

China Steel Corporation

**Financial Statements for the
Years Ended December 31, 2005 and 2004 and
Independent Auditors' Report**

INDEPENDENT AUDITORS' REPORT

The Board of Directors and Stockholders
China Steel Corporation

We have audited the accompanying balance sheets of China Steel Corporation (the "Corporation") as of December 31, 2005 and 2004 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 Corporation'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 (ROC). 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 the Corporation as of December 31, 2005 and 2004 and the results of its operations and its cash flows for the years then ended, in conformity with generally accepted accounting principles in the ROC.

January 27, 2006

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.

CHINA STEEL CORPORATION

BALANCE SHEETS

DECEMBER 31, 2005 AND 2004

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

ASSETS	2005		2004	
	Amount	%	Amount	%
CURRENT ASSETS				
Cash and cash equivalents (Notes 2 and 3)	\$ 13,239,481	5	\$ 26,402,765	11
Short-term investments (Notes 2 and 4)	16,693,866	7	23,855,035	10
Notes receivable (Note 5)	1,641,032	1	1,711,335	1
Accounts receivable, net of allowance for doubtful accounts of \$134 thousand as of December 31, 2004 (Notes 2, 5 and 20)	2,034,629	1	2,062,163	1
Other receivables	546,006	-	226,180	-
Inventories (Notes 2 and 6)	35,792,031	14	25,874,988	11
Deferred income tax assets (Note 17)	143,975	-	112,495	-
Pledged time deposits (Note 21)	4,600,000	2	4,700,000	2
Other	<u>1,160,737</u>	<u>-</u>	<u>148,485</u>	<u>-</u>
Total current assets	<u>75,851,757</u>	<u>30</u>	<u>85,093,446</u>	<u>36</u>
LONG-TERM INVESTMENTS (Notes 2 and 7)				
Long-term stock investments				
Equity method	52,825,719	21	40,642,218	17
Cost method	<u>12,876,831</u>	<u>5</u>	<u>9,717,543</u>	<u>4</u>
Total long-term stock investments	65,702,550	26	50,359,761	21
Prepaid long-term stock investments	-	-	90,000	-
Other	<u>179,263</u>	<u>-</u>	<u>182,211</u>	<u>-</u>
Total long-term investments	<u>65,881,813</u>	<u>26</u>	<u>50,631,972</u>	<u>21</u>
PROPERTIES (Notes 2, 8 and 21)				
Land	7,994,055	3	7,146,632	3
Land improvements	4,216,794	2	4,231,666	2
Buildings and improvements	36,016,863	14	35,994,405	15
Machinery and equipment	212,821,181	85	211,725,159	89
Transportation equipment	1,452,514	1	1,537,749	1
Miscellaneous equipment	<u>3,013,382</u>	<u>1</u>	<u>2,978,585</u>	<u>1</u>
Total cost	265,514,789	106	263,614,196	111
Appreciation	<u>17,668,482</u>	<u>7</u>	<u>17,795,827</u>	<u>7</u>
Total cost and appreciation	283,183,271	113	281,410,023	118
Less: Accumulated depreciation	<u>197,384,284</u>	<u>79</u>	<u>190,984,509</u>	<u>80</u>
	85,798,987	34	90,425,514	38
Constructions in progress	<u>19,768,057</u>	<u>8</u>	<u>8,909,449</u>	<u>4</u>
Net properties	<u>105,567,044</u>	<u>42</u>	<u>99,334,963</u>	<u>42</u>
OTHER ASSETS				
Rental assets - net (Notes 2 and 9)	3,066,346	2	3,095,044	1
Refundable deposits	346,830	-	73,793	-
Restricted assets - pledged time deposits (Note 21)	31,694	-	31,694	-
Unamortized repair costs and others (Note 2)	<u>16,856</u>	<u>-</u>	<u>148,082</u>	<u>-</u>
Total other assets	<u>3,461,726</u>	<u>2</u>	<u>3,348,613</u>	<u>1</u>
TOTAL	<u>\$ 250,762,340</u>	<u>100</u>	<u>\$ 238,408,994</u>	<u>100</u>

LIABILITIES AND STOCKHOLDERS' EQUITY	2005		2004	
	Amount	%	Amount	%
CURRENT LIABILITIES				
Short-term loans and overdraft (Notes 10 and 21)	\$ 11,473,383	4	\$ 4,465,959	2
Commercial paper payable (Note 11)	1,499,376	1	1,799,052	1
Notes and accounts payable (Note 20)	2,336,407	1	3,086,340	1
Income tax payable (Notes 2 and 17)	7,578,477	3	9,405,065	4
Accrued expenses (Note 14)	7,159,512	3	7,015,299	3
Bonds payable - current portion (Note 12)	10,000,000	4	5,000,000	2
Long-term bank loans - current portion (Notes 13 and 21)	727,220	-	-	-
Other payables	2,890,008	1	1,044,843	-
Other	<u>1,444,863</u>	<u>1</u>	<u>1,857,388</u>	<u>1</u>
Total current liabilities	<u>45,109,246</u>	<u>18</u>	<u>33,673,946</u>	<u>14</u>
LONG-TERM LIABILITIES				
Bonds payable, net of current portion (Note 12)	-	-	10,000,000	4
Bank loans, net of current portion (Notes 13 and 21)	<u>2,769,030</u>	<u>1</u>	<u>2,861,200</u>	<u>1</u>
Total long-term liabilities	<u>2,769,030</u>	<u>1</u>	<u>12,861,200</u>	<u>5</u>
RESERVE FOR LAND VALUE INCREMENT TAX (Note 8)	<u>2,171,124</u>	<u>1</u>	<u>3,370,813</u>	<u>2</u>
OTHER LIABILITIES				
Deferred income tax liabilities (Note 17)	2,944,097	1	2,930,165	1
Deferred credits - gain on intercompany transactions (Note 15)	<u>1,142,352</u>	<u>1</u>	<u>1,411,756</u>	<u>1</u>
Total other liabilities	<u>4,086,449</u>	<u>2</u>	<u>4,341,921</u>	<u>2</u>
Total liabilities	<u>54,135,849</u>	<u>22</u>	<u>54,247,880</u>	<u>23</u>
STOCKHOLDERS' EQUITY (Note 2 and 16)				
Capital stock - authorized 10,600,000 thousand shares at NT\$10 par value				
Common shares - issued 10,545,974 thousand shares and 9,888,937 thousand shares as of December 31, 2005 and 2004, respectively	105,459,736	42	98,889,368	42
Preferred shares - issued 40,698 thousand shares and 42,177 thousand shares as of December 31, 2005 and 2004, respectively	<u>406,980</u>	<u>-</u>	<u>421,770</u>	<u>-</u>
Total capital stock	<u>105,866,716</u>	<u>42</u>	<u>99,311,138</u>	<u>42</u>
Capital surplus	<u>2,744,741</u>	<u>1</u>	<u>1,172,320</u>	<u>-</u>
Retained earnings	<u>90,107,602</u>	<u>36</u>	<u>85,642,418</u>	<u>36</u>
Other equity items				
Unrealized loss on investees' long-term investments	(446,483)	-	(454,039)	-
Cumulative translation adjustments	(335,992)	-	(365,599)	-
Investees' unrecognized net loss on pension cost	<u>(36,872)</u>	<u>-</u>	<u>(32,003)</u>	<u>-</u>
Total other equity items	<u>(819,347)</u>	<u>-</u>	<u>(851,641)</u>	<u>-</u>
Treasury stock – 79,199 thousand shares and 84,463 thousand shares as of December 31, 2005 and 2004, respectively	<u>(1,273,221)</u>	<u>(1)</u>	<u>(1,113,121)</u>	<u>(1)</u>
Total stockholders' equity	<u>196,626,491</u>	<u>78</u>	<u>184,161,114</u>	<u>77</u>
TOTAL	<u>\$ 250,762,340</u>	<u>100</u>	<u>\$ 238,408,994</u>	<u>100</u>

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

CHINA STEEL CORPORATION

STATEMENTS OF INCOME FOR THE YEARS ENDED DECEMBER 31, 2005 AND 2004 (In Thousands of New Taiwan Dollars, Except Earnings Per Share)

	<u>2005</u>		<u>2004</u>	
	<u>Amount</u>	<u>%</u>	<u>Amount</u>	<u>%</u>
REVENUES (Notes 2 and 20)	\$ 186,317,669	100	\$ 168,270,036	100
COST OF REVENUES (Notes 18 and 20)	<u>118,991,792</u>	<u>64</u>	<u>104,311,061</u>	<u>62</u>
GROSS PROFIT	67,325,877	36	63,958,975	38
UNREALIZED GAIN ON INTERCOMPANY TRANSACTIONS	<u>376,905</u>	<u>-</u>	<u>3,890</u>	<u>-</u>
REALIZED GROSS PROFIT	<u>66,948,972</u>	<u>36</u>	<u>63,955,085</u>	<u>38</u>
OPERATING EXPENSES (Notes 18 and 20)				
Selling	2,248,551	1	2,239,585	1
General and administrative	2,682,343	1	2,634,895	2
Research and development	<u>1,114,714</u>	<u>1</u>	<u>1,063,858</u>	<u>1</u>
Total operating expenses	<u>6,045,608</u>	<u>3</u>	<u>5,938,338</u>	<u>4</u>
OPERATING INCOME	<u>60,903,364</u>	<u>33</u>	<u>58,016,747</u>	<u>34</u>
NONOPERATING INCOME AND GAINS				
Interest	540,381	-	237,266	-
Investment income under the equity method (Note 7)	4,442,401	3	7,635,403	5
Gain on disposal of investments	412,908	-	786,868	-
Other	<u>1,573,995</u>	<u>1</u>	<u>869,494</u>	<u>1</u>
Total nonoperating income	<u>6,969,685</u>	<u>4</u>	<u>9,529,031</u>	<u>6</u>
NONOPERATING EXPENSES AND LOSSES				
Interest (Note 20)	734,335	-	952,447	1
Impairment loss on long-term investment (Note 7)	906,000	1	54,000	-
Impairment loss on rental assets (Note 9)	-	-	594,000	-
Other	<u>1,120,285</u>	<u>1</u>	<u>923,317</u>	<u>-</u>
Total nonoperating expenses	<u>2,760,620</u>	<u>2</u>	<u>2,523,764</u>	<u>1</u>
INCOME BEFORE INCOME TAX	65,112,429	35	65,022,014	39
INCOME TAX (Notes 2 and 17)	<u>14,465,790</u>	<u>8</u>	<u>13,405,323</u>	<u>8</u>
NET INCOME	<u>\$ 50,646,639</u>	<u>27</u>	<u>\$ 51,616,691</u>	<u>31</u>

(Continued)

	<u>2005</u>		<u>2004</u>	
	Before Tax	After Tax	Before Tax	After Tax
EARNINGS PER SHARE (Note 19)				
Basic	\$ 6.21	\$ 4.83	\$ 6.21	\$ 4.93
Diluted	\$ 6.20	\$ 4.82	\$ 6.19	\$ 4.92

PRO FORMA INFORMATION - if the Corporation's shares held by subsidiaries had been accounted for as investments rather than treasury stock

Net Income	<u>\$ 50,966,883</u>		<u>\$ 51,975,464</u>	
	<u>2005</u>		<u>2004</u>	
	Before Tax	After Tax	Before Tax	After Tax
Basic earnings per share based on weighted-average number of outstanding common shares of 10,545,949 thousand and 10,544,474 thousand as of December 31, 2005 and 2004, respectively	\$ 6.20	\$ 4.83	\$ 6.19	\$ 4.92
Diluted earnings per share based on weighted-average number of outstanding common shares of 10,586,647 thousand and 10,586,651 thousand as of December 31, 2005 and 2004, respectively	\$ 6.18	\$ 4.81	\$ 6.18	\$ 4.91

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

(Concluded)

CHINA STEEL CORPORATION

STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY FOR THE YEARS ENDED DECEMBER 31, 2005 AND 2004 (In Thousands of New Taiwan Dollars, Except Cash Dividends Per Share)

	Capital Stock		Capital Surplus	Retained Earnings (Note 16)				Unrealized Loss	Cumulative	Investees'	Treasury	Total
	Common Stock	Preferred Stock	(Notes 8 and 16)	Legal Reserve	Special Reserve	Unappropriated	Total	on Investees' Long-term Investments (Note 2)	Translation Adjustments (Note 2)	Unrecognized Net Loss on Pension Cost	Stock (Note 16)	Stockholders' Equity
BALANCES, JANUARY 1, 2004	\$ 94,523,237	\$ 477,620	\$ 693,047	\$ 21,767,286	\$ 8,002,165	\$ 37,165,249	\$ 66,934,700	\$ (485,104)	\$ 91,700	\$ (21,711)	\$ (1,176,705)	\$ 161,036,784
Conversion of preferred shares to common shares	55,850	(55,850)	-	-	-	-	-	-	-	-	-	-
Appropriation of 2003 earnings (Note 16)												
Legal reserve	-	-	-	3,685,308	-	(3,685,308)	-	-	-	-	-	-
Special reserve	-	-	-	-	28,651	(28,651)	-	-	-	-	-	-
Capitalization of bonus to employees	985,263	-	-	-	-	(985,263)	(985,263)	-	-	-	-	-
Remuneration to directors and supervisors	-	-	-	-	-	(98,526)	(98,526)	-	-	-	-	(98,526)
Cash dividends to preferred shareholders - \$3.00 per share	-	-	-	-	-	(143,286)	(143,286)	-	-	-	-	(143,286)
Cash dividends to common shareholders - \$3.00 per share	-	-	-	-	-	(28,356,863)	(28,356,863)	-	-	-	-	(28,356,863)
Stock dividends to preferred shareholders - 3.5%	16,717	-	-	-	-	(16,717)	(16,717)	-	-	-	-	-
Stock dividends to common shareholders - 3.5%	3,308,301	-	-	-	-	(3,308,301)	(3,308,301)	-	-	-	-	-
Net income in 2004	-	-	-	-	-	51,616,691	51,616,691	-	-	-	-	51,616,691
Adjustment of equity in investees due to change in percentage of ownership	-	-	120,582	-	-	(17)	(17)	-	-	-	(90)	120,475
Reversal unrealized loss on investees' long-term investments	-	-	-	-	-	-	-	764	-	-	-	764
Cumulative translation adjustments on long-term investments (Note 7)	-	-	-	-	-	-	-	-	(457,299)	-	-	(457,299)
Investees' unrecognized net loss on pension cost	-	-	-	-	-	-	-	-	-	(10,292)	-	(10,292)
Transfer of treasury stock to employees	-	-	(82)	-	-	-	-	-	-	-	516	434
Disposal of the Corporation's shares held by subsidiaries	-	-	100,452	-	-	-	-	30,301	-	-	63,158	193,911
Cash dividends declared by the Corporation and received by subsidiaries	-	-	258,321	-	-	-	-	-	-	-	-	258,321
BALANCES, DECEMBER 31, 2004	98,889,368	421,770	1,172,320	25,452,594	8,030,816	52,159,008	85,642,418	(454,039)	(365,599)	(32,003)	(1,113,121)	184,161,114
Conversion of preferred stock to common shares	14,790	(14,790)	-	-	-	-	-	-	-	-	-	-
Adjustment for reserve for land value tax increment	-	-	1,196,189	-	-	-	-	-	-	-	-	1,196,189
Appropriation of 2004 earnings (Note 16)												
Legal reserve	-	-	-	5,161,667	-	(5,161,667)	-	-	-	-	-	-
Special reserve	-	-	-	-	436,524	(436,524)	-	-	-	-	-	-
Bonus to employees	1,590,021	-	-	-	-	(2,304,056)	(2,304,056)	-	-	-	-	(714,035)
Remuneration to directors and supervisors	-	-	-	-	-	(138,243)	(138,243)	-	-	-	-	(138,243)
Cash dividends to preferred shareholders - \$3.90 per share	-	-	-	-	-	(158,785)	(158,785)	-	-	-	-	(158,785)
Cash dividends to common shareholders - \$3.90 per share	-	-	-	-	-	(38,572,559)	(38,572,559)	-	-	-	-	(38,572,559)
Stock dividends to preferred shareholders - 5%	20,357	-	-	-	-	(20,357)	(20,357)	-	-	-	-	-
Stock dividends to common shareholders - 5%	4,945,200	-	-	-	-	(4,945,200)	(4,945,200)	-	-	-	-	-
Net income in 2005	-	-	-	-	-	50,646,639	50,646,639	-	-	-	-	50,646,639
Adjustment of equity in investees due to change in percentage of ownership	-	-	55,853	-	-	(42,255)	(42,255)	-	-	-	(213,620)	(200,022)
Reversal of unrealized loss on investees' long-term investments	-	-	-	-	-	-	-	7,556	-	-	-	7,556
Cumulative translation adjustments on long-term investments (Note 7)	-	-	-	-	-	-	-	-	29,607	-	-	29,607
Investees' unrecognized net loss on pension cost	-	-	-	-	-	-	-	-	-	(4,869)	-	(4,869)
Disposal of the Corporation's shares held by subsidiaries	-	-	34,425	-	-	-	-	-	-	-	60,955	95,380
Cash dividends declared by the Corporation and received by subsidiaries	-	-	285,954	-	-	-	-	-	-	-	-	285,954
Reacquired the corporation's issued shares	-	-	-	-	-	-	-	-	-	-	(7,435)	(7,435)
BALANCES, DECEMBER 31, 2005	<u>\$ 105,459,736</u>	<u>\$ 406,980</u>	<u>\$ 2,744,741</u>	<u>\$ 30,614,261</u>	<u>\$ 8,467,340</u>	<u>\$ 51,026,001</u>	<u>\$ 90,107,602</u>	<u>\$ (446,483)</u>	<u>\$ (335,992)</u>	<u>\$ (36,872)</u>	<u>\$ (1,273,221)</u>	<u>\$ 196,626,491</u>

Additional explanations for stockholders' equity accounts is appended.

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

CHINA STEEL CORPORATION

STATEMENTS OF CASH FLOWS FOR THE YEARS ENDED DECEMBER 31, 2005 AND 2004 (In Thousands of New Taiwan Dollars)

	2005	2004
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	\$ 50,646,639	\$ 51,616,691
Adjustments		
Depreciation	9,418,781	10,046,890
Amortization	87,520	329,218
Deferred income tax	(17,548)	(376,754)
Impairment loss on rental assets	-	594,000
Cash dividends from long-term investments under the equity method	5,282,274	3,354,496
Investment income under the equity method	(4,442,401)	(7,635,403)
Construction dividends from long-term investments under the cost method	131,884	15,616
Impairment loss on long-term investments under the cost method	906,000	54,000
Loss on disposal of properties	67,348	358,152
Reversal of allowance for loss on inventories	(164,689)	-
Gain on disposal of short-term investments	(412,496)	(575,170)
Gain on disposal of long-term investments	(412)	(211,698)
Unrealized gain on intercompany transaction	376,905	3,890
Effect of exchange rate changes on foreign-currency long-term bank loans	(287,960)	(48,300)
Others	94,034	(1,800)
Net cash provided by adjusted net income	61,685,879	57,523,828
Net changes in operating assets and liabilities		
Notes receivable	70,303	(1,223,409)
Accounts receivable	27,534	(1,011,421)
Inventories	(9,715,611)	(6,637,226)
Other receivable	(319,826)	(75,539)
Other current assets	(1,012,252)	293,800
Notes and accounts payable	(749,933)	793,906
Income tax payable	(1,826,588)	2,865,332
Accrued expenses	144,213	1,125,475
Other payables	1,806,051	511,411
Other current liabilities	(815,799)	77,274
Net cash provided by operating activities	49,293,971	54,243,431
CASH FLOWS FROM INVESTING ACTIVITIES		
Decrease in short-term investments	7,573,665	15,549,227
Increase in long-term investments	(17,061,785)	(2,951,894)
Proceeds from disposal of long-term investments	54,170	1,403,797
Acquisition of properties	(16,028,779)	(7,927,503)
Proceeds from sale of properties	96,234	-
Decrease in pledged time deposits	100,000	200,000
Decrease (increase) in other assets	(269,574)	12,532
Net cash provided by (used in) investing activities	(25,536,069)	6,286,159

(Continued)

	2005	2004
CASH FLOWS FROM FINANCING ACTIVITIES		
Increase (decrease) in short-term bank loans and overdraft	\$ 7,007,423	\$ (143,511)
Increase (decrease) in commercial paper payable	(299,676)	99,838
Repayments of bonds payable	(5,000,000)	(10,000,000)
Increase in long-term loans	923,010	684,200
Purchase of treasury stocks	(7,435)	-
Cash dividends	(38,692,230)	(28,481,980)
Remuneration to directors and supervisors and bonus to employees	(852,278)	(98,526)
Repayments of long-term bank loans	-	(50,000)
Proceeds from transfer of treasury stock to employees	<u>-</u>	<u>434</u>
Net cash used in financing activities	<u>(36,921,186)</u>	<u>(37,989,545)</u>
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(13,163,284)	22,540,045
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	<u>26,402,765</u>	<u>3,862,720</u>
CASH AND CASH EQUIVALENTS, END OF YEAR	<u>\$ 13,239,481</u>	<u>\$ 26,402,765</u>
SUPPLEMENTAL INFORMATION		
Interest paid	\$ 742,881	\$ 1,283,307
Income tax paid	16,309,926	10,916,745
PURCHASE OF PROPERTIES		
Acquisition of properties	\$ 16,054,622	\$ 7,617,154
Decrease (increase) in payable on properties purchased	<u>(25,843)</u>	<u>310,349</u>
	<u>\$ 16,028,779</u>	<u>\$ 7,927,503</u>
PAYMENTS OF CASH DIVIDENDS		
Total cash dividends payable to stockholders	\$ 38,731,344	\$ 28,500,149
Increase in dividends payable	<u>(39,114)</u>	<u>(18,169)</u>
	<u>\$ 38,692,230</u>	<u>\$ 28,481,980</u>
NONCASH FINANCING ACTIVITIES		
Current portion of long-term liabilities	<u>\$ 10,727,220</u>	<u>\$ 5,000,000</u>

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

(Concluded)

CHINA STEEL CORPORATION

NOTES TO FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2005 AND 2004 (In Thousands of New Taiwan Dollars, Except Amounts Stated Otherwise, Earnings and Dividends Per Share)

1. ORGANIZATION AND OPERATIONS

China Steel Corporation (the “Corporation”) was incorporated on December 3, 1971. It manufactures and sells steel products and engages in machinery and communications engineering and construction.

The Corporation’s stock is listed on the Taiwan Stock Exchange. As of December 31, 2005, the Ministry of Finance (formerly the Ministry of Economic Affairs), Republic of China owned 23.0% of the Corporation’s outstanding common stock.

As of December 31, 2005 and 2004, the Corporation had about 8,600 employees.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying financial statements have been prepared in conformity with the accounting principles generally accepted in the Republic of China (ROC). Under these principles, the Corporation is required to make certain estimates and assumptions on recorded assets, liabilities, revenues and expenses, including those related to doubtful accounts, inventory loss, depreciation of properties, impairment loss on assets, pension and loss on lawsuits. 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 additional disclosures that are not required under generally accepted accounting principles but are required by the Securities and Futures Bureau (SFB, formerly the Securities and Futures Commission before July 1, 2004) for their oversight purposes.

The Corporation’s significant accounting policies are summarized as follows:

Current and Noncurrent Assets and Liabilities

Current assets include cash and cash equivalents and other assets to be realized in cash or to be consumed within one year from the balance sheet date. Liabilities to be settled within one year are classified as current. All other assets and liabilities are classified as noncurrent.

Cash Equivalents

Cash equivalents are short-term notes and bills with maturities of three months or less. The carrying value of cash equivalents approximates fair value.

Short-term Investments

Short-term investments are bond funds, bank debentures, commercial paper with repurchase agreements, negotiable certificates of time deposit with maturities of three months or more, and stocks listed on the Taiwan Stock Exchange, which are not intended for long-term holding. These investments are stated at the lower of total cost or market value. If market value falls below carrying value, the decline is charged to loss, and an allowance for investment loss is provided. If market price recovers, the allowance will be reversed to the extent of the recovery up to cost. Cost is determined by the first-in, first-out method for bond funds; moving-average method for listed stocks; and individual identification method for commercial paper with repurchase agreements, bank debentures and negotiable certificates of time deposit. Market value is the net asset value of bond funds on the balance sheet date, the average closing price of listed stocks in the last month of the reporting period, the quotation price by financial institution of bank debentures and the book value for negotiable certificates of time deposit and commercial paper with repurchase agreements.

Stock dividends received from investees are not recorded as investment income but as an increase in shares. The carrying value per share is recalculated on the basis of totally owned shares after the stock dividends received. Cash dividends received within the year of investment acquisition are accounted for as a reduction of the carrying value of the investment but those received next year are accounted for as dividend income.

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 Corporation.
- 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.

The difference between the proceeds and the face value of the accounts receivable is recognized as a loss and recorded as nonoperating expenses.

Allowance for Doubtful Accounts

Allowance for doubtful accounts is provided on the basis of aging accounts and the collectibility of receivables.

Inventories

Inventories are raw materials, supplies, fuel, finished products, work in process, by-products and construction in progress. Inventories, except for construction in progress, are stated at the lower of total moving average cost or market value. Market value is the net realizable value for finished products, work in process, by-products and construction in progress, and replacement costs for raw materials, supplies and fuel. Contract project is accounted for in accordance with accounting practice for Long-Term Construction Contracts.

Long-term Investments

Long-term stock investments in which the Corporation owns 20% or more of the outstanding voting shares or where the Corporation has significant influence on the investees are accounted for by the equity method. When the equity method is first applied or when a stock is acquired, the difference between the carrying value of an investment and the proportionate equity in the investee is amortized over five years. The long-term investments under the equity method were previously based on the investees' financial statements

with closing date three months earlier than the Corporation. Starting 2005, the investment income or loss is recognized on the basis of the investees' financial statements for the same accounting period as that of the Corporation. If an investee issues additional shares and the Corporation acquires shares at a percentage different from its current equity in the investee, capital surplus is adjusted for the difference between the carrying values of the investments and the Corporation's equity in the investees' net assets. If the carrying value is less than equity in net assets, the difference is added to capital surplus. If the carrying value is more than equity in net assets, the difference is deducted from capital surplus, or from unappropriated earnings when capital surplus is insufficient for deduction for debiting purposes. If the market prices of investments significantly decline below carrying value and the decline is permanent, the investment loss should be recognized currently. This investment will be revalued if its market value becomes equal to or higher than carrying value per share. The difference between the new cost of the investment and the proportionate equity in the investee is amortized over five years.

Other investments are accounted for by the cost method. If evidence indicates that the market value of investments has significantly declined permanently below carrying value, the decline should be recognized as a realized investment loss. The previous carrying value less the amount of write-down becomes the new cost basis for such investments. Cash dividends received from an investee within the year of the acquisition and an accumulation of cash dividends received that exceed the previous year-end retained earnings after the year of acquisition are recorded as a reduction of investment cost, while received in subsequent years are recorded as investment income. Construction dividends are recorded as a reduction of investment cost.

For both equity-method and cost-method investments, the cost of investment sold is calculated using the weighted-average method.

Properties

Properties are stated at cost or cost plus appreciation, less accumulated depreciation. Interest expense for the purchase or construction of properties is capitalized as property cost. Major additions, renewals and betterments are capitalized, while maintenance and repairs are expensed currently.

Depreciation is calculated by the straight-line method over service lives estimated as follows: land improvements, 10 to 40 years; buildings and improvements, 5 to 60 years; machinery and equipment, 4 to 25 years; transportation equipment, 3 to 25 years; and miscellaneous equipment, 3 to 10 years. Depreciation on appreciation is calculated by the straight-line method over the remaining service lives of the revalued assets. When a property reaches its residual value but is still in use, its residual value is depreciated over its reestimated service life.

Upon sale or other disposal of properties, the related cost, appreciation and accumulated depreciation are removed from the accounts. Gains or losses are credited or charged to current income.

Rental Assets

Rental assets (included in other assets) are stated at the lower of carrying value or recoverable value.

Asset Impairment

Assets (primarily properties and long-term investments under the equity method) are evaluated on the basis of their recoverable value starting January 1, 2005. If the recoverable value is less than the carrying value of the assets, the decline is charged to impairment loss and accumulated impairment loss is established. If the value of the impaired assets recovers, the accumulated impairment loss will be reversed. However, 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), as if the assets had no impairment loss been recognized in prior years.

Unamortized Repair Costs

Unamortized repair costs refer to the major repairs of blast furnaces and are amortized over five years.

Treasury Stock

The Corporation reacquired its issued shares in accordance with government regulations and recorded this reacquisition as treasury stock at cost, which is presented as a deduction to stockholders' equity.

Effective 2002, the Corporation's shares acquired and held by subsidiaries are reclassified to treasury stock from long-term investments and accounted for at the carrying value recorded by subsidiaries for short-term or long-term investments as of January 1, 2002.

Effective 2005, the revised Statement of Financial Accounting Standards No. 7, "Consolidated Financial Statements", requires that equity-method investees that are not majority-owned but over which the Corporation has controlling capability in substance are deemed as subsidiaries. Thus, the Corporation's shares held by these investees are recorded as treasury stock.

Revenue Recognition

Revenues are recognized when titles to products and risks of ownership are transferred to customers as follows: domestic sales - when products are delivered out of the Corporation's premises to customers; exports - when products are loaded onto vessels.

Sales are measured at fair value, which is a price (net of trade discounts and sales discounts) agreed to by the Corporation and customers. But if the related receivable is due within one year, the difference between its present value and receivable amount is immaterial and sales transactions are frequent, the fair value of receivables is equivalent to the nominal amount of cash received.

Capitalization and Expense

Expenditure which amount is significant and has future economic benefits is classified as asset; otherwise is classified as expense or loss.

Pension

Pension costs under defined benefits pension plan are recognized on the basis of actuarial calculations. The difference between the actuarial pension cost and the amount appropriated to a special fund (Note 14) is recognized as accrued pension liability (included in accrued expenses). Unamortized net transition assets and actuarial gain or loss are amortized over 11 years and the average remaining service life of employees, respectively.

Pension costs under defined contribution plan are recognized based on contributions amounts by the Corporation to the employees' individual account.

Income Tax

Income tax is provided based on inter-period allocation basis. Tax effects of deductible temporary differences are recognized as deferred income tax assets. Valuation allowance is provided for deferred tax assets with uncertain realizability. Tax effects of taxable temporary differences are recognized as deferred tax liabilities. A deferred tax asset or liability is classified as current or noncurrent depending on the classification of the related asset or liability for financial reporting. But if the deferred income tax asset or liability cannot be related to an asset or liability for financial reporting, the classification is based on the expected reversal or realization date of the temporary difference.

Tax credits arising from expenditures for purchases of equipment, research and development, employees' training, and investment in newly emerging, important and strategic industries are recognized when those credits are granted.

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

Annual earnings are appropriated under a resolution adopted in the stockholders' meeting in the year following the year of earnings generation. Under tax regulations, unappropriated earnings generated after 1998 are subject to 10% income tax. This tax is recorded as expense in the year when the stockholders resolve to retain the earnings.

Foreign-currency Transactions

Foreign-currency transactions, except derivative transactions, are recorded in New Taiwan dollars at the rates of exchange in effect when the transactions occur. Gains or losses resulting from the application of prevailing exchange rates when foreign-currency assets and liabilities are settled or converted, are credited or charged to income in the year of settlement or conversion. On the balance sheet date, foreign-currency assets and liabilities are restated at the prevailing exchange rates, and resulting differences are accounted for as follows:

- (a) Equity-method stock investments - as cumulative translation adjustments under stockholders' equity;
- (b) Cost-method stock investments - same as (a) above if restated balances are lower than their costs; otherwise, no adjustment is made;
- (c) Other assets and liabilities - as credits or charges to current income.

3. CASH AND CASH EQUIVALENTS

	2005	2004
Cash on hand	\$ 20,273	\$ 45,039
Checking accounts and demand deposits	2,320,639	2,737,397
Time deposits	3,700,000	1,600,000
Cash equivalents - short-term notes and bills	<u>7,198,569</u>	<u>22,020,329</u>
	<u>\$ 13,239,481</u>	<u>\$ 26,402,765</u>

As of December 31, 2005, the Corporation had foreign bank deposits of \$2,417 thousand (¥9,000 thousand) in Japan-Osaka.

4. SHORT-TERM INVESTMENTS

	2005	2004
Bond funds	\$ 10,975,710	\$ 20,043,753
Negotiable certificates of time deposits	4,500,000	-
Stocks listed	967,456	967,456
Bank debentures	250,700	250,700
Commercial paper with repurchase agreements	<u>-</u>	<u>2,593,126</u>
	<u>\$ 16,693,866</u>	<u>\$ 23,855,035</u>

5. NOTES AND ACCOUNTS RECEIVABLE

The Corporation entered into two accounts receivable factoring contracts (without recourse) with The International Commercial Bank of China (ICBC) and Bank of Taiwan for the facilities of \$5.84 billion and \$2.5 billion, respectively. Under the contracts, the Corporation is empowered to sell accounts receivable to the banks upon the delivery of products to customers and is required to complete related formalities at the following banking day.

The Corporation entered into a commercial papers purchasing contract, which was due on October 31, 2005, with Chung Hsing Bills Finance Corporation for the facility of \$2.5 billion. Customers will issue commercial papers to the Corporation upon the delivery of products. The commercial papers will be sold to Chung Hsing Bills Finance Corporation (without recourse) upon the Corporation's endorsements.

As of December 31, 2005, the balance of endorsed commercial papers was \$680,551 thousand.

The Corporation sold its notes and accounts receivable in 2005 and 2004. The related information is as follows:

Transaction Counter - party	Total Factoring Amounts	Related Expenses	Proceeds Received	Interest Rate (%)
<u>2005</u>				
Notes Receivable				
Chung Hsing Bills Finance Corporation	\$ 3,368,849	\$ 20,531	\$ 3,348,318	1.70 ~ 2.10
Accounts Receivable				
ICBC	5,898,506	43,579	5,854,927	1.64 ~ 2.10
Bank of Taiwan	<u>3,208,548</u>	<u>21,386</u>	<u>3,187,162</u>	1.64 ~ 4.16
	<u>9,107,054</u>	<u>64,965</u>	<u>9,042,089</u>	
	<u>\$ 12,475,903</u>	<u>\$ 85,496</u>	<u>\$ 12,390,407</u>	
<u>2004</u>				
Notes Receivable				
Chung Hsing Bills Finance Corporation	\$ 3,057,342	\$ 15,887	\$ 3,041,455	1.64 ~ 1.70
Mentor Consulting Corporation	<u>442,559</u>	<u>2,639</u>	<u>439,920</u>	1.908
	<u>3,499,901</u>	<u>18,526</u>	<u>3,481,375</u>	
Accounts Receivable				
ICBC	5,274,192	28,721	5,245,471	1.58 ~ 1.70
Bank of Taiwan	<u>688,805</u>	<u>3,905</u>	<u>684,900</u>	1.64 ~ 1.70
	<u>5,962,997</u>	<u>32,626</u>	<u>5,930,371</u>	
	<u>\$ 9,462,898</u>	<u>\$ 51,152</u>	<u>\$ 9,411,746</u>	

6. INVENTORIES

	2005	2004
Finished products	\$ 6,776,286	\$ 4,751,613
Work in process	9,293,601	8,602,141
Raw materials	12,320,916	5,135,172
Supplies	5,210,244	3,921,113
Materials in transit and others	1,733,764	3,398,933
Fuel	89,186	105,158
Others	<u>368,034</u>	<u>125,547</u>
	35,792,031	26,039,677
Less: Allowance for losses	<u>-</u>	<u>164,689</u>
	<u>\$ 35,792,031</u>	<u>\$ 25,874,988</u>

7. LONG-TERM INVESTMENTS

	2005		2004	
	Amount	% of Owner-ship	Amount	% of Owner-ship
Stocks - under the equity method				
Stocks listed on the Taiwan Stock Exchange				
Chung Hung Steel Corporation (CHSC)	\$ 1,138,751	24	\$ 2,007,733	24
China Steel Chemical Corporation (CSCC)	1,099,876	30	1,050,325	30
China Hi-ment Corporation (CHC)	619,815	20	561,291	20
China Steel Structure Corporation (CSSC)	471,177	18	437,654	18
China Ecotek Corporation (CEC)	<u>407,238</u>	36	<u>383,270</u>	36
	3,736,857		4,440,273	
Less: Shares held by subsidiaries accounted for as treasury stock	<u>333,214</u>		<u>192</u>	
	<u>3,403,643</u>		<u>4,440,081</u>	
Stocks without quoted market prices				
Dragon Steel Corporation (DSC)	15,122,411	47	1,513,678	37
China Steel Express Corporation (CSE)	7,870,266	100	7,643,022	100
C. S. Aluminum Corporation (CAC)	7,031,956	100	6,885,517	98
Gains Investment Corporation (GIC)	6,341,240	100	5,779,470	100
China Prosperity Development Corporation (CPDC)	4,721,157	100	4,788,857	100
Kaohsiung Rapid Transit Corporation (KRTC)	3,112,060	31	3,176,545	31
China Steel Asia Pacific Holdings Pte Ltd (CSAPH)	2,408,502	100	3,306,414	100
China Steel Global Trading Corporation (CSGT)	1,135,359	100	1,242,487	100
China Steel Machinery Corporation (CSMC)	826,656	100	695,536	100
Goang Yaw Investment Corporation and other two companies	817,541	99	1,345,490	99
Info-Champ Systems Corporation (ICSC)	554,411	100	533,776	99
China Steel Security Corporation (CSS)	236,689	100	229,712	100
Taiwan Rolling Stock Co., Ltd. (TRSC)	164,447	27	163,395	27
China Steel Management Consulting Corporation (CSMCC)	8,533	38	8,848	38

(Continued)

	<u>2005</u>		<u>2004</u>	
	Amount	% of Owner- ship	Amount	% of Owner- ship
TaiAn Technologies Corporation (TTC)	\$ 3,420	17	\$ 2,319	17
Hi-mag Magnetic Corporation (HMC)	-	50	-	50
	<u>50,354,648</u>		<u>37,315,066</u>	
Less: Shares held by subsidiaries accounted for as treasury stock	<u>932,572</u>		<u>1,112,929</u>	
	<u>49,422,076</u>		<u>36,202,137</u>	
	<u>52,825,719</u>		<u>40,642,218</u>	
Stocks - under the cost method				
Listed stocks				
Maruichi Steel Tube Ltd.	757,919	2	757,919	2
Advanced Material Technology Corporation (AMTC)	243,290	2	243,290	2
Common stocks without quoted market prices				
Industrial Bank of Taiwan	1,000,000	4	1,000,000	4
CDIB & Partners Investment Holding Corporation	500,000	5	500,000	5
Asia Pacific Broadband Telecom Co., Ltd. (APBT)	240,000	2	1,146,000	2
Kaohsiung Arena Development Corp. (KADC)	135,000	18	-	-
CDIB BioScience Ventures I, Inc.	120,000	5	120,000	5
Phalanx Biotech Group Inc. (PBG)	105,370	15	105,370	15
Overseas Investment & Development Corporation	50,000	6	50,000	6
CTB I Venture Capital Co., Ltd.	50,000	5	50,000	5
GenMont Biotech Inc. (GMB)	-	-	55,269	14
Tang Eng Iron Works Corporation (TEIWC)	-	9	-	9
Preferred stocks without quoted market prices				
Taiwan High Speed Rail Corporation - Preferred C (THSRC)	4,646,991	19	1,499,997	14
Preferred B (THSRC)	934,384	4	984,384	4
East Asia United Steel Corporation (EAUS)	2,794,000	29	2,055,437	33
Dragon Steel Corporation	999,877	100	999,877	100
TaiGen Biotechnology Co., Ltd. (TBC)	<u>300,000</u>	24	<u>150,000</u>	24
	<u>12,876,831</u>		<u>9,717,543</u>	
Prepaid long-term investment				
KADC	-		<u>90,000</u>	
Fund - Sino-Canada Biotechnology Development Fund, LP (SCBDF)	<u>179,263</u>		<u>182,211</u>	
	<u>\$ 65,881,813</u>		<u>\$ 50,631,972</u>	

The market values of listed stocks based on the average closing prices in December are summarized as follows:

	2005	2004
Listed stocks under the equity method		
CSCC	\$ 2,537,477	\$ 2,889,178
CHSC	2,325,051	6,206,190
CHC	1,039,100	820,521
CSSC	371,426	469,953
CEC	<u>352,226</u>	<u>289,839</u>
	<u>\$ 6,625,280</u>	<u>\$ 10,675,681</u>
Listed stocks under the cost method		
Maruichi Steel Tube Ltd.	\$ 1,418,793	\$ 1,109,263
AMTC	<u>239,900</u>	<u>255,095</u>
	<u>\$ 1,658,693</u>	<u>\$ 1,364,358</u>

As of December 31, 2005 and 2004, the Corporation's total equity in CHSC was 39%, including directly owned - 24% and indirectly owned - 15%. The Corporation's total equity in TTC was 22%, including directly owned - 17% and indirectly owned through CSCC - 5%.

In November 2004, the Corporation increased its investment in GIC for \$500,000 thousand, with its equity interest unchanged.

In 2005, DSC issued additional shares and declared stock dividends on its preferred stock. The Corporation increased its investment in DSC by 980,032 thousand shares for \$13,230,426 thousand (\$13.50 per share) and stock dividends received by the Corporation. The Corporation's holding in DSC increased from 37% to 47%.

In August 2005, CSAPH reduced its capital 29,455 thousand shares and returned US\$18,000 thousand to the Corporation.

In May 2003, the Corporation signed a slab production joint-venture contract with Sumitomo Metal Industries, Ltd. and Sumitomo Corporation. In July 2003, the joint venture company of East Asia United Steel Corporation (EAUS) was established. The joint venture contract required the Corporation hold the investment in EAUS for 12 years (until June 2015). Upon the expiration of the joint venture contract, the Corporation has an option to sell its shareholding in EAUS, or other shareholders have an option to purchase the shareholding owned by the Corporation to terminate the contract. However, the contract will be extended if all shareholders consider it necessary. As of December 31, 2005, the Corporation had invested in EAUS at the amount of \$3,055,188 thousand (¥10 billion, Note 13). In June 2005, the Corporation's equity in EAUS decreased from 33% to 29% because EAUS issued additional shares but the Corporation did not subscribe proportionately for these shares. The long-term investment is valued under the cost method because the Corporation has no significant influence on EAUS. Because of changes in exchange rate in 2005, the Corporation incurred \$249,004 thousand cumulative translation adjustments to reduce stockholders' equity (the Corporation has borrowed the same amount of long-term bank loans in yen to hedge exchange rate fluctuations; Note 13). As of December 31, 2005, the cumulative translation adjustments amounted to \$261,188. The Corporation thus have a stable supply of good quality slab from this joint venture. The Corporation also signed a contract with CHSC to transfer the purchasing right of slabs from EAUS, and the Corporation receives premiums on this contract based on the volume purchased by CHSC.

In September 2003, the Corporation acquired 100,000 thousand preferred shares of THSRC for \$1,000,000. Dividends on these shares are at 5%, payable on a nonparticipating and cumulative basis. In April 2005 and August 2004, the Corporation acquired additional 505,370 thousand preferred shares of THSRC for \$3,199,944 thousand and \$1,499,997 thousand, respectively. These shares, which may be converted to common shares within four years from the acquisition date, have a 9.5% dividend in the first two years and 0% in the next two years. At the end of four years (i.e., in 2009 and 2008), if the Corporation does not convert the preferred shares into common shares and THSRC unredeem the shares, the unredeemed shares will have 4.71% dividends. THSRC builds and operates public transportation systems. The long-term investment is accounted for by the cost method because the Corporation's shares have no voting rights.

In November 2005 and March 2004, the Corporation totally acquired 20,000 thousand preferred shares of TBC for \$300,000 thousand. Preferred shareholders are entitled to 8% participating and noncumulative dividends as well as voting and election rights. TBC mainly researches and develops drugs. The long-term investment is accounted for by the cost method because the Corporation has no significant influence on the investee.

The Corporation promised to invest 100 units (10,000 thousand Canadian dollars) in the SCBDF fund. As of December 31, 2005, the Corporation had invested \$219,025 thousand (CAD\$9,435 thousand) in SCBDF fund, representing investment of 94.35%. The difference between the above cumulative investment and the carrying value was due to the cash dividends received by the Corporation.

In 2005, the Corporation recognized an impairment loss of \$906,000 thousand (recorded as nonoperating expense) on its investment in APBT.

In March 2005 and November 2004, the Corporation invested \$45,000 thousand and \$90,000 thousand to acquire 13,500 thousand shares of KADC, representing 18% equity in KADC. The Corporation plans to invest in KADC totaling \$270,000 thousand. KADC mainly engages in international trading, retailing and gymnasium development.

The Corporation's Board of Directors approved plans for additional investments in KADC, DSC, TRSC, etc. The related subscription schedule depends on the investees' capital increase requirements. As of December 31, 2005, the Corporation's further infuse capital in these investees amounted to \$5,247,058 thousand.

Investment income (loss) under the equity method was as follows:

	2005	2004
CSE	\$ 2,722,709	\$ 2,896,485
GIC	692,336	125,609
CHSC	(674,363)	818,947
Goang Yaw Investment Corporation and other two companies	(499,853)	528,225
CAC	483,448	613,357
DSC	366,086	491,361
CSGT	355,539	529,933
CSCC	304,511	331,524
CSAPH	185,550	988,812
CSSC	184,297	2,278
CHC	136,701	105,070
CSMC	135,794	9,759
ICSC	83,685	90,104
KRTC	(64,485)	58,379
CPDC	(42,401)	16,942
CEC	40,771	22,642

(Continued)

	2005	2004
CSS	\$ 25,794	\$ 21,316
CSMCC	4,129	4,939
TRSC	1,052	423
TTC	1,101	(5,309)
PBG	-	(15,393)
	<u>\$ 4,442,401</u>	<u>\$ 7,635,403</u>

The calculation of the above investment income (loss) was based on the investees' audited financial statements.

The Corporation has prepared the consolidated financial statements including majority-owned and controlled in-substance subsidiaries in accordance with the related regulations.

8. PROPERTIES

	Cost	Appreciation	Total
<u>December 31, 2005</u>			
Cost and appreciation			
Land	\$ 7,994,055	\$ 5,840,732	\$ 13,834,787
Land improvements	4,216,794	492,990	4,709,784
Buildings and improvements	36,016,863	2,424,236	38,441,099
Machinery and equipment	212,821,181	8,844,981	221,666,162
Transportation equipment	1,452,514	33,748	1,486,262
Miscellaneous equipment	<u>3,013,382</u>	<u>31,795</u>	<u>3,045,177</u>
	<u>265,514,789</u>	<u>17,668,482</u>	<u>283,183,271</u>
Accumulated depreciation			
Land improvements	3,097,184	421,746	3,518,930
Buildings and improvements	15,356,709	1,623,030	16,979,739
Machinery and equipment	164,474,811	8,841,645	173,316,456
Transportation equipment	1,170,916	33,728	1,204,644
Miscellaneous equipment	<u>2,332,735</u>	<u>31,780</u>	<u>2,364,515</u>
	<u>186,432,355</u>	<u>10,951,929</u>	<u>197,384,284</u>
Constructions in progress	<u>19,768,057</u>	<u>-</u>	<u>19,768,057</u>
	<u>\$ 98,850,491</u>	<u>\$ 6,716,553</u>	<u>\$ 105,567,044</u>

December 31, 2004

Cost and appreciation			
Land	\$ 7,146,632	\$ 5,850,597	\$ 12,997,229
Land improvements	4,231,666	492,990	4,724,656
Buildings and improvements	35,994,405	2,437,677	38,432,082
Machinery and equipment	211,725,159	8,946,631	220,671,790
Transportation equipment	1,537,749	33,748	1,571,497
Miscellaneous equipment	<u>2,978,585</u>	<u>34,184</u>	<u>3,012,769</u>
	<u>263,614,196</u>	<u>17,795,827</u>	<u>281,410,023</u>

(Continued)

	Cost	Appreciation	Total
Accumulated depreciation			
Land improvements	\$ 2,979,282	\$ 410,204	\$ 3,389,486
Buildings and improvements	14,487,030	1,573,464	16,060,494
Machinery and equipment	158,920,303	8,940,062	167,860,365
Transportation equipment	1,217,572	33,712	1,251,284
Miscellaneous equipment	<u>2,388,712</u>	<u>34,168</u>	<u>2,422,880</u>
	<u>179,992,899</u>	<u>10,991,610</u>	<u>190,984,509</u>
Constructions in progress	<u>8,909,449</u>	<u>-</u>	<u>8,909,449</u>
	<u>\$ 92,530,746</u>	<u>\$ 6,804,217</u>	<u>\$ 99,334,963</u>

In 1981 and 1994, the Corporation revalued its properties and patents in accordance with government regulations, resulting in an increment of \$17,662,343 thousand. After the deduction of the reserve for land value increment tax of \$3,370,813 thousand, an increment of \$14,291,530 thousand was credited to capital surplus. As of December 31, 2005, capital surplus from revaluation of assets totaling \$13,952,356 thousand had been transferred to capital stock, reducing the balance of capital surplus from revaluation of assets to \$339,174 thousand. In January 2005, the government revised the land increment tax law to reduce the tax rate. Thus, the reserve for land value increment tax decreased and the capital surplus from revaluation increment increased each by \$1,196,189 thousand. In 2005, the Corporation decreased reserve for land value increment tax by \$3,500 thousand resulting from sale of its land. As of December 31, 2005, the balance of reserve for land value increment tax amounted to \$2,171,124 thousand.

In January 2005, the Corporation repurchased land from CPDC for \$834,673 thousand, and after offsetting unrealized gain on intercompany transaction of \$268,876 thousand which occurred in 1999, the actual purchase cost was \$565,797 thousand.

9. RENTAL ASSETS

	2005	2004
Land - at cost	<u>\$ 2,966,398</u>	<u>\$ 2,966,398</u>
Machinery and equipment - at cost	2,000,000	2,000,000
Less: Accumulated depreciation	1,306,052	1,277,354
Accumulated impairment loss	<u>594,000</u>	<u>594,000</u>
	<u>99,948</u>	<u>128,646</u>
	<u>\$ 3,066,346</u>	<u>\$ 3,095,044</u>

The Corporation has leased to its subsidiaries some of its plant property and machinery (Note 20). The Corporation recognized an impairment loss of \$594,000 (recorded in nonoperating losses in 2004) on the rental machinery and equipment, based on future rental income.

10. SHORT-TERM LOANS AND OVERDRAFT

	2005	2004
Credit loans - interest at 1.387%-1.479% p.a. and 1.146%-1.164% p.a. as of December 31, 2005 and 2004, respectively	\$ 7,500,000	\$ 2,500,000
Letters of credit - due within 180 days; interest at 0.26%-5.38% p.a. and 0.46%-5.32% p.a. as of December 31, 2005 and 2004, respectively	674,869	108,323
Overdraft - interest at 1.1%-2.72% p.a. and 0.85%-2.377% p.a. as of December 31, 2005 and 2004, respectively	<u>3,298,514</u>	<u>1,857,636</u>
	<u>\$ 11,473,383</u>	<u>\$ 4,465,959</u>

11. COMMERCIAL PAPER PAYABLE

	2005	2004
Commercial paper - interest rates at 1.15%-1.34% p.a. and 0.922%-0.972% p.a. as of December 31, 2005 and 2004, respectively	\$ 1,500,000	\$ 1,800,000
Unamortized discounts	<u>(624)</u>	<u>(948)</u>
	<u>\$ 1,499,376</u>	<u>\$ 1,799,052</u>

12. LONG-TERM BONDS PAYABLE

	2005	2004
5-year unsecured bonds - issued at par in:		
November 2001; repayable in November 2006; interest at 3.1% p.a., repayable annually	\$ 3,500,000	\$ 3,500,000
November 2001; repayable in November 2006; interest at 3.0763% p.a., compounded semiannually and repayable annually	1,500,000	1,500,000
June 2001; repayable in June 2006; interest at 4.27% p.a., repayable annually	5,000,000	5,000,000
November 2000; repayable in December 2005; interest at 5.18% p.a., repayable annually	<u>-</u>	<u>5,000,000</u>
	10,000,000	15,000,000
Current portion	<u>10,000,000</u>	<u>5,000,000</u>
	<u>\$ -</u>	<u>\$ 10,000,000</u>

13. LONG-TERM DEBTS

	2005	2004
Mortgage bank loans:		
Repayable in July 2010 (¥4.4 billion); floating rate at 0.2288% and 0.2163% p.a. as of December 31, 2005 and 2004, respectively	\$ 1,230,680	\$ 1,368,400
Repayable in December 2006 (¥2.6 billion); floating rates at 0.2310% p.a. and 0.2160% p.a. as of December 31, 2005 and 2004, respectively	727,220	808,600
		(Continued)

	2005	2004
Repayable in July 2010 (¥2.2 billion); floating rates at 0.2750% p.a. and 0.259% p.a. as of December 31, 2005 and 2004, respectively	\$ 615,340	\$ 684,200
Repaid in July 2010 (¥3.3 billion); floating rates at 0.3625% p.a. as of December 31, 2005	<u>923,010</u>	<u>-</u>
	3,496,250	2,861,200
Current portion	<u>727,220</u>	<u>-</u>
	<u>\$ 2,769,030</u>	<u>\$ 2,861,200</u>

As of December 31, 2005, the Corporation has long-term loans in yen to hedge the exchange rate fluctuations on its investments in yen in East Asia United Steel Corporation and Maruichi Steel Tube Ltd (Note 7).

14. PENSION PLAN

The Labor Pension Act (the “Act”) effected from on July 1, 2005. The Corporation’s regular employees hired before June 30, 2005, have chosen to apply continuously their pension plan to the Labor standard Law (those employees may change their choice to the “Act” before July, 1, 2010), or have chosen their pension plan to apply to the Act, but remain their seniority before July 2005, to apply to the Labor Standards Law. Employees hired after July 1, 2005 can only adopt the pension plan under the Act.

Under the Act, the pension plan is a defined contribution plan, the Corporation makes monthly contribution to employees’ personal retirement account at 6% of their salaries and wages. The Corporation’s pension expense under the Act amounted to \$1,369,536 in 2005.

The Corporation 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 Corporation makes contributions, equal to a certain percentage of salaries, to a pension fund, which is deposited in the Central Trust of China in the name of, and administered by the employees’ pension fund supervisory committee. The changes in the fund are summarized as follows:

	2005	2004
Balance, beginning of year	\$ 10,503,035	\$ 9,270,619
Contributions	1,289,951	1,227,590
Gains appropriated	117,438	123,434
Payment of benefits	<u>(151,406)</u>	<u>(118,608)</u>
Balance, end of year	<u>\$ 11,759,018</u>	<u>\$ 10,503,035</u>

Since August 1999, the Corporation has also made contributions, equal to a certain percentage of salaries of management personnel (vice presidents and above), to another pension fund, which is deposited in the International Commercial Bank of China in the name of, and administered by an officers’ pension fund management committee. The changes in the fund are summarized as follows:

	2005	2004
Balance, beginning of year	\$ 9,982	\$ 7,250
Contributions	4,343	7,904
Interest income	153	110
Payment of benefits	<u>-</u>	<u>(5,282)</u>
Balance, end of year	<u>\$ 14,478</u>	<u>\$ 9,982</u>

The pension costs are as follows:

	2005	2004
Under Labor Standards Law	\$ 1,369,536	\$ 1,157,138
Under Labor Pension Act	<u>1,773</u>	<u>-</u>
	<u>\$ 1,371,309</u>	<u>\$ 1,157,138</u>

Under the defined benefits pension plan, pension information based on actuarial calculation is as follows:

	2005	2004
a. Net pension cost		
Service cost	\$ 1,254,577	\$ 1,159,792
Interest cost	431,026	345,922
Expected return on plan assets	(335,227)	(339,040)
Amortization	<u>19,160</u>	<u>(9,536)</u>
	<u>\$ 1,369,536</u>	<u>\$ 1,157,138</u>
b. Reconciliation of the funded status of the plan and accrued pension liability		
Benefit obligation		
Vested	\$ 263,749	\$ 192,430
Non-vested	<u>10,603,429</u>	<u>8,965,315</u>
Accumulated	10,867,178	9,157,745
Additional benefits based on future salaries	<u>3,181,579</u>	<u>2,403,094</u>
Projected	14,048,757	11,560,839
Fair value of plan assets	<u>(11,936,196)</u>	<u>(10,630,540)</u>
Funded status	2,112,561	930,299
Unrecognized net asset at transition	81,055	90,591
Unamortized net actuarial loss	<u>(2,032,626)</u>	<u>(942,819)</u>
Accrued pension liabilities (included in accrued expense)	<u>\$ 160,990</u>	<u>\$ 78,071</u>

The difference between the pension fund and the fair value of plan assets as of December 31, 2005 and 2004 represented the accrued interest income of the fund.

	2005	2004
c. Vested benefits	\$ 284,753	\$ 209,608
d. Actuarial assumptions		
Discount rate used in determining present values	3.5%	3.5%
Future salary increase rate	3.0%	2.5%
Expected rate of return on plan assets	3.5%	2.5%

15. DEFERRED CREDITS - GAIN ON INTERCOMPANY TRANSACTION

	2005	2004
Gain on disposal of land	\$ 1,136,164	\$ 1,405,040
Gain on contracted projects	<u>6,188</u>	<u>6,716</u>
	<u>\$ 1,142,352</u>	<u>\$ 1,411,756</u>

A deferred income of \$1,405,040 thousand was the unrealized gain from the sale of land to CPDC in February 1999. The Corporation repurchased some of the land in the first half of 2005 for office building construction and thus decreased its deferred credits by \$268,876 thousand. The remaining deferred credit will be recognized as income when CPDC sells the rest of the land to third parties.

The Corporation contracted projects with KRTC, resulting in a deferred revenue of \$6,188 thousand as of December 31, 2005. The accumulated credits will be recognized as income over the service lives of the buildings after completion of the construction, expected in 2007.

16. STOCKHOLDERS' EQUITY

a. Capital stock

In August 2005 and July 2004, the Corporation, through capitalizing of retained earnings, issued new common shares of 655,558 thousand and 431,028 thousand, respectively.

In 2005, preferred stock of 1,479 thousand shares were converted into common stock of which 13 thousand shares, has not yet registered with the government.

b. Treasury stock

Purpose	Thousand Shares			End of Year	
	Beginning of Year	Increase	Decrease	Thousand Shares	Book Carrying Value
<u>2005</u>					
1) Shares acquired and held by subsidiaries	106,652	6,891	34,644	78,899	\$ 1,265,786
2) Shares acquired by the Corporation for transfer to employees	<u>-</u>	<u>300</u>	<u>-</u>	<u>300</u>	<u>7,435</u>
	<u>106,652</u>	<u>7,191</u>	<u>34,644</u>	<u>79,199</u>	<u>\$ 1,273,221</u>

(Continued)

Purpose	Thousand Shares			End of Year	
	Beginning of Year	Increase	Decrease	Thousand Shares	Book Carrying Value
<u>2004</u>					
1) Shares acquired and held by subsidiaries	86,237	3,019	4,793	84,463	\$ 1,113,121
2) Shares acquired by the Corporation for transfer to employees	<u>36</u>	<u>-</u>	<u>36</u>	<u>-</u>	<u>-</u>
	<u>86,273</u>	<u>3,019</u>	<u>4,829</u>	<u>84,463</u>	<u>\$ 1,113,121</u>

1) Shares acquired and held by subsidiaries

The Corporation's shares acquired and held by subsidiaries (with 50% or more shareholdings) were accounted for as treasury stock (recorded as long-term or short-term investment by investees), and had 84, 463 thousand shares and carrying value of \$1,356,485 thousand as of December 31, 2004. As mentioned in Note 2, effective 2005, the Corporation's shares acquired and held by other equity-method investees substantially controlled by the Corporation were also reclassified as treasury stock. This accounting change resulted in an increase of 22,189 thousand treasury shares in treasury stock, with a carrying value of \$539,707 thousand as of January 1, 2005. In 2005 and 2004, treasury stock increased by 6,891 thousand shares and 3,019 thousand shares, due to subsidiaries' purchase and the Corporation's capitalization of retained earnings; treasury stock decreased by 34,644 thousand shares and 4,793 thousand shares due to subsidiaries' sales of their holdings of the Corporation's shares and due to change in percentage of ownership.

The difference between the sale prices (\$95,380 thousand in 2005 and \$163,518 thousand in 2004) and carrying values (\$60,955 thousand in 2005 and \$63,066 thousand in 2004) of \$34,425 thousand and \$100,452 thousand were credited to capital surplus.

As of December 31, 2005 and 2004, the market values of those treasury shares are \$1,922,771 thousand and \$3,020,383 thousand, respectively.

Although these shares are treated as treasury stock in the financial statements, the stockholders are entitled to exercise their rights on these stocks, except participation in the Corporation's capital increase by cash. However, effective June 2005, the revised Company Law restricts that treasury stockholders from exercise of voting rights.

2) Shares acquired for transfer to employees

In August 2004, the Corporation transferred 36 thousand treasury shares, which were reacquired in 2001, to its employees and resulted in decrease in capital surplus of \$82 thousand.

Starting December 2005, the Corporation under relevant regulations planed to reacquire its issued common shares from the public market at a total of 0.2 billion shares before February 20, 2006. As of December 31, 2005 the Corporation has reacquired 300 thousand issued common shares.

Under the Securities Transaction Law, the Corporation's share repurchase is restricted to up to 10% of total issued shares, and the total purchase amount should not exceed the sum of retained earnings, paid-in capital in excess of par value and realized capital surplus. In addition, the Corporation should transfer those shares to employees within three years. Otherwise these shares are deemed unissued and the Corporation should then register with the government for capital decrease. Further, the Corporation should not pledge these stocks as collateral and should not collect

dividends or exercise voting rights on these stocks.

c. Overseas depositary receipts

In May 1992, February 1997 and October 2003, the ROC's Ministry of Economic Affairs (MOEA) (the shares were transferred to the Ministry of Finance in 2005) sold its shares in the Corporation through issuances of 88,329,150 units of Global Depositary Receipts (international GDR), with each unit representing 20 shares of the Corporation's common stock, or equivalent to the Corporation's common shares totalling 1,873,506,074 shares. The depositary shares increased by 5,346,146 units when retained earnings were capitalized. Under relevant regulations, the International GDR holders may also request the conversion to the shares represented by the International GDR. The foreign investors may also request the reissuance of such depositary receipts within the originally approved units. As of December 31, 2005, the outstanding depositary receipts were 16,706,675 units, equivalent to 334,133,634 common shares and 3.17% of the outstanding common shares.

d. Preferred stock

Preferred stockholders have the following entitlements or rights:

- 1) 14% annual dividends, with dividend payments ahead of those to common stockholders;
- 2) Preference over common stock in future payment of dividends in arrears;
- 3) Redemption of stock, at the Corporation's option out of its retained earnings or the proceeds from issuance of new shares;
- 4) The same rights as common stockholders, except the right to vote for directors and supervisors; and
- 5) Conversion of shares into common stock.

e. Capital surplus

Following are the capital surplus sources:

	2005	2004
Revaluation increment on assets (Note 8)	\$1,535,363	\$ 339,174
Treasury stock transaction	960,872	638,668
Long-term investments under the equity method	240,407	186,379
Others	<u>8,099</u>	<u>8,099</u>
	<u>\$2,744,741</u>	<u>\$1,172,320</u>

Under relevant regulations, the capital surplus from revaluation increment on assets may only be used to offset a deficit. Capital surplus from treasury stock transaction may be used to offset a deficit or transferred to capital. Capital surplus from long-term investments accounted for under the equity method is prohibited from any use.

f. Appropriation of retained earnings

The Corporation's Articles of Incorporation provides that the annual net income, less any deficit, should be appropriated in the following order of presentation:

- 1) 10% as legal reserve, until its balance equals the issued capital stock;
- 2) Preferred stock dividends at 14% of paid-in capital;

- 3) Of the remainder, 0.3% as compensation to directors and supervisors and 3% to 5% as bonus to employees (in their meeting in June 2004, the stockholders resolved to change the appropriation rate for employee bonus from 3% to between 3% and 5%, which was effective from the 2004 earnings distribution in 2005);
- 4) Common stock dividends at 14% of paid-in capital; and
- 5) The remainder, if any, as additional dividends divided equally between the holders of preferred and common stocks.

The Board of Directors should propose the appropriation of annual income. If necessary, it may, after appropriating preferred stock dividends at 14% of paid-in capital, propose to retain certain earnings as a special reserve. These proposals should be submitted to the stockholders' meeting for approval.

The Corporation is required to appropriate a special reserve from annual earnings for any net debit balance resulting from adjustments to the stockholders' equity, excluding treasury stock. Effective 2002, if the market price is lower than the carrying value of the Corporation's shares held by subsidiaries, the Corporation should appropriate a special reserve equal to the difference between market price and carrying value. The Corporation may release a portion of this special reserve when debit balances are partially or fully reversed.

The Corporation's steel business is in a phase of stable growth; thus, more than 75% of the appropriation of dividends and bonus should be in cash and less than 25% in stock.

Under the Company Law, the aforementioned legal reserve may be used to offset a deficit; also, when the Company makes no profit in the current year and the reserve has reached 50% of the paid - in capital, up to 50% thereof may be distributed as dividends and bonuses; in addition, while the Company has no deficit and where the legal reserve reaches over 50% of the paid - in capital, the amount in excess can be capitalized.

In their June 2005 and 2004 meetings, the Corporation's stockholders approved the following appropriation of the 2004 and 2003 earnings, which was proposed by the Board of Directors in March 2005 and 2004, respectively.

	<u>Amount</u>		<u>Dividends Per Share</u>	
	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>
Legal reserve	\$ 5,161,667	\$ 3,685,308		
Special reserve	436,524	28,651		
Preferred Stock				
Cash dividends	158,785	143,286	\$ 3.90	\$ 3.00
Stock dividends	20,357	16,717	<u>0.50</u>	<u>0.35</u>
			<u>\$ 4.40</u>	<u>\$ 3.35</u>
Common Stock				
Cash dividends	38,572,559	28,356,863	3.90	3.00
Stock dividends	4,945,200	3,308,301	<u>0.50</u>	<u>0.35</u>
			<u>\$ 4.40</u>	<u>\$ 3.35</u>
Remuneration to directors and supervisors	138,243	98,526		
Bonus to employees				
Cash dividends	714,035	-		
Stock dividends	<u>1,590,021</u>	<u>985,263</u>		
	<u>\$ 51,737,391</u>	<u>\$ 36,622,915</u>		

As of January 27, 2006, the auditors' report date, the appropriation of 2005 earnings had not been proposed by the Board of Directors. Information on the Board of Directors' proposed appropriation of the 2005 earnings and related stockholders' meeting will be published on the web site of the Taiwan Stock Exchange Corporation.

- g. Effect of bonus to employees and compensation to directors and supervisors if charged to expense

The aforementioned appropriation of bonus to employees and compensation to directors and supervisors was as follows:

	Amount	Shares (Thousands)	Percentage to Common Shares Outstanding as of each year-end (%)
<u>2004</u>			
Bonus to employees			
Stock dividends	\$ 1,590,021	159,002	1.51
Cash dividends	714,035	-	-
Remuneration to directors and supervisors - cash	<u>138,243</u>	-	-
	<u>\$ 2,442,299</u>		
<u>2003</u>			
Bonus to employees - stock	\$ 985,263	98,526	1.04
Remuneration to directors and supervisors - cash	<u>98,526</u>	-	-
	<u>\$ 1,083,789</u>		

Had the bonus to employees and remuneration to directors and supervisors been charged to expense (stock bonus calculation was based on par value) in 2004 and 2003, the basic earnings per share (after tax) for 2004 and 2003 would have decreased (the capitalization of retained earnings in 2005 and 2004 already reflected the retroactive adjustment to the shares) from \$4.93 to \$4.70 for 2004 and from \$3.77 to \$3.70 for 2003.

17. INCOME TAX

- a. Reconciliation between the income tax expense and the income tax calculated on pre-tax financial statement income based on the statutory tax rate:

	2005	2004
Tax on pretax income at statutory rate (25%)	<u>\$ 16,278,107</u>	<u>\$ 16,255,504</u>
Add (deduct) tax effects of differences of:		
Permanent		
Gain disposal of investments	(103,227)	(196,717)
Cash dividends	(59,201)	(33,516)
Investment income	(1,064,213)	(1,661,648)
Tax-exempt income	(37,573)	(31,346)
Others	<u>22,767</u>	<u>7,768</u>
	<u>(1,241,447)</u>	<u>(1,915,459)</u>
		(Continued)

	2005	2004
Temporary		
Investment income	\$ (46,387)	\$ (247,203)
Cash dividends	164,897	-
Impairment loss on long-term investments	226,500	-
Investment loss resulting from investees' capital decrease	(102,180)	-
Depreciation	177,765	201,960
Reversal of allowance for loss on inventory	(41,172)	(1,250)
Unrealized gain on intercompany transactions	94,226	973
Unrealized foreign exchange loss (gain)	(89,399)	17,102
Impairment loss on assets	-	148,500
Others	<u>(54,203)</u>	<u>5,095</u>
	<u>330,047</u>	<u>125,177</u>
Income tax payable based on taxable income	15,366,707	14,465,222
Tax credits	(884,544)	(653,154)
Prior periods' adjustments	(48,692)	(48,912)
Separate income tax on interest income	<u>49,867</u>	<u>18,921</u>
Tax payable	14,483,338	13,782,077
Deferred tax adjustments	<u>(17,548)</u>	<u>(376,754)</u>
Income tax	<u>\$ 14,465,790</u>	<u>\$ 13,405,323</u>
b. Change in income tax payable		
Balance, beginning of the year	\$ 9,405,065	\$ 6,539,733
Current income tax	14,483,338	13,782,077
Payment in current the year	<u>(16,309,926)</u>	<u>(10,916,745)</u>
Balance, ending of year	<u>\$ 7,578,477</u>	<u>\$ 9,405,065</u>
c. Deferred income tax assets and liabilities		
Current		
Deferred income tax assets		
Unrealized gain on intercompany transactions	\$ 94,358	\$ -
Severance pay	57,657	43,638
Provision of allowance for inventory loss	-	41,172
Others	<u>16,971</u>	<u>52,511</u>
	168,986	137,321
Deferred income tax liabilities		
Temporary difference between tax reporting and financial reporting - inventory	<u>(25,011)</u>	<u>(24,826)</u>
	<u>143,975</u>	<u>112,495</u>
Noncurrent		
Deferred income tax assets		
Impairment loss on long-term investment	240,000	13,500
Impairment loss on rental assets	107,927	134,029
Unrealized foreign exchange loss (gain)	(89,399)	4,911
Others	<u>2,301</u>	<u>3,173</u>
	<u>260,829</u>	<u>155,613</u>

(Continued)

	2005	2004
Deferred income tax liabilities		
Temporary difference between tax reporting and financial reporting – depreciation methods	\$ (2,881,691)	\$ (3,085,778)
Foreign investment income	<u>(323,235)</u>	<u>-</u>
	<u>(3,204,926)</u>	<u>(3,085,778)</u>
	<u>(2,944,097)</u>	<u>(2,930,165)</u>
Total deferred income tax liabilities - net	<u>\$ (2,800,122)</u>	<u>\$ (2,817,670)</u>

Under related regulations, the above tax credits resulted from certain purchases of machinery and equipment, research and development, employees' training, and investment in newly emerging, important and strategic industries.

Temporary difference for depreciation between tax reporting and financial reporting resulted from the adoption of accelerated depreciation method in the filing of income tax returns.

The Corporation's income tax returns through 2002 had been examined and cleared by the tax authorities.

d. Imputation tax system

Under the Imputation Tax System, domestic stockholders are allowed a tax credit for the income tax paid by the Corporation on earnings generated since 1998. Nonresident stockholders, including holders of overseas depository receipts, are allowed only a tax credit from the 10% income tax on undistributed earnings, which can be used to offset withholding income tax on dividends paid.

As of December 31, 2005, the balance of the imputation credit account (ICA) aggregated \$7,263,905 thousand. The estimated creditable tax ratio for the 2005 earnings was 29.11%, and the actual ratio for the 2004 earnings was 28.89%.

As of December 31, 2005, undistributed earnings generated up to 1997 amounted to \$35,440 thousand, which is not subject to the Imputation Tax System.

18. PERSONNEL EXPENDITURE, DEPRECIATION AND AMORTIZATION

	2005				2004			
	Cost of Revenues	Operating Expense	Others	Total	Cost of Revenues	Operating Expense	Others	Total
Personnel Expenditure								
Salary	\$ 14,425,508	\$ 2,504,219	\$ 150,488	\$ 17,080,215	\$ 14,085,149	\$ 2,671,911	\$ 70,926	\$ 16,827,986
Labor and health insurance	521,086	88,829	1,495	611,410	494,236	86,272	981	581,489
Pension and consolation costs	1,167,221	227,063	123,377	1,517,661	978,943	196,734	132,983	1,308,660
Others	<u>497,379</u>	<u>81,214</u>	<u>40,973</u>	<u>619,566</u>	<u>348,065</u>	<u>58,925</u>	<u>32,566</u>	<u>439,556</u>
	<u>\$ 16,611,194</u>	<u>\$ 2,901,325</u>	<u>\$ 316,333</u>	<u>\$ 19,828,852</u>	<u>\$ 15,906,393</u>	<u>\$ 3,013,842</u>	<u>\$ 237,456</u>	<u>\$ 19,157,691</u>
Depreciation	\$ 9,086,337	\$ 303,379	\$ 29,065	\$ 9,418,781	\$ 9,672,083	\$ 304,316	\$ 70,491	\$ 10,046,890
Amortization	79,712	1,260	6,548	87,520	318,848	1,605	8,765	329,218

19. EARNINGS PER SHARE

Earnings per share (EPS) were calculated using the following numerators and denominators:

Numerator, net income:

	2005		2004	
	Before Tax	After Tax	Before Tax	After Tax
Net income	\$ 65,112,429	\$ 50,646,639	\$ 65,022,014	\$ 51,616,691
Less: Preferred dividend	<u>73,251</u>	<u>56,977</u>	<u>74,383</u>	<u>59,048</u>
Basic EPS				
Net income of common stockholders	65,039,178	50,589,662	64,947,631	51,557,643
Effect of potentially dilutive shares:				
14% cumulative and convertible preferred stocks	<u>73,251</u>	<u>56,977</u>	<u>74,383</u>	<u>59,048</u>
Diluted EPS				
Net income of common stockholders and effect of potentially dilutive shares	<u>\$ 65,112,429</u>	<u>\$ 50,646,639</u>	<u>\$ 65,022,014</u>	<u>\$ 51,616,691</u>

Denominator - thousand shares:

	2005	2004
Weighted average of issued common shares	10,545,974	9,888,937
Add: Retroactive adjustments for capitalization of retained earnings	-	655,558
Less: Weighted average of treasury stocks		
Issued stocks purchased by the Corporation	25	21
Corporation's shares held by subsidiaries	<u>78,899</u>	<u>88,686</u>
	10,467,050	10,455,788
Potentially dilutive preferred stocks	<u>40,698</u>	<u>42,177</u>
	<u>10,507,748</u>	<u>10,497,965</u>

In EPS calculation, the number of outstanding shares is retroactively adjusted for the effect of capitalization of retained earnings. Thus basic EPS before tax and after tax decreased from \$6.62 to \$6.21 and from \$5.26 to \$4.93, respectively, for the year ended December 31, 2004.

20. RELATED-PARTY TRANSACTIONS

a. Related parties

Related Parties	Relationship with the Corporation
C. S. Aluminum Corporation (CAC)	Subsidiary
China Steel Express Corporation (CSE)	Subsidiary
China Steel Chemical Corporation (CSCC)	Subsidiary
China Steel Global Trading Corporation (CSGT)	Subsidiary
China Hi-ment Corporation (CHC)	Subsidiary
China Ecotek Corporation (CEC)	Subsidiary
China Steel Structure Corporation (CSSC)	Subsidiary
Chung Hung Steel Corporation (CHSC)	Subsidiary
China Steel Machinery Corporation (CSMC)	Subsidiary

(Continued)

Related Parties	Relationship with the Corporation
Gains Investment Corporation (GIC)	Subsidiary
China Steel Security Corporation (CSS)	Subsidiary
China Prosperity Development Corporation (CPDC)	Subsidiary
Info-Champ Systems Corporation (ICSC)	Subsidiary
China Steel Management Consulting Corporation (CSMCC)	Subsidiary
Hi-mag Magnetic Corporation (HMC)	Subsidiary
Long-Yuan-Fa Investment Corporation	Subsidiary
Horng-Yih Investment Corporation	Subsidiary
Goang-Yaw Investment Corporation	Subsidiary
Dragon Steel Corporation (DSC)	Subsidiary
China Steel Asia Pacific Holdings Pte Ltd. (CSAPH)	Subsidiary
Chung Mao Trading (BVI) Corp. (CSGT-BVI)	Indirect investee under Corporation's substantial control
Chung Mao Trading (SAMOA)	Indirect investee under Corporation's substantial control
CSGT (Singapore) Pte. Ltd.	Indirect investee under Corporation's substantial control
Mentor Consulting Corporation (MCC)	Indirect investee under Corporation's substantial control
Steel Castle Technology Corp.	Indirect investee under Corporation's substantial control
Ningbo Huayang Aluminum-Tech Co., Ltd.	Indirect investee under Corporation's substantial control
Betacera Inc.	Indirect investee under Corporation's substantial control
Wabo Globe Trading Corporation (WGTC)	Indirect investee under Corporation's substantial control
Universal Exchange Inc. (UEI)	Indirect investee under Corporation's substantial control
United Steel Engineering and Construction Corporation (USECC)	Indirect investee under Corporation's substantial control
Thintech Materials Technology Co., Ltd.	Indirect investee under Corporation's substantial control
Pao Good Industrial Co., Ltd.	Indirect investee under Corporation's substantial control
Ornasteel Enterprise Corp. (M) Sdn. Bhd. (OEC)	Indirect investee under Corporation's substantial control
Group Steel Enterprise Corp. (M) Sdn. Bhd (GEC)	Indirect investee under Corporation's substantial control
CSGT (JAPAN) Co., Ltd.	Indirect investee under Corporation's substantial control
CSGT Hong Kong Limited	Indirect investee under Corporation's substantial control
CSGT (SHANGHAI) Co., Ltd.	Indirect investee under Corporation's substantial control
China Steel Structure (KUNLUM Mount) Co., Ltd	Indirect investee under Corporation's substantial control
Taiwan Rolling Stock Co., Ltd. (TRSC)	Investee
Kaohsiung Rapid Transit Corporation (KRTC)	Investee
TaiAn Technologies Corporation (TTC)	Investee
Kaohsiung Labor Assemble & Disassemble Co., Ltd.	Indirect investee under Corporation's substantial control

b. Significant related-party transactions:

	2005		2004	
	Amount	%	Amount	%
Sales				
CSSC	\$ 3,243,159	2	\$ 3,625,648	2
OEC	2,513,078	1	3,486,361	2
CSCC	1,754,811	1	1,421,948	1
CHSC	1,140,929	1	1,640,709	1
Others	<u>2,774,069</u>	<u>1</u>	<u>2,510,603</u>	<u>1</u>
	<u>\$ 11,426,046</u>	<u>6</u>	<u>\$ 12,685,269</u>	<u>8</u>
Purchases				
CSE	\$ 13,220,944	16	\$ 17,390,754	28
CAC	1,784,766	2	1,702,437	3
CSGT	1,161,914	1	635,020	-
CHSC	440,996	1	1,235,664	2
Others	<u>505,411</u>	<u>1</u>	<u>445,656</u>	<u>2</u>
	<u>\$ 17,114,031</u>	<u>21</u>	<u>\$ 21,409,531</u>	<u>35</u>

Sales to and purchases from related parties are made under normal terms, except those with OEC, CAC, CSCC, CHC, and CSE, for which there were no similar transactions in the market for comparison.

Assets lease

The Corporation leases its land and office to CAC, CSSC, CHC, CSCC and CSMC, etc. Rentals are calculated at 4% to 10% p.a. of land value as published by the government or under arm's length basis. Rentals are collected semiannually, except for rentals from CAC and that from CSCC on the storage tank and pipelines, which are collected monthly. Lease information is as follows:

	Expiry Date	Rental Income	
		2005	2004
CAC	February 2016	\$ 47,353	\$ 51,783
CSMC	November 2011	22,959	22,967
CSCC	December 2010	19,939	20,441
CSSC	May 2018	16,054	20,469
CHC	April 2012	4,927	4,938
Others	April 2009	<u>3,606</u>	<u>3,270</u>
		<u>\$ 114,838</u>	<u>\$ 123,868</u>

Factoring of notes receivable

The Corporation sold some of its notes receivable to MCC without recourse for \$442,559 thousand for the year ended 2004. The related expenses were \$2,639 thousand in 2004.

Property transaction

In January 2005, the Corporation bought land from CPDC for office construction. The price was based on an agreement between the Corporation and CPDC.

Other expenditures

Other expenditures paid to related parties pertained to furnace slag and clearance services, property maintenance or construction, export shipping charges, commissions for export and import services, etc.

	2005	2004
CEC	\$ 2,040,106	\$ 983,665
CSMC	1,260,775	669,277
CSSC	1,017,263	795,548
USECC	544,868	387,943
CHC	522,038	528,118
CSE	274,913	264,367
Others	<u>1,071,295</u>	<u>1,091,052</u>
	<u>\$ 6,731,258</u>	<u>\$ 4,719,970</u>

Other revenues

Other revenues pertained to labor services, processing of products, utilities, and other services to related parties.

	2005	2004
KRTC	\$ 1,225,521	\$ 282,048
DSC	239,535	55,415
CHSC	238,711	131,947
CAC	156,169	137,459
CSCC	106,010	89,631
Others	<u>325,852</u>	<u>1,277,673</u>
	<u>\$ 2,291,798</u>	<u>\$ 1,974,173</u>

Short-term loans payable to related parties

In January 2005, the Corporation borrowed \$1,238,738 thousand (USD\$38,500 thousand) at no interest from CSAPH and repaid in September 2005.

c. Balances at year-end

	2005		2004	
	Amount	%	Amount	%
Receivables				
DSC	\$ 166,031	8	\$ 342	-
CSCC	115,473	6	139,995	7
Others	<u>124,446</u>	<u>6</u>	<u>252,642</u>	<u>12</u>
	<u>\$ 405,950</u>	<u>20</u>	<u>\$ 392,979</u>	<u>19</u>
Payables				
CSE	\$ 761,699	33	\$ 1,158,805	38
CAC	86,247	4	109,130	4
CHSC	-	-	313,121	10
Others	<u>22,561</u>	<u>-</u>	<u>29,298</u>	<u>-</u>
	<u>\$ 870,507</u>	<u>37</u>	<u>\$ 1,610,354</u>	<u>52</u>

21. PLEDGED ASSETS

- a. Time deposits of \$4,631,694 thousand and \$4,731,694 thousand as of December 31, 2005 and 2004, respectively, had been pledged mainly as collateral for bank overdraft, etc.
- b. The Corporation provided machinery and equipment with carrying values of \$2,723,469 thousand and \$2,991,337 thousand as of December 31, 2005 and 2004, respectively, as collaterals for long-term credit lines with banks.

22. COMMITMENTS AS OF DECEMBER 31, 2005

- a. The Corporation engaged in several construction contracts, under guarantees of \$1,279,282 thousand granted by The International Commercial Bank of China and Taipei Fubon Bank.
- b. Unused letters of credit amounted to \$10.6 billion.
- c. The Corporation sold its notes receivable of \$680,551 thousand to Chung Hsing Bills Finance Corporation (CHBFC) and also fully endorsed these receivables. To reduce its risk on this endorsement, the Corporation obtained credit risk insurance from an insurance company and also entered into an agreement with CHBFC to eliminate any loss on this credit risk.
- d. The Corporation has raw material purchase contracts with suppliers from Australia, India, Brazil, Canada, Indonesia, North Korea, Japan, Philippines, Russia, Vietnam and domestic companies with contract terms of 1 to 10 years. Contracted annual purchases of 8,600,000 metric tons of coal, 16,000,000 metric tons of iron ore, and 2,800,000 metric tons of limestone are at prices negotiable every year. Unpaid purchase amounts as of December 31, 2005 were \$83.2 billion (16,950,000 metric tons of coal; 19,720,000 metric tons of iron ore; and 300,000 metric tons of limestone).
- e. CHSC entered into one Syndicated Credit Facility Agreement with Chiao Tung Bank and 23 other Banks, the other Agreement with The International Commercial Bank of China and 19 other financial institutions. Under these agreements, the Corporation and its related parties should collectively hold at least 30% of CHSC's issued shares and have over half of CHSC's board seats as well as significant influence on its operations. As of December 31, 2005, the Corporation had total direct and indirect shareholdings in CHSC of 39% and two-thirds of the seats in the Board of Directors and influence on its operations.
- f. KRTC entered a Syndicated Credit Facility Agreement with the Taiwan Bank and 23 other Banks. Under this agreement, the Corporation and its subsidiaries should collectively hold at least 30% of KRTC's capital stock during the construction period. As of December 31, 2005, the Corporation's total equity in KRTC was 31%.

23. FINANCIAL INSTRUMENTS

For the years ended December 31, 2005 and 2004, the Corporation had no derivative transactions.

As of December 31, 2005 and 2004, the estimated fair values of nonderivative financial instruments were as follows:

	2005		2004	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Assets				
Cash and cash equivalents	\$ 13,239,481	\$ 13,239,481	\$ 26,402,765	\$ 26,402,765
Short-term investments	16,693,866	20,069,967	23,855,035	26,360,811
Notes receivable	1,641,032	1,641,032	1,711,335	1,711,335
Accounts receivable	2,034,629	2,034,629	2,062,163	2,062,163
Other receivable	546,006	546,006	226,180	226,180
Pledged time deposits	4,631,694	4,631,694	4,731,694	4,731,694
Long-term investments	65,881,813	71,261,909	50,631,972	56,403,837
Refundable deposits	346,830	346,830	73,793	73,793
Liabilities				
Short-term loans and overdraft	11,473,383	11,473,383	4,465,959	4,465,959
Commercial paper payable	1,499,376	1,499,376	1,799,052	1,799,052
Notes and accounts payable	2,336,407	2,336,407	3,086,340	3,086,340
Accrued expenses	7,159,512	7,159,512	7,015,299	7,015,299
Long-term bonds	10,000,000	10,034,101	15,000,000	15,880,323
Long-term bank debts	3,496,250	3,496,250	2,861,200	2,861,200

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

- 1) The carrying values of cash and cash equivalents, notes and accounts receivable, other receivables, pledged time deposits, short-term bank loans and overdraft, commercial paper payable, notes and accounts payable, accrued expenses and dividend payable approximate fair value because of the short maturities of these instruments.
- 2) The fair values of short-term investments and long-term investments are determined at market values or net asset values.
- 3) The fair values of long-term liabilities are determined by the present values of future cash flows, with the values discounted at the interest rates of similar long-term debts available for the Corporation.
- 4) The fair values of refundable deposits are determined at their carrying values.

CHINA STEEL CORPORATION
ADDITIONAL EXPLANATION FOR ACCOUNTS IN STOCKHOLDERS' EQUITY
YEARS ENDED DECEMBER 31, 2005 AND 2004

1. Adjustment of equity in investees due to change in percentage of ownership.

(1) Long-term investment adjustment

When an investee's capital surplus changes, the investor should adjust its long-term investment account and capital surplus account based on its stockholding percentage.

(2) Adjustment of equity in investees due to change in percentage of ownership

If an investee issues new shares and the original stockholders do not subscribe the new shares proportionately, then the investment percentage, e.g. the equity in the investee's net assets, will change. This change shall be reflected as an adjustment of the additional paid-in capital (capital surpluses) and the long-term investments accounts. If this adjustment is to reduce the additional paid-in capital resulting from long-term stock investments and its balance is insufficient, the difference should be adjusted to the unappropriated retained earnings.

2. Reversal of unrealized loss on investees' long-term investments

When the market value of cost-method investee's shares traded in the public market falls below carrying value, the decline is charged to unrealized loss on investees' long-term investments as a reduction of stockholder's equity. When the market value recovers, the unrealized loss will be reversed up to zero.

3. Investees' unrecognized net loss on pension cost

Unrecognized net loss on pension cost is the minimum pension liability exceeding the sum of unrecognized prior service cost and unrecognized transitional net benefit obligation. It is classified as a reduction of stockholders' equity.

Minimum pension liability, which is calculated actuarially, is the minimum amount of pension liability that is required to be recognized on the balance sheet.

Prior service cost is the increase in projected benefit obligation due to an employee's accumulation of service years at the initial introduction of pension data or the subsequent pension data amendment.

Unrecognized transitional net assets or benefit obligation means the amount resulting from a change from a method specified in Statement of Financial Accounting Standards No.18, "Accounting for Pensions." This amount is the difference between (a) the fair market value of plan assets plus accrued pension liability or less prepaid pension cost recognized previously in the books and (b) the projected benefit obligation. If the difference is positive, it is treated as unrecognized transition net assets; if the difference is negative, it is treated as unrecognized transition net benefit obligations.

4. Transfer of treasury stock to employees.

Treasury stock is transferred at the price which is determined at the purchase cost plus the Corporation financial cost up to the time that the transfer is made.

When treasury stocks are transferred, if the transfer price is higher than the book value, the difference should be credited to capital surplus. If the transfer price is lower than book value, the difference should first be offset against capital surplus from the same class of treasury stock transactions, and the remainder, if any, should be debited to unappropriated retained earnings.

5. Disposal of the Corporation's shares held by subsidiaries

A parent company should account for its outstanding stocks held by its subsidiary as treasury stocks when it recognizes investment income and prepares financial statements, and the accounting treatment is the same as that stated in item 4 above.

6. Cash dividends declared by the Corporation and received by subsidiaries

When an investor receives cash dividends from short-term investments or long-term cost-method investments from a year after investment acquisition, it records these dividends as investment income. But if the cash dividend is from the parent company, the accounting for these dividends is the same as that for treasury stock, i.e., the investment income should be credited to capital surplus when the parent company prepares financial statements.