to Nil (2004: US\$ 516,000).

**11 Other payables and accrued expenses**

Other payables and accrued expenses mainly represent deposits received from customers and accruals for operating expenses.

**12 Ordinary share**

In September 2003, the Company paid a dividend in the form of 1,290,517 ordinary shares of ordinary share of US\$0.01 each, payable at the ratio of four shares of stock per ten shares of stock of the Company.

In August 2004, the Company paid a dividend in the form of 2,258,443 ordinary shares of ordinary share of US\$0.01 each, payable at the ratio of five shares of stock per ten shares of stock of the Company.

The effect of the above has been reflected retroactively in the accounts and the net income per ordinary share computations.

During the year ended December 31, 2005, the Company issued 640,530 ordinary shares for stock options exercised and cancelled 52,846 shares surrendered for exercise of stock options.

### **13 Goodwill**

The Company accounted for the acquisition in accordance with SFAS No. 141 Business Combinations, which resulted in the recognition of goodwill. Goodwill represents the excess of acquisition cost over the estimated fair value of net assets acquired as of October 18, 2005 as described in Note 9.

As of December 31, 2005, the Company completed the annual impairment test. (i.e. comparing the carrying amount of the net assets, including goodwill, with the fair value of the Company as of December 31, 2005) Based on the result of the first step of the test, the Company believes that there was no further impairment of goodwill as of December 31, 2005.

### **14 Treasury stock**

The Company authorized a stock buyback program in December 2000 pursuant to which up to 341,250 shares, but not to exceed US\$281,250 in value, of the Company's ordinary share could be purchased in the open market from time to time as market and business conditions warrant. The Company repurchased a total of 36,445 shares and 304,206 shares of ordinary share during 2000 and 2001 for considerations of approximately US\$16,000 and US\$221,000, respectively. There was no reissuance of treasury stock during each of the three years ended December 31, 2005.

### **15 PRC statutory reserve**

Under the relevant PRC laws and regulations, the PRC subsidiaries are required to appropriate certain percentage of their respective net income to two statutory funds i.e. the statutory reserve fund and the statutory staff welfare fund. The PRC subsidiaries also appropriated certain amount of their net income to the expansion funds.

#### **(i) Statutory reserve funds**

Pursuant to applicable PRC laws and regulations, the PRC subsidiaries are required to allocate at least 10% of the companies' net income to the statutory reserve funds until such funds reaches 50% of the companies' registered capital. The statutory reserve funds can be utilized upon the approval by the relevant authorities, to offset accumulated losses or to increase registered capital of the companies, provided that such funds be maintained at a minimum of 25% of the companies' registered capital.

#### **(ii) Statutory welfare funds**

Pursuant to applicable PRC laws and regulations, the PRC subsidiaries are required to allocate certain amount of the companies' net income to the staff welfare funds determined by the Company. The staff welfare funds can only be used to provide staff welfare facilities and other collective benefits to the companies' employees. This fund is non-distributable other than upon liquidation of the PRC subsidiaries.

#### **(iii) Expansion funds**

The expansion reserve shall only be used to make up losses, expand the PRC subsidiaries' production operations, or increase the capital of the subsidiaries. The expansion fund can be utilized upon approval by relevant authorities, to convert into registered capital and issue bonus capital to existing investors, provided that such funds be maintained at a minimum of 25% of the companies' registered capital.



**EURO TECH HOLDINGS COMPANY LIMITED****NOTES TO THE CONSOLIDATED ACCOUNTS****16 Stock options****(i) Management Options Plan**

A total of 4,586,400 shares of ordinary share have been reserved for issuance under the Company's management option plan (the Management Options). The Management Options provide for the grant of options to its officers, directors and employees as the Company's Chairman of the Board of Directors and Chief Executive Officer may direct. In 1997, the Company granted its officers, directors and employees options under the Management Options, which allow them to purchase up to 4,353,804 shares of ordinary share. The exercise price of the options granted was US\$ 1.221 per share for 1,310,400 of such options and US\$ 1.6789 per share for the remaining 3,043,404. During the year ended December 31, 2000, 36,036 options with the exercise price of US\$ 1.6789 were cancelled. During the same year, the Company further granted 242,697 options under the Management Options with the exercise price of US\$ 1.6789 per share to its officers, directors and employees, which allowed them to purchase up to 242,697 shares of ordinary share. The options vested for a period of one year and will expire in March 2007. During the year ended December 31, 2002, 27,573 options with the exercise price of US\$1.6789 were cancelled. During the year ended December 31, 2003, no options were exercised, cancelled or granted.

In 2004, the Company granted 46,000 shares with the exercise price of US\$1.6789 per share to its offices, director and employees, which allowed them to purchase up to 46,000 shares of ordinary share. The options have a vesting period of one year and will expire in March 2007. The Company further cancelled 32,760 options with an exercise price of US\$1.6789. No options were exercised during the financial year 2004.

During the year ended December 31, 2005, 52,416 options with the exercise price of US\$ 1.6789 were cancelled. During the same year, 180,000 options under the Management Options with the exercise price of US\$ 1.221 per share were exercised.

**(ii) 2000 Stock Option Plan**

A total of 1,195,740 shares of ordinary share have been reserved for issuance under the Company's 2000 Stock Option Plan (the 2000 Stock Options). The 2000 Stock Options provide for the grant of options to its officers, directors and employees as the Company's Chairman of the Board of Directors and Chief Executive Officer may direct. During the year ended December 31, 2000, the Company granted such options to its officers, directors and employees under the 2000 Stock Options, which allow them to purchase up to 742,560 shares of ordinary share. The exercise price of all options granted is US\$ 0.5787 per share. During the year ended December 31, 2002, 43,680 options with exercise price of US\$0.5787 were cancelled. The Company further granted 477,750 options and 19,110 options under the 2000 Stock Options with an exercise price of US\$0.8191 and US\$0.6809 per share, respectively, to its officers, directors and employees, which allow them to purchase up to 496,860 shares of ordinary share. The options vested within a six-month to one-year period and will expire in August 2010.

During the year ended December 31, 2004, 35,490 options with an exercise price of US\$0.5787 per share and 23,940 options with exercise price of US\$0.8191 per share were cancelled. Further, there were no options exercised or granted in 2004.

During the year ended December 31, 2005, 35,490 options with the exercise price of US\$ 0.5787 were cancelled. During the same year, 338,520 options, 52,500 options and 6,510 options with exercise price of US\$ 0.5787, US\$0.8191 and US\$0.6809 per share, respectively, were exercised.





## (iii) 2002 Employees Stock Option and Incentive Plan and 2002 Officers and Directors Stock Option and Incentive Plan

A total of 294,000 shares and 840,000 shares of ordinary share have been reserved for issuance under the Company's 2002 Employees Stock Option and Incentive Plan (the 2002 Employee Stock Options) and 2002 Officers and Directors Stock Option and Incentive Plan (the 2002 D&O Stock Options), respectively. Both 2002 Employee Stock Options and the 2002 D&O Stock Options provide for the grant of options to its employees as the Company's Chairman of the Board of Directors and Chief Executive Officer may direct. During the year ended December 31, 2002, the Company granted such options to its employees, officers and directors under the 2002 Employee Stock Options and the 2002 D&O Stock Options, which allow them to purchase up to 294,000 and 840,000 shares of ordinary share at an exercise price of US\$0.7618 and US\$0.5857, respectively. The options vested for a period of a six-month period and will expire in April 2012 and November 2012, respectively. During the years ended December 31, 2004, 2003 and 2002, no options had been exercised.

In 2004, 92,400 options with an exercise price of US\$0.7618 per share were cancelled and no further options were granted.

During the year ended December 31, 2005, 16,800 options with the exercise price of US\$ 0.7618 were cancelled. During the same year, 63,000 options with exercise price of US\$ 0.5857 per share were exercised.

Changes in outstanding options under various plans mentioned above were as follows:

	2005	Weighted average exercise price US\$	2004	Weighted average exercise price US\$	2003	Weighted average exercise price US\$
	Number of options		Number of options		Number of options	
Outstanding, beginning of year	6,724,042	1.24	6,862,632	1.24	6,862,632	1.24
Granted			46,000	1.68		
Cancelled	(104,706 )	(1.16 )	(184,590 )	(0.93 )		
Exercised	(640,530 )	(0.78 )				
Outstanding, end of year	5,978,806	1.31	6,724,042	1.26	6,862,632	1.24
Exercisable, end of year	5,978,806	1.31	6,724,042	1.26	6,862,632	1.24

As of December 31, 2005, the options outstanding and exercisable had exercise prices in the range of US\$0.5787 to US\$1.6789 and a weighted average unexpired life of approximately 2.5 years.

Pro forma information regarding net income and earnings per share is required by SFAS No. 123, and has been determined as if the Company had accounted for its employee stock options under the fair value method of SFAS No. 123. The weighted average fair value of stock options at date of grant of \$0.93 per option for the year ended December 31, 2002, and \$1.44 per option for the year ended December 31, 2004, were estimated using the Black-Scholes option pricing model with the following assumptions. There were no options granted during the year ended December 31, 2003 and 2005.

	2005	2004	2003
Risk-free interest rate		2.88	%
Expected dividend yield		0	%
Expected option life		2.3	years
Expected stock price volatility		208	%

The Black-Scholes option-pricing model requires the input of subjective assumptions, including the expected volatility of stock price. Because changes in subjective input assumptions can materially affect the fair value estimate, in directors' opinion, the existing model may not necessarily provide a realizable measure of the fair value of the stock options.

## 17 Pension plan

Prior to December 1, 2000, the Group had only one defined contribution pension plan for all its Hong Kong employees. Under this plan, all employees were entitled to pension benefits equal to their own contributions plus 50% to 100% of individual fund account balances contributed by the Group, depending on their years of service with the Group. The Group was required to make specific contributions at approximately 10% of the basic salaries of the employees to an independent fund management company.

With the introduction of the Mandatory Provident Fund Scheme, a defined contribution scheme managed by an independent trustee on December 1, 2000, the Group and its employees who joined the Group subsequently make monthly contributions to the scheme at 5% of the employee's cash income as defined under the Mandatory Provident Fund legislation. Contributions of both the Group and its employees are subject to a maximum of HK\$1,000 per month and thereafter contributions are voluntary and are not subject to any limitation. The Group and its employees made their first contributions in December 2000.

As stipulated by the rules and regulations in the PRC, the Group contributes to state-sponsored retirement plans for its employees in Mainland China. The Group contributes approximately ranging from 10% to 22% of the basic salaries of its employees, and has no further obligations for the actual payment of pension or post-retirement benefits beyond the annual contributions. The state-sponsored retirement plans are responsible for the entire pension obligations payable to retired employees.

During the years ended December 31, 2005, 2004 and 2003, the aggregate contributions of the Group to the aforementioned pension plans and retirement benefit schemes were approximately US\$191,000, US\$166,000 and US\$137,000 respectively.

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## **18 Risk factor and Derivative Instruments**

Financial risk factors

The Group's activities expose it to a variety of financial risks: foreign exchange rate risk and credit risk.

### **(i) Credit risk**

The Group has no significant concentration of credit risk. The Group has policies in place to ensure that sales of products are made to customers with an appropriate credit history. The Group has policies that limit the amount of credit exposure to any customers. Derivative counterparties and cash transactions are limited to high credit quality banks.

### **(ii) Foreign exchange risk**

The Group operates in Hong Kong, the PRC and trades with both local and overseas customers, and is exposed to foreign exchange risk arising from various currency exposures, primarily with respect to purchases in, Hong Kong dollar, Reminbi and Euro. Foreign exchange risk arises from committed and unmatched future commercial transactions, such as confirmed import purchase orders and sales orders, recognized assets and liabilities, and net investment in the PRC operations. The Group uses derivative financial instruments such as foreign exchange contracts to hedge certain foreign currency exposures.

The Group's prevailing risk management policy is to hedge the net committed transactions (mainly sales and import purchases) in each major currency.

The Company's policy generally permits the use of derivatives if they are associated with underlying assets or liabilities, forecasted transactions, or legally binding rights or obligations.

As of December 31, 2005, the Company has no foreign forward contract commitments (2004: US\$468,000 and 2003: Nil). The fair value of this derivative instrument was expensed in the consolidated statement of income as it is not qualified as hedge accounting treatment.

## **19 Related party transactions**

A related party is an entity that can control or significantly influence the management or operating policies of another entity to the extent one of the entities may be prevented from pursuing its own interests. A related party may also be any party the entity deals with that can exercise that control.

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(i) The transactions with related parties are summarized as follows:

	2005 US\$ 000	2004 US\$ 000	2003 US\$ 000
<b>Sale of goods to</b>			
Eurotherm Limited		27	43
Armtison Limited		1	
<b>Purchase of goods from</b>			
Eurotherm Limited	242	7,503	7,219
Armtison Limited			4
Action Instruments (China) Limited		5	10
Euro Electron (Far East) Limited		4	
Interest income on trade receivables earned from Armtison Limited		2	3
Rental income of office premises earned from Eurotherm Limited	2	30	34
Rental expenses for office premises charged by Armtison Limited	11	25	33
<b>Management fees charged by</b>			
Eurotherm Limited	4	29	29
Patwin Inc.	18	30	30
<b>Management fees received from</b>			
Pact Asia Pacific Ltd			9
Armtison Limited	2	9	

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

	2005 US\$ 000	2004 US\$ 000
Action Instruments (China) Limited		1
Eurotherm Limited		1,265
		1,266

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Armtison Limited and Action Instruments (China) Limited are beneficially owned by Mr. T. C. Leung, Chief Executive Officer and Chairman of the Board of Directors. Patwin Inc. is beneficially owned by the brother of Mr. T.C. Leung. Mr. T. C. Leung is also a director of Eurotherm Limited as at December 31, 2004 and 2003 and retired in February 2005.

(iii) As of December 31, 2003, prepayments and other current assets included advances to certain PRC employees of the Group, net of provision, of approximately US\$261,000. The advances are provided to those PRC employees in order for them to finance the operations of certain retail shops established in the PRC by the employees to market the Group's products. The advances are unsecured, bear interest at a nominal rate and have no fixed repayment terms. During the years ended December 31, 2003, provisions in respect of the recoverability of such advances of US\$45,000 were made by the Group. The Group does not account for the related sales to these retail shops until the related inventories are sold to third parties.

As at December 31, 2005 and 2004, the Group has included the financial results of these retail shops with the application of FIN 46 Consolidation of Variable Interest Entities. All material intercompany balances and transactions have been eliminated in consolidation.

## **20 Commitments and contingencies**

### **(i) Operating leases**

The Group has various operating lease agreements for office and industrial premises. Rental expenses for the years ended December 31, 2005, 2004 and 2003 were approximately US\$321,000, US\$257,000, and US\$139,000, respectively. Future minimum rental payments as of December 31, 2005, under agreements classified as operating leases with non-cancellable terms amounted to US\$423,000 of which US\$283,000 are payable in the year 2006 and US\$140,000 are payable each year from 2007 to 2009.

### **(ii) Banking facilities**

As at December 31, 2005, 2004 and 2003, the Group has various banking facilities available for overdraft, import and export credits and foreign exchange contracts from which the Group can access up to approximately US\$4,167,000, US\$4,167,000 and US\$4,321,000 respectively, of which approximately US\$422,000, US\$2,394,000 and US\$1,723,000 was utilized.

## **21 Fair value of financial instruments**

The carrying values of financial instruments, which consist of cash and cash equivalents, accounts receivable and accounts payable, bills receivable, bills payable, other payables and balances with related companies approximate their fair values due to the short-term nature of these instruments.

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## 22 Segment information

(i) The Group reports under two segments: Trading and manufacturing, and Engineering.

Operating income represents total revenues less operating expenses, excluding other expense, interest and income taxes. The identifiable assets by segment are those used in each segment's operations. Intersegment amounts are not significant and are eliminated to arrive at consolidated totals.

	2005 US\$ '000	2004 US\$ '000	2003 US\$ '000
<b>Revenue</b>			
Trading and manufacturing	26,348	32,155	27,332
Engineering	4,902	127	110
	31,250	32,282	27,442
<b>Operating income</b>			
Trading and manufacturing	(180 )	462	517
Engineering	1,331	(14 )	12
	1,151	448	529

	2005 US\$ '000	2004 US\$ '000	2003 US\$ '000
<b>Depreciation:</b>			
Trading and manufacturing	178	184	190
Engineering	3		
	181	184	190
<b>Capital Expenditures, Gross</b>			
Trading and manufacturing	108	101	74
Engineering	2		
	110	101	74

	2005 US\$ '000	2004 US\$ '000
<b>Assets</b>		
Trading and manufacturing	11,623	15,018
Engineering	5,754	110
Investments in affiliates		571
	17,377	15,699
<b>Liabilities</b>		
Trading and manufacturing	5,731	7,861
Engineering	1,892	1
	7,623	7,862

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(ii) Geographical analysis of revenue by customer location is as follows:

	2005 US\$ '000	2004 US\$ '000	2003 US\$ '000
Revenue			
The PRC	25,005	25,245	20,194
Hong Kong	5,932	6,820	7,092
Others	313	217	156
	31,250	32,282	27,442

(iii) Long-lived assets (1)

Geographical analysis of long-lived assets is as follows:

	2005 US\$ '000	2004 US\$ '000
Hong Kong	969	968
The PRC	766	798
	1,735	1,766

(1) Long-lived assets represent property, plant and equipment, net.

(iv) Major suppliers

Details of individual suppliers accounting for more than 5% of the Group's purchases are as follows:

	2005	2004	2003
Eurotherm Limited	3 %	29 %	31 %
Hioki E.E. Corp.	29 %	15 %	12 %
Hach Company Inc.	4 %	11 %	8 %
Lachat Instruments Inc.	6 %	7 %	3 %
US Filter/Chemical Feed and Disinfection Group	8 %	4 %	3 %
ThermoQuest Corporation	2 %	5 %	3 %
Calipers Life Sciences Inc.	5 %	2 %	3 %

Some of the purchase agreements signed with the Group's suppliers are memorialized. They are not formal contracts and are arranged through other acknowledgements or correspondence which may contain vague description of the terms and conditions of such arrangements, and therefore may be unenforceable.

