

Chung Hung Steel Co., Ltd.

**Financial Statements for the
Years Ended December 31, 2007 and 2006
and Independent Auditors' Report**

INDEPENDENT AUDITORS' REPORT

The Board of Directors and Stockholders
Chung Hung Steel Co., Ltd.

We have audited the accompanying balance sheets of Chung Hung Steel Co., Ltd. (the "Company") as of December 31, 2007 and 2006, and the related statements of income, changes in stockholders' equity and cash flows for the years then ended. 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 in accordance with the Rules Governing the Audit of Financial Statements by Certified Public Accountants and auditing standards generally accepted in the Republic of China. Those rules and 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. 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 audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to in the first paragraph present fairly, in all material respects, the financial position of Chung Hung Steel Co., Ltd. as of December 31, 2007 and 2006, and the results of its operations and its cash flows for the years then ended in conformity with the Guidelines Governing the Preparation of Financial Reports by Securities Issuers, requirements of the Business Accounting Law and Guidelines Governing Business Accounting relevant to financial accounting standards, and accounting principles generally accepted in the Republic of China.

As stated in Note 3 to the accompanying financial statements, effective 2006, the Company adopted the newly issued Statements of Financial Accounting Standards ("Statements") No. 34 - "Financial Instruments: Recognition and Measurement" and No. 36 - "Financial Instruments: Disclosure and Presentation" and the related revisions of previously issued Statements.

January 28, 2008

Notice to Readers

The accompanying financial statements are intended only to present the financial position, results of operations and cash flows in accordance with accounting principles and practices generally accepted in the Republic of China and not those of any other jurisdictions. The standards, procedures and practices to audit such financial statements are those generally accepted and applied in the Republic of China.

For the convenience of readers, the auditors' report and the accompanying financial statements have been translated into English from the original Chinese version prepared and used in the Republic of China. If there is any conflict between the English version and the original Chinese version or any difference in the interpretation of the two versions, the Chinese-language auditors' report and financial statements shall prevail. Also, as stated in Note 2 to the financial statements, the additional footnote disclosures that are not required under generally accepted accounting principles were not translated into English.

CHUNG HUNG STEEL CO., LTD.

BALANCE SHEETS

DECEMBER 31, 2007 AND 2006

(In Thousands of New Taiwan Dollars, Except Par Value)

ASSETS	2007		2006		LIABILITIES AND STOCKHOLDERS' EQUITY	2007		2006	
	Amount	%	Amount	%		Amount	%	Amount	%
CURRENT ASSETS					CURRENT LIABILITIES				
Cash	\$ 40,927	-	\$ 293,022	1	Short-term loans (Notes 13 and 22)	\$ 4,390,860	14	\$ 4,233,156	15
Financial assets at fair value through profit or loss (Notes 2 and 4)	17,004	-	-	-	Commercial paper payable (Notes 14 and 22)	499,778	2	579,906	2
Notes receivable (Notes 2 and 5)	262,030	1	-	-	Accounts payable	2,061,227	6	1,927,657	7
Accounts receivable (Notes 2 and 5)	862,624	3	715,014	3	Accounts payable to related parties (Note 21)	116,735	-	306,558	1
Accounts receivable from related parties (Note 21)	149,181	-	43,225	-	Income tax payable (Note 18)	802,195	2	229,565	1
Income tax refund receivable	313,749	1	308,954	1	Accrued expenses	444,244	1	389,570	1
Inventories (Notes 2 and 6)	7,861,890	24	7,255,122	25	Payable on purchase contract loss (Notes 2 and 23)	199,662	1	-	-
Prepayments for purchases	525,762	2	67,895	-	Sales allowances payable (Note 2)	216,604	1	350,447	1
Pledged time deposits (Note 22)	300,000	1	300,000	1	Current portion of long-term loans (Notes 15 and 22)	2,287,143	7	947,143	3
Others	83,179	-	110,204	1	Others (Note 21)	171,081	1	72,310	-
Total current assets	<u>10,416,346</u>	<u>32</u>	<u>9,093,436</u>	<u>32</u>	Total current liabilities	<u>11,189,529</u>	<u>35</u>	<u>9,036,312</u>	<u>31</u>
LONG-TERM INVESTMENTS					LONG - TERM LIABILITIES				
Available-for-sale financial assets - noncurrent (Notes 2 and 7)	1,916,511	6	1,479,998	5	Financial liability at fair value through profit or loss - noncurrent (Notes 2 and 4)	377	-	-	-
Financial assets carried at cost - noncurrent (Notes 2 and 8)	291,850	1	291,850	1	Long-term loans, net of current portion (Notes 15 and 22)	4,285,714	13	5,472,857	19
Investments accounted for by the equity method (Notes 2 and 9)	2,369,016	7	2,193,911	8	Total long-term liabilities	<u>4,286,091</u>	<u>13</u>	<u>5,472,857</u>	<u>19</u>
Other financial assets - noncurrent (Notes 2 and 10)	2,222,627	7	5,760	-	ACCRUED PENSION COST (Notes 2 and 16)	<u>443,935</u>	<u>1</u>	<u>454,584</u>	<u>2</u>
Total long-term investments	<u>6,800,004</u>	<u>21</u>	<u>3,971,519</u>	<u>14</u>	Total liabilities	<u>15,919,555</u>	<u>49</u>	<u>14,963,753</u>	<u>52</u>
PROPERTIES (Notes 2, 11, 22 and 23)					CAPITAL STOCK - NT\$10 par value, authorized 2,043,160 thousand shares; issued and outstanding - 1,284,571 thousand shares	<u>12,845,706</u>	<u>40</u>	<u>12,845,706</u>	<u>45</u>
Land	4,963,577	15	4,941,414	17	RETAINED EARNINGS (Note 17)				
Buildings and improvements	2,669,018	8	2,624,046	9	Legal reserve	39,324	-	-	-
Machinery and equipment	13,128,249	40	13,076,864	46	Unappropriated earnings	2,694,377	8	390,419	1
Miscellaneous equipment	2,454,863	8	2,358,455	8	Total retained earnings	<u>2,733,701</u>	<u>8</u>	<u>390,419</u>	<u>1</u>
Total cost	23,215,707	71	23,000,779	80	OTHER EQUITY ITEMS				
Less: Accumulated depreciation	8,862,101	27	7,942,171	28	Unrealized valuation gain on financial instruments (Notes 2 and 17)	1,002,699	3	499,099	2
Accumulated impairment loss - land	1,724,863	5	1,444,267	5	Net loss not recognized as pension cost	(1)	-	-	-
Construction-in-progress	491,648	2	260,938	1	Total other equity items	<u>1,002,698</u>	<u>3</u>	<u>499,099</u>	<u>2</u>
Prepayments for equipment	450,453	1	79,780	-	Total stockholders' equity	<u>16,582,105</u>	<u>51</u>	<u>13,735,224</u>	<u>48</u>
Net properties	<u>13,570,844</u>	<u>42</u>	<u>13,955,059</u>	<u>48</u>	TOTAL	<u>\$ 32,501,660</u>	<u>100</u>	<u>\$ 28,698,977</u>	<u>100</u>
OTHER ASSETS (Notes 2 and 12)									
Assets leased to others	49,641	-	50,185	-					
Nonoperating assets, net	1,571,930	5	1,571,930	6					
Others	92,895	-	56,848	-					
Total other assets	<u>1,714,466</u>	<u>5</u>	<u>1,678,963</u>	<u>6</u>					
TOTAL	<u>\$ 32,501,660</u>	<u>100</u>	<u>\$ 28,698,977</u>	<u>100</u>					

The accompanying notes are an integral part of the financial statements.
(With Deloitte & Touche audit report dated January 28, 2008)

CHUNG HUNG STEEL CO., LTD.

STATEMENTS OF INCOME

YEARS ENDED DECEMBER 31, 2007 AND 2006

(In Thousands of New Taiwan Dollars, Except Basic Earnings Per Share)

	2007		2006	
	Amount	%	Amount	%
REVENUES (Notes 2, 21 and 26)	\$ 47,878,070	101	\$ 46,399,586	102
Less: SALES RETURNS	7,353	-	9,237	-
SALES ALLOWANCES	<u>544,002</u>	<u>1</u>	<u>928,285</u>	<u>2</u>
NET REVENUES	47,326,715	100	45,462,064	100
SERVICE REVENUE	<u>261,937</u>	<u>1</u>	<u>246</u>	<u>-</u>
TOTAL OPERATING REVENUE	47,588,652	101	45,462,310	100
COST OF REVENUES (Notes 19 and 21)	<u>42,588,899</u>	<u>90</u>	<u>37,712,509</u>	<u>83</u>
GROSS PROFIT	<u>4,999,753</u>	<u>11</u>	<u>7,749,801</u>	<u>17</u>
OPERATING EXPENSES (Note 19)				
Selling expenses	740,492	2	797,557	2
General and administrative expenses	<u>263,299</u>	<u>-</u>	<u>291,139</u>	<u>-</u>
Total operating expenses	<u>1,003,791</u>	<u>2</u>	<u>1,088,696</u>	<u>2</u>
OPERATING INCOME	<u>3,995,962</u>	<u>9</u>	<u>6,661,105</u>	<u>15</u>
NONOPERATING INCOME AND GAINS				
Interest (Note 24)	18,586	-	14,121	-
Investment income recognized under the equity method, net (Note 9)	108,019	-	91,734	-
Dividends (Note 2)	147,271	1	164,682	1
Valuation gain on financial assets (Notes 2 and 4)	17,199	-	8,444	-
Others (Notes 9 and 11)	<u>57,295</u>	<u>-</u>	<u>55,056</u>	<u>-</u>
Total nonoperating income and gains	<u>348,370</u>	<u>1</u>	<u>334,037</u>	<u>1</u>
NONOPERATING EXPENSES AND LOSSES				
Interest (Notes 11 and 24)	250,458	1	392,083	1
Loss on decline in inventory value (Note 2)	-	-	1,726	-
Impairment loss on assets (Notes 2, 11 and 12)	280,596	1	778,231	2
Purchase contract loss (Notes 2 and 23)	199,662	-	-	-
Others	<u>6,744</u>	<u>-</u>	<u>21,817</u>	<u>-</u>
Total nonoperating expenses and losses	<u>737,460</u>	<u>2</u>	<u>1,193,857</u>	<u>3</u>

(Continued)

CHUNG HUNG STEEL CO., LTD.

STATEMENTS OF INCOME

YEARS ENDED DECEMBER 31, 2007 AND 2006

(In Thousands of New Taiwan Dollars, Except Basic Earnings Per Share)

	2007		2006	
	Amount	%	Amount	%
INCOME BEFORE INCOME TAX	3,606,872	8	5,801,285	13
INCOME TAX (Notes 2 and 18)	<u>921,949</u>	<u>2</u>	<u>718,484</u>	<u>2</u>
INCOME BEFORE CUMULATIVE EFFECT OF CHANGES IN ACCOUNTING PRINCIPLES	2,684,923	6	5,082,801	11
CUMULATIVE EFFECT OF CHANGES IN ACCOUNTING PRINCIPLES (Note 3)	<u>-</u>	<u>-</u>	<u>(180)</u>	<u>-</u>
NET INCOME	<u>\$ 2,684,923</u>	<u>6</u>	<u>\$ 5,082,621</u>	<u>11</u>
	2007		2006	
	Before Income Tax	After Income Tax	Before Income Tax	After Income Tax
BASIC EARNINGS PER SHARE (Note 20)	<u>\$ 2.81</u>	<u>\$ 2.09</u>	<u>\$ 4.52</u>	<u>\$ 3.96</u>

The accompanying notes are an integral part of the financial statements.

(With Deloitte & Touche audit report dated January 28, 2008)

(Concluded)

CHUNG HUNG STEEL CO., LTD.

STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY YEARS ENDED DECEMBER 31, 2007 AND 2006 (In Thousands of New Taiwan Dollars)

	Issued and Outstanding Capital Stock	Retained Earnings			Other Equity Items			Total Stockholders' Equity
		Legal Reserve	Unappropriated Earnings	Total	Unrealized Valuation Gain on financial Instruments	Cumulative Translation Adjustments	Net Loss not Recognized as Pension Cost	
BALANCE, JANUARY 1, 2006	\$ 12,845,706	\$ 234,980	\$(4,924,365)	\$(4,689,385)	\$ (23,422)	\$ 3,716	\$ -	\$ 8,136,615
Effect of first adoption of SFAS No.34 (Note 3)	-	-	-	-	26,036	-	-	26,036
Offset of deficit against legal reserve	-	(234,980)	234,980	-	-	-	-	-
Change in unrealized valuation gain on available-for-sale financial assets	-	-	-	-	446,798	-	-	446,798
Adjustment of equity in investees due to change in percentage of ownership	-	-	(2,817)	(2,817)	49,687	-	-	46,870
Net income in 2006	-	-	5,082,621	5,082,621	-	-	-	5,082,621
Translation adjustments on long-term stock investments	-	-	-	-	-	(3,716)	-	(3,716)
BALANCE, DECEMBER 31, 2006	12,845,706	-	390,419	390,419	499,099	-	-	13,735,224
Appropriation of the 2006 earnings (Note 17)								
Legal reserve	-	39,324	(39,324)	-	-	-	-	-
Cash dividends - 2.5%	-	-	(321,143)	(321,143)	-	-	-	(321,143)
Bonuses to employees - cash	-	-	(17,082)	(17,082)	-	-	-	(17,082)
Remuneration to directors and supervisors	-	-	(3,416)	(3,416)	-	-	-	(3,416)
Change in unrealized valuation gain on available-for-sale financial assets	-	-	-	-	436,513	-	-	436,513
Adjustment of equity in investees due to change in percentage of ownership	-	-	-	-	67,087	-	(1)	67,086
Net income in 2007	-	-	2,684,923	2,684,923	-	-	-	2,684,923
BALANCE, DECEMBER 31, 2007	<u>\$ 12,845,706</u>	<u>\$ 39,324</u>	<u>\$ 2,694,377</u>	<u>\$ 2,733,701</u>	<u>\$ 1,002,699</u>	<u>\$ -</u>	<u>\$ (1)</u>	<u>\$ 16,582,105</u>

The accompanying notes are an integral part of the financial statements.

(With Deloitte & Touche audit report dated January 28, 2008)

CHUNG HUNG STEEL CO., LTD.

STATEMENTS OF CASH FLOWS YEARS ENDED DECEMBER 31, 2007 AND 2006 (In Thousands of New Taiwan Dollars)

	2007	2006
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	\$ 2,684,923	\$ 5,082,621
Cumulative effect of changes in accounting principles	-	180
Adjustments		
Depreciation	1,016,712	999,316
Amortization	4,850	38,775
Impairment loss on assets, net	280,596	778,231
Purchase contract loss	199,662	-
Provision (reversal of provision) for loss on inventories	(16,875)	1,726
Valuation gain on financial instruments	(16,627)	-
Loss (gain) on disposal of assets	(4,596)	4,277
Investment income recognized under the equity method	(108,019)	(91,734)
Provision for pension cost	(10,649)	(5,280)
Deferred income tax	-	487,000
Others	-	12,192
Net changes in operating assets and liabilities		
Notes and accounts receivable	(407,519)	(279,290)
Accounts receivable from related parties	(105,956)	(24,114)
Income tax refund receivable	(4,795)	-
Inventories	(589,893)	2,927,388
Prepayments for purchases	(457,867)	36,676
Other current assets	27,025	592,875
Accounts payable	133,570	1,421,101
Accounts payable to related parties	(189,823)	194,901
Income tax payable	572,630	229,565
Accrued expenses	54,674	109,667
Sales allowances payable	(133,843)	(233,549)
Other current liabilities	<u>101,372</u>	<u>(38,189)</u>
Net cash provided by operating activities	<u>3,029,552</u>	<u>12,244,335</u>
CASH FLOWS FROM INVESTING ACTIVITIES		
Decrease (increase) in other financial assets - noncurrent	(2,219,000)	19,200
Acquisition of properties	(917,874)	(307,737)
Proceeds of the disposal of assets	7,320	3
Increase in other assets	(16,100)	(23,800)
Decrease in refundable deposits	12	713
Increase in long-term stock investments under the equity method	-	(26,000)
Proceeds of the disposal of financial assets carried at cost	-	10,141
Proceeds of the disposal of investments accounted for by the equity method	-	54,866
Others	<u>(24,797)</u>	<u>-</u>
Net cash used in investing activities	<u>(3,170,439)</u>	<u>(272,614)</u>

(Continued)

CHUNG HUNG STEEL CO., LTD.

STATEMENTS OF CASH FLOWS YEARS ENDED DECEMBER 31, 2007 AND 2006 (In Thousands of New Taiwan Dollars)

	2007	2006
CASH FLOWS FROM FINANCING ACTIVITIES		
Increase (decrease) in short-term loans	\$ 157,704	\$ (7,568,282)
Decrease in commercial paper payable	(80,128)	(1,173,028)
Repayments of long-term loans	(947,143)	(8,960,000)
Increase in long-term loans	1,100,000	6,000,000
Cash dividends	(321,143)	-
Bonuses to employees	(17,082)	-
Remuneration to directors and supervisors	<u>(3,416)</u>	<u>-</u>
Net cash used in financing activities	<u>(111,208)</u>	<u>(11,701,310)</u>
NET INCREASE (DECREASE) IN CASH	(252,095)	270,411
CASH, BEGINNING OF YEAR	<u>293,022</u>	<u>22,611</u>
CASH, END OF YEAR	<u>\$ 40,927</u>	<u>\$ 293,022</u>
SUPPLEMENTAL CASH FLOW INFORMATION		
Interest paid (excluding capitalized interest)	\$ 248,847	\$ 400,316
Income tax paid	349,319	1,919
PURCHASE OF PROPERTIES		
Acquisition of properties	\$ 915,273	\$ 350,312
Decrease (increase) in payable on properties purchased	<u>2,601</u>	<u>(42,575)</u>
Cash paid	<u>\$ 917,874</u>	<u>\$ 307,737</u>
NONCASH INVESTING AND FINANCING ACTIVITIES		
Current portion of long-term loans	\$ 2,287,143	\$ 947,143
Other receivables reclassified into accounts receivable	2,121	-
Properties reclassified into other assets	-	5,432

The accompanying notes are an integral part of the financial statements.

(With Deloitte & Touche audit report dated January 28, 2008)

(Concluded)

CHUNG HUNG STEEL CO., LTD.

NOTES TO FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2007 AND 2006

(In Thousands of New Taiwan Dollars, Unless Stated Otherwise)

1. ORGANIZATION AND OPERATIONS

Chung Hung Steel Co., Ltd. (the "Company") was incorporated in September 1983 and started operations in September 1985. It mainly manufactures, processes and sells steel products, such as cold and hot rolled coils and steel pipes. China Steel Corporation, the Company's parent company and major stockholder (39%), controls the Company's management and operations. As of December 31, 2007 and 2006, the Company had 922 and 912 employees, respectively.

The Company's shares are traded on the Taiwan Stock Exchange.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The financial statements of the Company are prepared in conformity with the Guidelines Governing the Preparation of Financial Reports by Securities Issuers, Business Accounting Law, Guidelines Governing Business Accounting and accounting principles generally accepted in the Republic of China. According to these guidelines, laws and principles, the Company is required to make certain assumptions and estimates, which affect the amounts of recorded assets, liabilities, revenues and expenses, including provisions for doubtful accounts and inventory losses, purchase contract loss, allowance for sales discounts, depreciation of property, impairment loss on assets, pension cost and income tax. Actual results could differ from these estimates.

For the convenience of readers, the accompanying financial statements have been translated into English from the original Chinese version prepared and used in the Republic of China. If there is any conflict between the English version and the original Chinese version or any difference in the interpretation of the two versions, the Chinese-language financial statements shall prevail. However, the accompanying financial statements do not include the English translation of the additional footnote disclosures that are not required under generally accepted accounting principles but are required by the Securities and Futures Bureau (SFB, formerly "Securities and Futures Commission" before July 1, 2004) for their oversight purposes.

The Company's significant accounting policies are summarized as follows.

Current and Noncurrent Assets and Liabilities

Current assets include cash and those assets held primarily for trading purposes or to be realized, sold or consumed within one year from the balance sheet date. All other assets such as property, plant and equipment and intangible assets are classified as noncurrent. Current liabilities are obligations incurred for trading purposes or to be settled within one year from the balance sheet date. All other liabilities are classified as noncurrent.

Financial Instruments at Fair Value Through Profit or Loss

Financial instruments at fair value through profit or loss include financial assets or financial liabilities held for trading. These financial instruments are initially recognized at fair value, and related transaction costs are expensed currently. When these instruments are remeasured at fair value, the changes in fair value are recognized under current income. A regular purchase or sale of financial assets is recorded using trade date accounting.

Derivatives that do not meet the criteria for hedge accounting are treated as financial assets or liabilities held for trading. When the fair value of the derivative is a positive number, the financial instrument is recorded as a financial asset; when the fair value is a negative number, the financial instrument is recorded as a financial liability.

Fair value of derivatives with no active market fair value is determined using valuation techniques.

Available-for-sale Financial Assets

Available-for-sale financial assets are initially recognized at fair value plus transaction costs that are directly attributable to the acquisition. When subsequently measured at fair value, the changes in fair value are excluded from earnings and reported as a separate component of stockholders' equity. The accumulated gains or losses are recognized under earnings when the financial asset is derecognized from the balance sheet. A regular purchase or sale of financial assets is recorded using trade date accounting.

The recognition and derecognized bases of available-for-sale financial assets are similar to those of financial instruments at fair value through profit or loss.

Cash dividends received on investment in equity securities are recognized as income in the period received. Stock dividends received are recognized only as an increase in the number of shares of stock held on the ex-dividend date. Costs of investments sold are determined by the weighted-average method.

If there is objective evidence that a financial asset is impaired, an impairment loss is recognized. If the impairment loss decreases, for equity securities, the previously recognized impairment loss is reversed to the extent of the decrease and recorded as an adjustment to stockholders' equity; for debt securities, the amount of the decrease is recognized under earnings if the decrease is clearly attributable to an event that occurred after impairment loss recognition.

The fair value of financial assets and financial liabilities at the balance sheet date are determined at the closing prices of publicly traded stocks.

Factoring of Accounts Receivable

The following three conditions must be met to recognize factoring of accounts receivable:

- a. The accounts receivable have been legally isolated from the Company.
- b. The transferees have obtained the right to pledge or exchange the accounts receivable, which are either the transferred accounts receivable or beneficial interest in the transferred assets.
- c. The transferor does not maintain effective control, through an agreement to repurchase or redeem the transferred accounts receivable before their maturity, over the transferred accounts receivable.

If the three conditions are met, the difference between the proceeds and the face value of the accounts receivable is recognized as a loss and recorded as nonoperating expenses.

Revenue Recognition, Sales Returns and Allowances and Allowance for Doubtful Accounts

Revenue is recognized when the titles to products and evident risks of ownership are transferred to customers, primarily upon shipment. Domestic sales are recognized when products are delivered to and accepted by the customers, and export sales are recognized when products are loaded onto shipping vessels in accordance with the sales terms.

Sales are measured at fair value, which is a price (net of trade discounts and sales discounts) agreed by the Company and customers. However, if the related receivables are due within one year, the differences between their fair values and receivable amounts are immaterial and sales transactions are frequent, the fair values of related receivables are not calculated using the discounted imputed interest rate.

Sales returns are recorded as reductions of sales in the year of actual return, and the related cost of sales is reversed to inventory. Sales allowances are monetary discounts applied when sales volume reaches a certain level and are recorded as sales allowances payable.

An allowance for doubtful accounts is provided on the basis of a review of the collectibility of receivables. This review includes an aging analysis of receivables and economic situation. However, aging analysis of receivables had exceeded certain period and was reclassified into overdue receivables.

Inventories

Inventories are stated at the lower of aggregate weighted-average cost or market value. The book value of inventory is reduced to market value when its cost is lower than market value. Market value represents the net realizable values of finished goods, work-in-process and scraps and the replacement costs of raw materials and supplies.

Financial Assets Carried at Cost

Investments with no quoted market prices, such as non-publicly traded stocks and mutual funds, and with fair values that cannot be reliably measured are carried at original cost. If there is objective evidence of financial asset impairment, impairment loss is recognized. No recording of a subsequent recovery of fair value is allowed.

Investments Accounted for by the Equity Method

The equity method is applied to investments in companies in which the Company owns 20% or more of investees' common stock or exercises significant influence over their operating and financial policy decisions.

These investments are initially stated at cost, and their carrying amounts are subsequently adjusted for the Company's proportionate share in the net income or net loss and cumulative translation adjustment. Cash dividends received are accounted for as a reduction of the carrying value of the investments. When the investee recognizes unrealized valuation gains or losses on financial instruments, the Company also records its equity in the investee's unrealized gains or losses as an adjustment to stockholders' equity.

Other Financial Assets — Nonperforming Loans

Other financial assets are mainly nonperforming loans (NPLs), which are recorded at cost at the time of acquisition. The costs of acquired NPLs include the purchase price and necessary handling charges on acquisition. All expenditures related to bid participation - government fees, outsourcing costs, appraisal fees, etc. - are expensed when incurred. For any default on loans, costs related to the application to a court for a provisional seizure of assets or provisional disposition - fees for adjudication request, foreclosure ruling, and appraisal field review, etc. - are recorded as expenses.

The cost recovery method is used to recognize revenues from the recovery or disposal of acquired NPLs. After the cost of an acquired loan is recovered, revenue is recognized for the amounts recovered in excess of the acquisition cost of the loan. The acquired NPLs are de-recognized from the balance sheet on the disposal of the collaterals for the acquired loans or on the recovery of assets upon loan settlement. If there is NPL impairment, an impairment loss should be recognized.

Properties

Lands are stated at cost, and other properties are stated at cost less accumulated depreciation. Major additions, renewals and betterments are capitalized, while maintenance and repairs are expensed currently. Interest incurred during the construction and acquisition period is also capitalized as cost of the property.

Depreciation is calculated using the straight-line method over service lives estimated as follows: buildings and improvements, 15 to 60 years; machinery and equipment, 3 to 18 years; and miscellaneous equipment, 3 to 18 years. The residual values of properties that have reached the end of their original service lives but are still in use are further depreciated over their reestimated remaining service lives.

Upon retirement or disposal of properties, the related cost and accumulated depreciation are removed from the accounts. Any resulting gain or loss is credited or charged to current income.

Nonoperating Assets

Nonoperating assets (included in other assets) are stated at the lower of carrying value or net fair value.

Rental Assets

Rental assets (included in other assets) are stated at the lower of carrying value (cost less accumulated depreciation) or recoverable value. Depreciation is calculated by the straight-line method over estimated service lives of 55 years.

Asset Impairment

Assets (primarily properties, investments accounted for by the equity method and other assets) are evaluated on the basis of their recoverable value. If an asset is determined to be impaired and its recoverable value is less than its carrying value, the decline is recognized as impairment loss. If impairment loss is reversed, the loss reversal is only to the extent that the increased carrying amount of an asset would not exceed the asset carrying amount (net of depreciation) had no impairment loss been recognized in prior years.

Deferred Charges

Deferred charges (included in other assets) pertain to fees for syndicated bank loans. These are amortized over 3 to 7 years.

Purchase Contract Losses

Purchase contract losses pertain to irrevocable raw materials purchase contracts. If the estimated costs of finished goods are in excess of their expected net realizable values, payable on purchase contract losses are recognized as nonoperating losses.

Pension

The Company has two types of pension plans: defined contribution and defined benefit.

Pension costs under the defined contribution plan are recognized on the basis of the Company's required monthly contributions to the employees' individual pension accounts.

Pension costs under the defined benefit plan are recognized on the basis of actuarial calculations. The balance of total provision less the funded amounts is recorded in the accrued pension cost account. Payment of retirement benefits is made initially from the pension fund or is charged against accrued pension costs, and any shortage will be charged to expense when paid.

Income Tax

The Company applies the inter-year and intra-year income tax allocation method. Tax effects of deductible temporary differences and unused loss carryforwards are recognized as deferred income tax assets. Valuation allowance is provided for deferred tax assets that are not certain to be realized. Tax effects of taxable temporary differences are recognized as deferred tax liabilities. A deferred tax asset or liability is classified as current or noncurrent on the basis of the classification of the related asset or liability for financial reporting; otherwise, it is classified according to the expected reversal or realization period of the temporary difference.

Tax credits for certain purchases of equipment, research and development and employees' training are recognized as a reduction of current income tax.

Adjustments of prior years' tax liabilities are added to or deducted from the current year's tax expense.

Annual earnings should be appropriated by the Company's stockholders under a resolution passed in the year following the year of earnings generation. Based on tax regulations, undistributed earnings generated since 1998 are subject to 10% income tax. This tax is recorded as expense in the year when the stockholders resolve to retain these earnings.

Foreign Currency Transactions and Translation of Foreign-currency Financial Statements

Non-derivative foreign-currency transactions are recorded in New Taiwan dollars at the rates of exchange in effect when the transactions occur. Exchange differences arising from settlement of foreign-currency assets and liabilities are recognized in profit or loss.

At the balance sheet date, foreign-currency monetary assets and liabilities are revalued using prevailing exchange rates and the exchange differences are recognized in profit or loss.

At the balance sheet date, foreign-currency nonmonetary assets (such as equity instruments) and liabilities that are measured at fair value are revalued using prevailing exchange rates, with the exchange differences treated as follows:

- a. Recognized in stockholders' equity if the changes in fair value are recognized in stockholders' equity;
- b. Recognized in profit or loss if the changes in fair value is recognized in profit or loss.

Foreign-currency nonmonetary assets and liabilities that are carried at cost continue to be stated at exchange rates at trade dates.

If the functional currency of an equity-method investee is a foreign currency, translation adjustments will result from the translation of the investee's financial statements into the reporting currency of the Company. Such adjustments are accumulated and reported as a separate component of stockholders' equity.

Reclassifications

Certain accounts in the financial statements as of and for the year ended December 31, 2006 have been reclassified to conform to the presentation of the financial statements as of and for the year ended December 31, 2007.

3. EFFECTS OF CHANGES IN ACCOUNTING PRINCIPLES

a. Adoption of New and Revised Standards

On January 1, 2006, the Company adopted the newly released Statement of Financial Accounting Standards (SFAS or “Statement”) No.34 - “Financial Instruments: Recognition and Measurement” and SFAS No. 36 - “Financial Instruments: Disclosure and Presentation” and the related revisions of previously released Statements.

The Company recategorized its financial assets and liabilities upon making the accounting changes. The adjustments made to the carrying amounts of the financial instruments categorized as financial assets or financial liabilities at fair value through profit or loss were included in the cumulative effect of changes in accounting principles; on the other hand, the adjustments made to the carrying amounts of those categorized as available-for-sale financial assets were recognized as adjustments to stockholders’ equity.

The adjustments based on the accounting changes are summarized as follows:

	Recognized as Cumulative Effect of Changes in Accounting Principles (Net of Tax)	Recognized as a Separate Component of Stockholders’ Equity (Net of Tax)
Financial assets at fair value through profit or loss	\$ (180)	\$ -
Available-for-sale financial assets	<u>-</u>	<u>2,614</u>
	<u>\$ (180)</u>	<u>\$ 2,614</u>

The net effect of the change in accounting principles is not significant to the Company’s net income and basic earnings per share for the year ended December 31, 2006.

b. Recent Accounting Pronouncements

In March 2007, the Accounting Research Development Foundation in Taiwan issued an interpretation that requires companies to recognize bonuses paid to employees, directors and supervisors as compensation expenses beginning January 1, 2008. These bonuses are currently recorded as appropriations from earnings.

4. FINANCIAL INSTRUMENTS AT FAIR VALUE THROUGH PROFIT OR LOSS

The Company used forward exchange contracts in 2007 and 2006 to manage exposures due to changes in exchange rates for foreign currencies used to buy fixed assets.

As of December 31, 2007, the amounts of financial assets and liabilities at fair value through profit or loss were NT\$17,004 thousand and NT\$377 thousand, respectively.

Outstanding forward exchange contracts were as follows:

<u>December 31, 2007</u>	Currency	Maturity Date	Amount (In Thousands)
Buy	USD/NT	2008.01.25-2009.01.28	USD12,000/NT\$376,383
Buy	EUR/NT	2008.01.21-2009.09.30	EUR7,150/NT\$318,425

Financial instruments at fair value through profit or loss brought net gains of NT\$17,199 thousand and net losses of NT\$377 thousand in 2007, and net gains of NT\$8,444 thousand in 2006 (included in nonoperating gains and losses)

5. RECEIVABLES

	December 31	
	2007	2006
Notes receivable	\$ 262,030	\$ -
Accounts receivable	879,703	715,014
Less: Allowance for doubtful accounts (Note 2)	<u>17,079</u>	<u>-</u>
	<u>862,624</u>	<u>715,014</u>
	<u>\$ 1,124,654</u>	<u>\$ 715,014</u>

Movements of allowances for doubtful accounts were as follows:

	Year Ended December 31					
	2007			2006		
	Accounts Receivable	Other financial assets- Noncurrent (Note 10)	Total	Accounts Receivable	Other financial assets- Noncurrent (Note 10)	Total
Balance, beginning of year	\$ -	\$ 54,065	\$ 54,065	\$ -	\$ 54,065	\$ 54,065
Add (deduct): Amount reclassified	<u>17,079</u>	<u>(17,079)</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>
Balance, end of year	<u>\$ 17,079</u>	<u>\$ 36,986</u>	<u>\$ 54,065</u>	<u>\$ -</u>	<u>\$ 54,065</u>	<u>\$ 54,065</u>

The Company entered into a factoring accounts receivable contract (without recourse) with Mega International Commercial Bank ("Mega," formerly The International Commercial Bank of China, which merged with the Bank of Communications to become Mega). Under the contract, the Company is authorized to sell accounts receivable to Mega upon the delivery of products to customers and is required to complete related formalities on the next banking day. Under this contract, the Company does not bear the risk of the uncollectibility of the accounts receivable. The receivables sold and the related credit lines, which may be used on a revolving basis, were as follows:

Counter-parties	Receivables Sold	Amounts Collected	Advances Received at Year-end	Interest Rates on Advances Received (%)	Credit Line
<u>Year ended December 31, 2007</u>					
Mega Bank	<u>\$ 4,586,087</u>	<u>\$ 2,828,747</u>	<u>\$ 1,757,340</u>	2.24-2.79	\$2.422billion
<u>Year ended December 31, 2006</u>					
Mega Bank	<u>\$ 3,703,736</u>	<u>\$ 2,182,603</u>	<u>\$ 1,521,133</u>	2.09-2.21	\$2.323billion

6. INVENTORIES

	<u>December 31</u>	
	2007	2006
Finished goods	\$ 2,158,987	\$ 2,103,021
Work-in-process	1,041,143	1,046,522
Raw materials	1,958,838	2,215,956
Supplies	982,148	802,648
Scraps	13,184	13,806
Materials and supplies in transit	<u>1,707,590</u>	<u>1,073,169</u>
	<u>\$ 7,861,890</u>	<u>\$ 7,255,122</u>

7. AVAILABLE-FOR-SALE FINANCIAL ASSETS - NONCURRENT

	<u>December 31</u>	
	2007	2006
Domestic quoted stocks		
China Steel Corporation (CSC)	\$ 1,030,586	\$ 1,030,586
Adjustments for appraisal (Note 17)	<u>885,925</u>	<u>449,412</u>
	<u>\$ 1,916,511</u>	<u>\$ 1,479,998</u>

8. FINANCIAL ASSETS CARRIED AT COST

	<u>December 31</u>	
	2007	2006
Emerging market stocks		
Yieh United Steel Corp.	\$ 257,600	\$ 257,600
Domestic unquoted common stocks		
Riselink Venture Capital Corp.	30,000	30,000
Pacific Harbour Stevedoring Corp.	2,750	2,750
Cheng Shin House Management Consulting Corp.	<u>1,500</u>	<u>1,500</u>
	<u>\$ 291,850</u>	<u>\$ 291,850</u>

Stocks with no quoted prices and their fair values could not be measured reliably were classified as financial assets carried at cost.

The Company also had investments in Sol Hwang Enterprise, Chateav Bridgetop Inc., Taiwan Vespa, Sol Hwang Enterprise and Far Glory Life Insurance. The carrying amounts of these investments were reduced to zero because of impairment losses on these investments.

9. INVESTMENTS ACCOUNTED FOR BY THE EQUITY METHOD

	December 31			
	2007		2006	
	Amount	% of Owner- ship	Amount	% of Owner- ship
Trans Glory Investment Corp. (TGIC)	\$ 2,304,871	41	\$ 2,140,320	41
Hong Kao Investment Corp. (HKIC)	40,665	100	30,281	100
Taiwan Steel Corp.(TSC)	<u>23,480</u>	100	<u>23,310</u>	100
	<u>\$ 2,369,016</u>		<u>\$ 2,193,911</u>	

In June 2005, the Company acquired 41% equity in TGIC for NT\$2,000,000 thousand. TGIC participated in a cash capital increase of Dragon Steel Corp., a subsidiary of China Steel Corporation, which plans to build a steel mill.

In September 2006, the Company invested NT\$25,000 thousand to acquire 100% equity in HKIC. In December 2006, HKIC issued additional shares and the Company acquired all of these shares for NT\$1,000 thousand. HKIC engages in investments.

In October 2006, the Company sold all United Winner Metals Corp. (UWM) shares to YUSC at UWM's net worth per share, a total of NT\$54,866 thousand, and the gain on this sale was NT\$5,635 thousand, which was recorded as nonoperating gain.

The recognition of the following investment income (loss) from investments accounted for by the equity method was based on the investees' audited financial statements of the same reporting periods as those of the Company:

	Years Ended December 31	
	2007	2006
TGIC	\$ 105,629	\$ 95,560
HKIC	2,220	(63)
TSC	170	(7,329)
UWM	<u>-</u>	<u>3,566</u>
	<u>\$ 108,019</u>	<u>\$ 91,734</u>

10. OTHER FINANCIAL ASSETS - NONCURRENT

	December 31	
	2007	2006
Nonperforming loans (Note 2)	<u>\$ 2,219,000</u>	<u>\$ -</u>
Other receivables	36,986	56,186
Less: Allowance for doubtful accounts (Notes 2 and 5)	<u>36,986</u>	<u>54,065</u>
	<u>-</u>	<u>2,121</u>
Refundable deposits	<u>3,627</u>	<u>3,639</u>
	<u>\$ 2,222,627</u>	<u>\$ 5,760</u>

To expand the value chain of the Company's product, the Board of Directors approved the acquisition of the obligatory rights on from the collateralized syndicated bank loans of NT\$6.887 billion of Jenn An Steel Co., Ltd (JAS), and the processing of this acquisition was delegated to Far Eastern Asset Management Co., Ltd. The Company used NT\$2.219 billion to acquire these rights. JAS's syndicated bank loan of NT\$6.887 billion consisted of (a) NT\$6.287 billion (89.32% of JAS's total syndicated loan of NT\$7.039 billion), which were collateralized with land, buildings and equipment for cold-rolled and zinc-galvanized coils, etc. and (b) NT\$0.6 billion collateralized with stock shares of An Feng Steel Co., Ltd. After the Company completed the rights acquisition and payment on November 30, 2007, the Company requested the court to execute the auction of JAS's collaterals.

11. PROPERTIES

Accumulated depreciation consisted of:

	<u>December 31</u>	
	<u>2007</u>	<u>2006</u>
Buildings and improvements	\$ 796,107	\$ 723,836
Machinery and equipment	6,793,215	6,058,430
Miscellaneous equipment	<u>1,272,779</u>	<u>1,159,905</u>
	<u>\$ 8,862,101</u>	<u>\$ 7,942,171</u>
Accumulated impairment loss on land – Kuo An Section	<u>\$ 1,724,863</u>	<u>\$ 1,444,267</u>

As of December 31, 2007 and 2006, the Company had impairment losses of NT\$280,596 thousand and NT\$604,363 thousand, respectively, on its land in the Kuo An Section in Kaohsiung because of the decline in its market value, as determined by appraisers.

A certain crane, which was not being used before 2006, was reinstalled and used in the Company's factory in 2006. Thus, the Company reclassified this crane from nonoperating asset into property and recognized a reversal of impairment loss amounting to NT\$7,098 thousand (included in nonoperating income and gains).

Interest expenses capitalized were as follows:

	<u>Years Ended December 31</u>	
	<u>2007</u>	<u>2006</u>
Total interest expense	\$ 265,723	\$ 396,787
Interest capitalized	<u>(15,265)</u>	<u>(4,704)</u>
Interest expense reflected in the income statement	<u>\$ 250,458</u>	<u>\$ 392,083</u>
Capitalized interest rate	2.15%-2.72%	2.08%-2.60%

12. OTHER ASSETS

	<u>December 31</u>	
	<u>2007</u>	<u>2006</u>
Rental assets (Note 2)		
Land – Taipei office	\$ 64,026	\$ 64,026
Buildings and improvements	<u>30,289</u>	<u>30,289</u>
	94,315	94,315
Less: Accumulated depreciation	6,174	5,630
Accumulated impairment loss	<u>38,500</u>	<u>38,500</u>
	<u>\$ 49,641</u>	<u>\$ 50,185</u>

The Company leased the Taipei office to a third party under a renewable operating lease contract. The lease runs between July 2007 and June 2008. As of December 31, 2007, the rental income was NT\$320 thousand monthly.

	<u>December 31</u>	
	<u>2007</u>	<u>2006</u>
Nonoperating assets (Note 2)		
Land		
Kaohsiung Long Hua Section	\$ 2,867,515	\$ 2,867,515
Shin Bin Industrial District	<u>122,502</u>	<u>122,502</u>
	2,990,017	2,990,017
Less: Accumulated impairment loss - Kaohsiung Long Hua Section	1,391,337	1,391,337
Accumulated impairment loss - Shin Bin Industrial District	<u>26,750</u>	<u>26,750</u>
	<u>1,418,087</u>	<u>1,418,087</u>
	<u>\$ 1,571,930</u>	<u>\$ 1,571,930</u>

In 2006, the Company recognized an impairment loss of NT\$180,966 thousand (included in nonoperating expenses and losses) on land in the Kaohsiung Long Hua Section based on an appraisal report.

The Company bought farmlands for warehousing at the Jia Xing Section and Bai Mi Section of the Gangshan Town in Kaohsiung County in July 2007, October 2005, and April 2005, respectively. As of December 31, 2007 and 2006, the farmlands amounted to NT\$56,399 thousand and NT\$31,602 thousand, respectively. However, because certain regulations prohibit the Company from registering the title of this farmland in the Company's name, the registration was made in the name of Mr. Liu Ji Gang, the Company's president. Mr. Liu Ji Gang consented to fully cooperate with the Company in changing the land title in the future and pledged the land to the Company as collateral.

13. SHORT-TERM LOANS

	<u>December 31</u>	
	<u>2007</u>	<u>2006</u>
Revolving loans - interest of 2.32%-2.5% in 2007 and 1.705%-1.79% in 2006	\$ 2,154,700	\$ 2,288,300
Letters of credit loans - interest of 2.32%-2.378% in 2007 and 1.71%-1.79% in 2006	1,952,681	1,661,704
Bank overdraft - interest of 1.655% in 2007 and 1.375% in 2006	<u>283,479</u>	<u>283,152</u>
	<u>\$ 4,390,860</u>	<u>\$ 4,233,156</u>

14. COMMERCIAL PAPER PAYABLE

	<u>December 31</u>	
	<u>2007</u>	<u>2006</u>
Commercial paper - interest of 2.08% in 2007 and 1.39%-1.64% in 2006	\$ 500,000	\$ 580,000
Unamortized discounts	<u>(222)</u>	<u>(94)</u>
	<u>\$ 499,778</u>	<u>\$ 579,906</u>

15. LONG-TERM LOANS

	<u>December 31</u>	
	<u>2007</u>	<u>2006</u>
Syndicated bank loans		
Mega International Commercial Bank, etc.		
Repayable in 14 installments from April 2007 to October 2013; interest -2.9133 % in 2007 and 2.3478% in 2006	\$ 5,142,857	\$ 6,000,000
Repayment in January 2008; interest – 2.6723% in 2007	1,100,000	-
Bank loans		
Repayable until June 30, 2010; interest – 2.6895%- 2.9491% in 2007 and 2.1178%-2.9491% in 2006	<u>330,000</u>	<u>420,000</u>
	6,572,857	6,420,000
Less: Current portion	<u>2,287,143</u>	<u>947,143</u>
	<u>\$ 4,285,714</u>	<u>\$ 5,472,857</u>

In September 2006, the Company entered into a syndicated credit facility agreement with Mega International Commercial Bank and 21 other banks and obtained a credit line of \$14 billion, consisting of secured loans of \$6 billion (non-revolving credit) and unsecured loans of \$8 billion (revolving credit). Under the agreement, China Steel Corporation and its related parties should collectively hold at least 30% of the Company's issued shares, have over half of the seats in the board of directors and control the Company's operation. Starting 2007, the Company's net tangible assets should not be less than half of the capital, and the ratio of financial liabilities to net tangible assets should not exceed 350%.

The amounts referring to the above restrictions should be based on audited financial statements. If the Company breaches the agreement, the Company should take remedial measures within six months from the next day of the financial statements' declaration date or adjust the interest rate and the rate of the guarantee fee in accordance with the agreement.

In 2007 and 2006, the Company was in compliance with the syndicated credit facility agreement.

16. PENSION PLAN

The Labor Pension Act (the "Act") became effective on July 1, 2005. The Company regular employees hired before June 30, 2005 have chosen to continue their pension plan under the Labor Standards Law (those employees may change their choice to the "Act" before July 1, 2010), or have chosen the pension plan under the Act, but retained their employment seniority earned until June 30, 2005. Employees hired after July 1, 2005 can only adopt the pension plan under the Act.

Under the Act, a defined contribution plan, the Company makes monthly contribution to employees' personal retirement accounts at amounts equal to 6% of the salaries and wages of employees. According to above regulation, pension cost for the years ended December 31, 2007 and 2006 was NT\$4,740 thousand and NT\$3,983 thousand, respectively.

The Company has a retirement plan in accordance with the Labor Standards Law. Retirement benefits are based on employee's length of service and his/her average salaries and wages of the last six months before retirement.

The Company contributes amounts equal to 12.9% (12.6% before January 2007) of total monthly salaries and wages to a pension fund, which is deposited in the Bank of Taiwan (formerly, the Central Trust of China was the government-designated custodian of pension funds; it merged with the Bank of Taiwan in July 2007, with the Bank of Taiwan as the survivor entity) in the name of, and administered by, the employees' pension fund administration committee. The defined benefit pension costs were NT\$67,748 thousand for 2007 and NT\$64,716 thousand for 2006.

Information about the defined benefit plan was as follows:

a. Components of net pension cost

	Years Ended December 31	
	2007	2006
Service cost	\$ 34,966	\$ 32,672
Interest cost	25,238	22,954
Projected return on plan assets	(3,890)	(2,344)
Amortization	<u>11,434</u>	<u>11,434</u>
Net pension cost	<u>\$ 67,748</u>	<u>\$ 64,716</u>

b. Reconciliation of the fund status of the plan and accrued pension cost

	December 31	
	2007	2006
Benefit obligations		
Vested	\$ 351,497	\$ 327,058
Non-vested	<u>252,479</u>	<u>228,577</u>
Accumulated	603,976	555,635
Additional benefits based on future salaries	<u>164,512</u>	<u>171,334</u>
Projected benefit obligations	768,488	726,969
Fair value of plan assets	<u>(202,471)</u>	<u>(131,246)</u>
Funded status	566,017	595,723
Unrecognized prior service cost	(68,345)	(73,602)
Unrecognized net transition obligation	(37,064)	(43,241)
Unrecognized net actuarial loss	<u>(16,673)</u>	<u>(24,296)</u>
Accrued pension cost	<u>\$ 443,935</u>	<u>\$ 454,584</u>
Vested benefits	<u>\$ 482,385</u>	<u>\$ 467,762</u>

(Continued)

	<u>Years Ended December 31</u>	
	<u>2007</u>	<u>2006</u>
c. Actuarial assumptions		
Discount rate used in determining present value	3.5%	3.5%
Future salary increase rate	2.0%	2.0%
Expected rate of return on plan assets	2.5%	2.5%
d. Contributions to the fund during the year	<u>\$ 77,845</u>	<u>\$ 69,996</u>
e. Payments from the fund during the year	<u>\$ 10,907</u>	<u>\$ 10,317</u>

17. STOCKHOLDERS' EQUITY

Appropriation of Retained Earnings and Dividend Policy

The Company's Articles of Incorporation provide that from annual net income less any prior years' deficit, 10% should be set aside as legal reserve as well as a certain percentage as special reserve based on relevant laws or regulations or as requested by the authorities in charge. The remaining earnings should be appropriated in accordance with the resolution passed at a stockholders' meeting if the dividend per share is not lower than NT\$0.02. The appropriation should include (a) at least 0.3% as bonus to employees and (b) 1% as remuneration to directors and supervisors.

The Company is in a mature steel industry. Thus, dividends will be appropriated in cash or in stock at an appropriate ratio, with cash dividends to be at least 50% of total dividends.

These appropriations and disposition of the remaining net income should be resolved by stockholders in their annual meeting, and given effect to in the financial statements of, the year following the year of earnings generation.

Under the Company Law, legal reserve should be appropriated from retained earnings until its balance equals the Company's paid-in capital. Legal reserve may be used to offset a deficit. When the reserve exceeds 50% of the Company's paid-in capital, (a) the excess may be distributed as dividends and bonuses if the Company has no unappropriated earnings or (b) the excess portion that is over 25% of the Company's paid-in capital may be transferred to capital if the Company has no deficit.

In their annual meeting on June 29, 2006, the Company's stockholders approved the offset of the 2005 deficit against legal reserve. In their annual meeting in June 2005, the Company's stockholders approved the following appropriation of the 2006 earnings:

	<u>Amount</u>	<u>Dividends Per Share</u>
Legal reserve	\$ 39,324	
Cash dividends	321,143	\$ 0.25
Bonus to employees - cash	17,082	
Remuneration to directors and supervisors	<u>3,416</u>	
	<u>\$ 380,965</u>	

Had the above bonus to employees, directors and supervisors been paid entirely in cash and charged to expenses in 2006, the after-tax basic earnings per share would have decreased from NT\$3.96 to NT\$3.94 in 2006.

Information on earnings appropriation may be accessed online through the Market Observation Post System on the Web site of the Taiwan Stock Exchange Corporation.

Unrealized Valuation gain on financial instruments

For the years ended December 31, 2007 and 2006, movements of unrealized valuation gain (loss) on financial instruments were as follows:

	<u>Available-for- sale Financial Assets</u>	<u>Equity-method Investments</u>	<u>Total</u>
<u>Year Ended December 31, 2007</u>			
Balance, beginning of year	\$ 449,412	\$ 49,687	\$ 499,099
Recognized in stockholders' equity	<u>436,513</u>	<u>67,087</u>	<u>503,600</u>
Balance, end of year	<u>\$ 885,925</u>	<u>\$ 116,774</u>	<u>\$ 1,002,699</u>
<u>Year Ended December 31, 2006</u>			
Balance, beginning of year	\$ (23,422)	\$ -	\$ (23,422)
Effect of first adoption of SFAS No. 34	26,036	-	26,036
Recognized in stockholders' equity	<u>446,798</u>	<u>49,687</u>	<u>496,485</u>
Balance, end of year	<u>\$ 449,412</u>	<u>\$ 49,687</u>	<u>\$ 499,099</u>

18. INCOME TAX

The ROC government enacted the Alternative Minimum Tax Act ("AMT Act"), which took effect on January 1, 2006. The alternative minimum tax (AMT) imposed under the AMT Act is a supplemental tax levied at 10%, which is payable if the income tax payable determined under the Income Tax Law is below the minimum amount prescribed under the AMT Act. The taxable income for calculating the AMT includes most of the income that is exempted from income tax under various laws and statutes. The Company has considered the impact of the AMT Act in determining its tax liabilities.

- a. A reconciliation of income tax expense based on income before income tax at the 25% statutory rate and income tax expense was as follows:

	<u>Years Ended December 31</u>	
	<u>2007</u>	<u>2006</u>
Tax on pretax income at statutory rate (25%)	\$ 901,718	\$ 1,450,321
Tax effect on adjusting items:		
Permanent differences		
Loss on land impairment	70,149	196,332
Dividend income	(36,818)	(41,171)
Investment income under the equity method - domestic	(27,005)	(22,042)
Deferred interest expenses for nonoperating assets - land	11,488	10,777
Others	(2,446)	(743)
Temporary differences		
Unrealized (realized) purchase contract loss	49,916	(238,548)
Difference between financial reporting and tax reporting of foreign investment disposal	-	(15,450)
Recovery of sales discounts	(33,461)	(58,387)

(Continued)

	Years Ended December 31	
	2007	2006
Recovery of loss on inventories	\$ (4,219)	\$ (1,039,350)
Others	(7,913)	(5,269)
Use of loss carryforwards	-	(3,279)
Investment tax credits used	-	(1,707)
Additional 10% income tax on unappropriated earnings	<u>1,227</u>	<u>-</u>
Deferred income tax	922,636	231,484
Current Income tax expense	-	487,000
Adjustments for prior years' tax	<u>(687)</u>	<u>-</u>
Income tax expense	<u>\$ 921,949</u>	<u>\$ 718,484</u>

b. Changes in income tax payable

	Years Ended December 31	
	2007	2006
Balance, beginning of year	\$ 229,565	\$ -
Current income tax payable	922,636	231,484
Adjustments for prior years' tax	(687)	-
Payments in current year	<u>(349,319)</u>	<u>(1,919)</u>
Balance, end of year	<u>\$ 802,195</u>	<u>\$ 229,565</u>

c. Deferred income tax assets and liabilities were as follows:

	December 31	
	2007	2006
Current		
Allowance for doubtful accounts	\$ 54,151	\$ 87,612
Purchase contract loss	49,916	-
Allowance for inventory loss	9,937	14,156
Others	<u>(3,903)</u>	<u>490</u>
	110,101	102,258
Less: Valuation allowance	<u>110,101</u>	<u>102,258</u>
	<u>-</u>	<u>-</u>
Noncurrent		
Unfunded pension cost	110,984	113,646
Tax and financial accounting differences on depreciation	<u>-</u>	<u>858</u>
	110,984	114,504
Less: Valuation allowance	<u>110,984</u>	<u>114,504</u>
	<u>-</u>	<u>-</u>
Total deferred income tax assets	<u>\$ -</u>	<u>\$ -</u>

Valuation allowance is fully provided for deferred tax assets because the steel industry constantly changes.

d. Information about integrated income tax was as follows:

For distribution of earnings generated after January 1, 1998, the ratio for the imputation credits allocated to stockholders of the Company is based on the balance of the ICA as of the date of dividend distribution. The expected creditable ratio for the 2006 earnings may be adjusted, depending on the ICA balance on the date of dividend distribution. As of December 31, 2007 and 2006, the balances of the imputation credits allocable to stockholders were NT\$ 1,079,970 thousand and NT\$790,353 thousand, respectively. The creditable ratios for the distribution of the earnings of 2007 and 2006 were 33.38% (estimate) and 33.33% (actual), respectively.

e. The tax returns through 2004 have been assessed by the tax authorities.

19. PERSONNEL, DEPRECIATION AND AMORTIZATION

	Years Ended December 31							
	2007				2006			
	Cost of Revenues	Operating Expenses	Others	Total	Cost of Revenues	Operating Expenses	Others	Total
Personnel								
Salary (including annual bonus)	\$ 701,630	\$ 148,366	\$ -	\$ 849,996	\$ 702,269	\$ 158,465	\$ -	\$ 860,734
Insurance	39,172	6,660	-	45,832	38,099	7,707	-	45,806
Pension cost	62,144	10,344	-	72,488	57,491	11,208	-	68,699
Welfare benefits	164,894	25,492	-	190,386	141,173	22,022	-	163,195
Other	1,658	10,248	-	11,906	2,101	6,632	-	8,733
	<u>\$ 969,498</u>	<u>\$ 201,110</u>	<u>\$ -</u>	<u>\$ 1,170,608</u>	<u>\$ 941,133</u>	<u>\$ 206,034</u>	<u>\$ -</u>	<u>\$ 1,147,167</u>
Depreciation	\$ 101,455	\$ 5,713	\$ 544	\$ 1,016,712	\$ 991,034	\$ 6,073	\$ 2,209	\$ 999,316
Amortization	-	-	4,850	4,850	-	-	38,775	38,775

20. BASIC EARNINGS PER SHARE

The Company has a simple capital structure; thus, basic earnings per share (EPS) are presented. The numerators and denominators used in the computation of basic EPS were as follows:

a. Basic EPS

	Years Ended December 31			
	2007		2006	
	Before Tax	After Tax	Before Tax	After Tax
Net income before cumulative effect of changes in accounting principles	\$ 2.81	\$ 2.09	\$ 4.52	\$ 3.96
Cumulative effect of changes in accounting principles	-	-	-	-
Net income	<u>\$ 2.81</u>	<u>\$ 2.09</u>	<u>\$ 4.52</u>	<u>\$ 3.96</u>

b. Numerator, net income

	Years Ended December 31			
	2007		2006	
	Before Tax	After Tax	Before Tax	After Tax
Income before cumulative effect of changes in accounting principles	\$ 3,606,872	\$ 2,684,923	\$ 5,801,285	\$ 5,082,801
Cumulative effect of changes in accounting principles	-	-	(180)	(180)
Net income	<u>\$ 3,606,872</u>	<u>\$ 2,684,923</u>	<u>\$ 5,801,105</u>	<u>\$ 5,082,621</u>

c. Denominator - shares (thousands)

	Years Ended December 31	
	2007	2006
Weighted average of outstanding common shares	<u>1,284,571</u>	<u>1,284,571</u>

21. RELATED-PARTY TRANSACTIONS

a. Related parties

Related Party	Relationship with the Company
China Steel Corporation (CSC)	Major stockholder (39%)
China Steel Global Trading Corporation (CSGC)	CSC's subsidiary
Infor-Champ Systems Corporation (ICSC)	CSC's subsidiary
China Ecotdk Corporation (CEC)	CSC's subsidiary
China Steel Machinery Corporation (CSMS)	CSC's subsidiary
China Steel Structure Corporation	CSC's subsidiary
China Hi-ment Corporation	CSC's subsidiary
Universal Exchange Inc.	CSC's subsidiary
Union Steel Development Corporation	CSC's subsidiary
Hi-mag Magnetic Corporation	CSC's subsidiary
Long-Yuan-Fa Investment Corporation	CSC's subsidiary
Hornng-Yih Investment Corporation	CSC's subsidiary
China Steel Management Consulting Corporation	CSC's subsidiary
Dragon Steel Corporation (DSC)	CSC's subsidiary
Steel Castle Technology Corporation (SCT)	CSC's subsidiary
China Steel Security Corporation (CSS)	CSC's subsidiary
Ornasteel Enterprise Corp. (M) SDN BHD (OEC)	CSC's subsidiary
Group Steel Corp. (M) SDN BHD (GSC)	CSC's subsidiary
Taiwan Steel Co., Ltd.	Subsidiary with no significant transaction
Hong Kao Investment Corporation	Subsidiary with no significant transaction

b. Significant related-party transactions were as follows:

	Years Ended December 31			
	2007		2006	
	Amount	% to Total	Amount	% to Total
<u>For the year</u>				
1) Sale of steel products				
OEC	\$ 646,386	2	\$ 968,495	2
GSC	85,834	-	483,694	1
Others	<u>3,612</u>	<u>-</u>	<u>534</u>	<u>-</u>
	<u>\$ 735,832</u>	<u>2</u>	<u>\$ 1,452,723</u>	<u>3</u>

The selling prices of steel products were similar to those for third parties. However, OEC and GSC had to pay by telegraphic transfers (T/T) from 7 to 30 days of the product shipment, and this payment arrangement was dissimilar to those for third parties, from whom payments were collected in advance.

2) Service revenue

CSC	<u>\$ 246,839</u>	<u>94</u>	<u>\$ -</u>	<u>-</u>
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In June 2007, the Company entered into an agreement with CSC for the Company to do certain processing work on CSC's steel products. The calculation of processing charges to CSC was based on the formula stated in the agreement. The Company bills CSC within two months after approval of delivery.

	Years Ended December 31			
	2007		2006	
	Amount	% to Total	Amount	% to Total
3) Purchase of materials				
CSC	\$ 1,393,883	4	\$ 4,581,112	17
Others	<u>175,657</u>	<u>-</u>	<u>141,718</u>	<u>-</u>
	<u>\$ 1,569,540</u>	<u>4</u>	<u>\$ 4,722,830</u>	<u>17</u>

Payment terms for purchases of materials were similar to normal purchases from third parties.

4) Authorization fees

In May 2003, CSC, Sumitomo Metal Industries, Ltd. (SMI) and Sumitomo Corporation (SC) entered into a joint venture agreement and established a holding company named East Asia United Steel Corporation (EAUS) in July 2003. CSC will have a stable supply of good quality slab through this joint venture. CSC then signed a contract with the Company, transferring to the Company the right to buy slab from EAUS. The Company should pay authorization fees of US\$6.00 per ton to CSC. These fees (included in the purchase of materials) were \$311,745 thousand in 2007 and \$331,329 thousand in 2006. As of December 31, 2007 and 2006, authorization fees payable (included in payables to related parties) were \$92,116 thousand and \$97,808 thousand, respectively. The calculation of slab purchase prices was based on the formula stated in the agreement.

5) Lending and returning of steel slabs

To maintain steel slabs for production, the Company entered into a contract with CSC, under which the Company can borrow slabs from CSC when the Company needs more production materials and then return the slabs to CSC when the Company has a surplus of materials. The borrowing and returning of steel slabs in 2007 and 2006 are summarized as follows:

	Years Ended December 31			
	2007		2006	
	Tons	Amount	Tons	Amount
Balance, beginning of year	-	\$ -	40,558	\$ 562,752
Lending for the year	161,310	2,281,599	14,538	185,444
Returns for the year	(161,758)	(2,311,521)	(55,096)	(748,196)
Allowance for inventory loss	(828)	2,626	-	-
Balance, end of year	<u>(1,276)</u>	<u>\$ (27,296)</u>	<u>-</u>	<u>\$ -</u>

As of December 31, 2007, the amount of the slabs to be lent by CSC was included in other current liabilities.

6) Construction- in-progress and other expenditures

Other expenditures paid to related parties, which pertained to construction or maintenance, were as follows:

	Years Ended December 31			
	2007		2006	
	Other Expenditures	Construction- in-progress	Other Expenditures	Construction- in-progress
CEC	\$ -	\$ 160,247	\$ 29,400	\$ 59,270
ICSC	-	31,370	-	4,190
SCT	10	14,885	9	-
CSMS	-	12,100	-	39,230
CSGC	9,168	-	6,337	-
CSS	8,625	-	7,872	-
CSC	6,644	-	6,544	10,386
Others	1,402	819	2,929	-
	<u>\$ 25,849</u>	<u>\$ 219,421</u>	<u>\$ 53,091</u>	<u>\$ 113,076</u>

The payments for the above were paid by T/T within one month of the transactions.

	December 31			
	2007		2006	
	Amount	% to Total	Amount	% to Total
<u>At end of year</u>				
1) Accounts receivable				
CSC	\$ 149,166	15	\$ -	-
OEC	-	-	35,550	5
GSC	-	-	7,035	1
Others	15	-	640	-
	<u>\$ 149,181</u>	<u>15</u>	<u>\$ 43,225</u>	<u>6</u>

(Continued)

	December 31			
	2007		2006	
	Amount	% to Total	Amount	% to Total
2) Accounts payable				
CSC	\$ 101,100	5	\$ 256,580	11
CSMC	6,995	-	14,127	1
CEC	-	-	18,643	1
Others	<u>8,640</u>	<u>-</u>	<u>17,208</u>	<u>1</u>
	<u>\$ 116,735</u>	<u>5</u>	<u>\$ 306,558</u>	<u>14</u>

22. PLEDGED ASSETS

Assets pledged or mortgaged as collaterals for debts and performance guarantees were as follows:

	December 31	
	2007	2006
Properties, net	\$ 10,411,098	\$ 11,328,419
Pledged time deposits	<u>300,000</u>	<u>300,000</u>
	<u>\$ 10,711,098</u>	<u>\$ 11,628,419</u>

23. COMMITMENTS AND CONTINGENCY AS OF DECEMBER 31, 2007

- a. Unused letters of credit for purchases of raw materials and machinery and equipment amounted to about NT\$9 billion. Guarantee notes issued for debts and purchases of raw materials amounted to about NT\$48.4 billion.
- b. The Company had signed agreements to buy equipment and obtain construction services for NT\$1,518,322 thousand, of which NT\$838,508 thousand had been paid (included in construction-in-progress and prepayments for equipment).
- c. The Company had signed contracts with foreign suppliers to buy slabs to ensure sufficiency of production materials. Unpaid purchase amounts for 482,800 tons of slabs as of December 31, 2007 were NT\$8.1 billion (included in the unused letters of credit for purchases of raw materials).

24. FINANCIAL INSTRUMENTS

- a. As of December 31, 2007 and 2006, the fair values of financial instruments were as follows:

	December 31			
	2007		2006	
	Carrying Value	Fair Value	Carrying Value	Fair Value
<u>Nonderivative financial instruments</u>				
Assets				
Available-for-sale financial assets	\$ 1,916,511	\$ 1,916,511	\$ 1,479,998	\$ 1,479,998
Financial assets carried at cost	291,850	-	291,850	-
Other financial assets – noncurrent (excluding NPL)	3,627	3,627	5,760	5,760
Nonperforming loans	2,219,000	-	-	-
Liabilities				
Long-term debts	6,572,857	6,572,816	6,420,000	6,420,346
<u>Derivative financial instruments</u>				
Forward contracts				
Financial assets at fair value through profit and loss – current	17,004	17,004	-	-
Financial liabilities at fair value through profit and loss – noncurrent	377	377	-	-

- b. The assumptions and methods used to estimate the fair values of financial instruments are as follows:

- 1) The carrying values of cash, notes and accounts receivable, accounts receivable from related parties, pledged time deposits, short-term loans, commercial paper payable, accounts payable, accounts payable to related parties, accrued expenses, other payables, payable on purchase contract loss and sales allowances payable, approximate fair value because of the short maturities of these instruments.

- 2) The fair values of available-for-sale financial assets are determined at their market value.

If derivative financial instruments have no market values, the fair values are determined by using valuation methods incorporating assumptions consistent with those used in the market. The fair values of forward contracts are calculated at exchange rates quoted by financial institutions on the maturity dates.

- 3) Other financial assets – noncurrent include refundable deposits and long-term receivables. The fair values of refundable deposits are determined at their carrying values, and those of long-term receivables at the present values of future cash flows.
- 4) Financial assets carried at cost held by non-public corporations and Nonperforming loans of other financial assets-noncurrent were unquoted market prices in an active market and their fair value determination entailed an unreasonably high cost.
- 5) The fair values of long-term liabilities are determined at the present values of future cash flows discounted at the interest rates of similar long-term debts available for the Company.

- c. Valuation gains arising from changes in fair value of financial instruments with fair values determined using valuation techniques were NT\$16,822 thousand for 2007 and NT\$8,444 thousand for 2006.

- d. As of December 31, 2007 and 2006, financial liabilities exposed to fair value interest rate risk amounted to NT\$30,000 thousand and NT\$120,000 thousand, respectively; financial assets exposed to cash flow interest rate risk amounted to NT\$334,006 thousand and NT\$591,354 thousand, respectively; and financial liabilities exposed to cash flow interest rate risk amounted to NT\$11,433,495 thousand and NT\$11,113,062 thousand, respectively.
- e. As of December 31, 2007 and 2006, the interest income (expense) associated with financial assets (liabilities) other than those at fair value through profit or loss was as follows:

	Years Ended December 31	
	2007	2006
Total interest income	\$ 18,586	\$ 14,121
Total interest expense (excluding capitalized interest)	250,458	392,083

g. Financial risk information

1) Market risk

This includes fair value risk on interest and exchange rate changes and on market prices. The Company's financial instruments had no significant fair value risk on interest and exchange rate changes. However, its investment in the shares of China Steel Corporation (CSC) involves market risk, i.e., if CSC's share price increases or decreases by NT\$1.00, fair value will increase or decrease by NT\$44,058 thousand.

2) Credit risk

Credit risk represents the potential loss that would be incurred by the Company if the counter-parties or third-parties breach the contracts. Factors affecting credit risk are credit risk concentration, instrument components, contract amounts and other receivables.

As of December 31, 2007, the Company's credit risks amounted to NT\$776,805 thousand (including notes and accounts receivable, receivables from related parties, other receivables and refundable deposits, notes and accounts receivable after deducted with factored accounts receivable and L/C transaction of NT\$500,657 thousand), and the maximum credit risk on the instruments and the carrying value of these instruments are the same. The credit risks on the Company's cash and bank deposits (including pledged time deposits) were considered insignificant. In addition, for the nonperforming loans, since there are sufficient properties to cover the risks involved, the Company does not expect the exposure due to default to be material.

3) Liquidity risk

The Company has sufficient operating capital to meet future cash needs. Thus, the cash flow risk is low.

In addition, available-for-sale financial assets can be readily sold at prices approximating fair values.

There are liquidity risks, however, for financial assets carried at cost because they have no market values.

4) Cash flow risk on interest rate changes

Market interest rate changes will influence the effective interest rate for financial instruments with cash flow risk on interest rate changes and will affect future cash flows. Thus, as the market interest rate increases by 1%, the Company's cash outflow will increase by about NT\$110,995 thousand.

25. SEGMENT INFORMATION

The Company belongs to the steel manufacturing industry. Under Statement of Financial Accounting Standards No. 20 – “Disclosure of Segment Financial Information,” the Company's export sales and significant customers are disclosed as follows:

a. Export sales

Area	Years Ended December 31			
	2007		2006	
	Amount	% to Total	Amount	% to Total
Asia	\$ 11,630,040	24	\$ 10,600,897	23
North America	886,390	2	1,261,995	3
Others	483,831	1	666,471	2
	<u>\$ 13,000,261</u>	<u>27</u>	<u>\$ 12,529,363</u>	<u>28</u>

b. Major customers

	Years Ended December 31			
	2007		2006	
	Amount	% to Sale	Amount	% to Sale
Company A	\$ 5,278,321	11	\$ 4,514,556	10
Company B	5,212,050	11	4,266,214	9
Company C	4,382,670	9	4,955,229	11
	<u>\$ 14,873,041</u>	<u>31</u>	<u>\$ 13,735,999</u>	<u>30</u>