

**TWINHEAD INTERNATIONAL CORP.**

**Financial Statements**

**December 31, 2007 and 2006  
(With Auditors' Report Thereon)**

**Address: 10F, 550 Rueiguang Road, Neihu, Taipei 114,  
Taiwan, R.O.C.**

## Independent Auditors' Report

The Board of Directors  
Twinhead International Corp.:

We have audited the accompanying balance sheets of Twinhead International Corp. (the Company) as of December 31, 2007 and 2006, and the related statements of earnings, 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 did not audit the financial statements of Gammatech Computer Corporation, Twinhead GmbH and Fiberlogic Inc. as of and for the years ended December 31, 2007 and 2006, the investments in which are reflected in the accompanying financial statements using the equity method. Those financial statements were audited by other auditors, whose reports have been furnished to us, and our opinion, in so far as it relates to the amounts included for Gammatech Computer Corporation, Twinhead GmbH and Fiberlogic Inc., is based solely on the reports of the other auditors. The investments in Gammatech Computer Corporation, Twinhead GmbH and Fiberlogic Inc. as of December 31, 2007 and 2006, amounted to \$87,277 thousand and \$83,367 thousand and represented 2.98% and 2.74%, respectively, of total assets, and the equity in their net gain amounted to \$11,085 thousand and \$23,265 thousand and represented 14.41% of income before income tax and 4.34% of loss before income tax for the years ended December 31, 2007 and 2006, respectively.

We conducted our audits in accordance with Republic of China generally accepted auditing standards and the Regulations Governing Auditing and Certification of Financial Statements by Certified Public Accountants. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. 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 and the reports of the other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and the reports of the other auditors, the financial statements referred to above present fairly, in all material respects, the financial position of Twinhead International Corp. 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 Regulations Governing Financial Reporting for Issuers of Stock Certificates, the related financial accounting standards of the "Business Entity Accounting Act" and of the "Regulation on Business Entity Accounting Handling", and Republic of China generally accepted accounting principles.

KPMG

April 3, 2008

The accompanying financial statements are intended only to present the financial position, results of operations and cash flows in accordance with the 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.

The auditors' report and the accompanying financial statements are the English translation of the Chinese version prepared and used in the Republic of China. If there is any conflict between, or any difference in the interpretation of, the English and Chinese language auditors' report and financial statements, the Chinese version shall prevail.

**TWINHEAD INTERNATIONAL CORP.**  
**Balance Sheets**  
**December 31, 2007 and 2006**  
(expressed in thousands of New Taiwan dollars)

Assets	2007 Amount	%	2006 Amount	%	Liabilities and Stockholders' Equity	2007 Amount	%	2006 Amount	%
<b>Current assets:</b>					<b>Current liabilities:</b>				
Cash and cash in banks (note 4)	\$ 651,614	22	484,219	16	Short-term borrowings (notes 9 and 16)	\$ 743,759	25	749,488	25
Notes receivable	35	-	33	-	Notes payable	1,651	-	2,687	-
Accounts receivable, net of allowance for doubtful accounts of \$5,862 and \$12,277 in 2007 and 2006, respectively (note 16)	408,173	14	692,016	23	Accounts payable	281,047	10	266,557	9
Accounts receivable—related parties (notes 6 and 15)	213,134	7	114,986	4	Other payables to related parties (note 15)	10,380	-	5,011	-
Other financial assets—current	2,025	-	13,159	-	Accrued expenses	97,850	3	237,254	8
Inventories (note 5)	215,549	7	210,640	7	Other notes payable (note 10)	22,500	1	-	-
Deferred income tax assets—current (note 12)	77,514	3	128,017	3	Deferred credit (notes 6 and 15)	27,456	1	41,274	1
Prepaid expenses and other current assets	15,537	1	80,426	3	Other current liabilities	33,960	1	67,695	2
	<u>1,583,581</u>	<u>54</u>	<u>1,723,496</u>	<u>56</u>		<u>1,218,603</u>	<u>41</u>	<u>1,369,966</u>	<u>45</u>
<b>Long-term equity investments (notes 6, 14 and 15):</b>					<b>Long term notes payable (note 10)</b>	<u>11,691</u>	<u>1</u>	<u>-</u>	<u>-</u>
Long-term investments under equity method	302,294	11	297,434	10	<b>Other liabilities:</b>				
Available-for-sale financial assets—noncurrent	4,053	-	5,581	-	Guarantee deposits received	2,655	-	2,396	-
Financial assets carried at cost—noncurrent	177,124	6	113,515	4	Other liabilities—other (note 6)	64,215	2	51,872	2
	<u>483,471</u>	<u>17</u>	<u>416,530</u>	<u>14</u>		<u>66,870</u>	<u>2</u>	<u>54,268</u>	<u>2</u>
<b>Property, plant and equipment, net (notes 7 and 16):</b>					<b>Total liabilities</b>	<u>1,297,164</u>	<u>44</u>	<u>1,424,234</u>	<u>47</u>
Cost:					<b>Stockholders' equity (notes 6, 12 and 13):</b>				
Land	118,424	4	118,424	4	Common stock, \$10 par value, 277,281 thousand shares issued and 700,000 thousand shares outstanding in both 2007 and 2006	2,772,809	95	2,772,809	91
Buildings and improvement	444,359	15	509,839	17	Convertible preferred stock, \$10 par value, 23 thousand shares issued and outstanding in both 2007 and 2006	228	-	228	-
Machinery and equipment	248,997	9	272,518	9		<u>2,773,037</u>	<u>95</u>	<u>2,773,037</u>	<u>91</u>
Transportation equipment	3,220	-	3,220	-	Paid-in capital in excess of par	263,663	9	859,439	28
Office equipment	150,410	5	143,738	5	Unappropriated retained earnings (accumulated deficit)	16,877	1	(595,776)	(20)
	965,410	33	1,047,739	35	Other items in stockholders' equity:				
Less: accumulated depreciation	600,075	21	606,899	20	Cumulative foreign currency translation adjustments	(28,083)	(1)	(26,942)	(1)
accumulated asset impairment	10,593	-	70,593	2	Unrealized loss on financial instrument	(466,403)	(16)	(464,626)	(15)
Prepayment for equipment	2,814	-	8,473	-		<u>(494,486)</u>	<u>(17)</u>	<u>(491,568)</u>	<u>(16)</u>
	<u>357,556</u>	<u>12</u>	<u>378,720</u>	<u>13</u>	Treasury stock	(926,869)	(32)	(926,869)	(30)
<b>Other assets:</b>					<b>Total stockholders' equity</b>	1,632,222	56	1,618,263	53
Assets leased to others (notes 8 and 16)	216,638	7	163,684	5	<b>Commitments and contingencies (notes 8, 13, 15, and 17)</b>				
Refundable deposits (note 17)	20,542	1	11,545	-					
Deferred charges	11,243	-	7,588	-					
Long-term account receivable from related parties, net of allowance for doubtful accounts of \$143,403 and \$138,541 in 2007 and 2006, respectively (notes 6 and 15)	124,958	4	138,533	5					
Deferred income tax assets—noncurrent (note 12)	131,397	5	140,894	5					
Other assets—others (note 11)	-	-	61,507	2					
	<u>504,778</u>	<u>17</u>	<u>523,751</u>	<u>17</u>					
<b>Total assets</b>	<u>\$ 2,929,386</u>	<u>100</u>	<u>3,042,497</u>	<u>100</u>	<b>Total liabilities and stockholders' equity</b>	<u>\$ 2,929,386</u>	<u>100</u>	<u>3,042,497</u>	<u>100</u>

See accompanying notes to financial statements.

**TWINHEAD INTERNATIONAL CORP.**

**Income Statements**

**For the years ended December 31, 2007 and 2006**  
(expressed in thousands of New Taiwan dollars)

	<b>2007</b>		<b>2006</b>	
	<b>Amount</b>	<b>%</b>	<b>Amount</b>	<b>%</b>
Sales revenue (note 15)	3,311,932	105	4,305,204	101
Less: Sales returns	170,956	5	46,627	1
Sales discounts	<u>4,207</u>	<u>-</u>	<u>4,029</u>	<u>-</u>
<b>Operating revenue</b>	<b>3,136,769</b>	<b>100</b>	<b>4,254,548</b>	<b>100</b>
<b>Cost of goods sold (notes 11, 15 and 18)</b>	<b><u>2,873,158</u></b>	<b><u>92</u></b>	<b><u>4,145,281</u></b>	<b><u>97</u></b>
<b>Gross profit</b>	<b>263,611</b>	<b>8</b>	<b>109,267</b>	<b>3</b>
Add: Realized gain on intercompany transactions	8,209	-	13,768	-
Less: Unrealized gain on intercompany transactions (note 15)	<u>(7,621)</u>	<u>-</u>	<u>(8,209)</u>	<u>-</u>
<b>Realized gross profit</b>	<b>264,199</b>	<b>8</b>	<b>114,826</b>	<b>3</b>
<b>Operating expenses (notes 11, 15 and 18)</b>	<b><u>378,937</u></b>	<b><u>12</u></b>	<b><u>451,768</u></b>	<b><u>10</u></b>
<b>Operating loss</b>	<b><u>(114,738)</u></b>	<b><u>(4)</u></b>	<b><u>(336,942)</u></b>	<b><u>(7)</u></b>
<b>Non-operating income and gain:</b>				
Interest income	14,149	-	12,536	-
Other investment gain, net (note 6)	13,230	-	21,142	1
Gain on disposal of investments (note 6)	-	-	16,325	-
Gain on reversal of impairment loss (note 7)	60,000	2	-	-
Gain on physical inventory	-	-	5	-
Gain on exchange, net	-	-	18,599	-
Gain from price recovery of inventory	1,694	-	-	-
Other income (notes 8 and 17)	<u>178,155</u>	<u>6</u>	<u>14,401</u>	<u>-</u>
	<u>267,228</u>	<u>8</u>	<u>83,008</u>	<u>1</u>
<b>Non-operating expense and loss:</b>				
Interest expenses	33,211	1	27,656	1
Investment loss recognized under equity method	23,276	1	116,263	3
Loss on disposal of fixed assets	159	-	3,569	-
Loss on physical inventory	6	-	-	-
Loss on exchange, net	4,589	-	-	-
Loss on inventory devaluation and obsolescence	-	-	50,745	1
Impairment loss (notes 6 and 7)	-	-	80,000	2
Other loss	<u>14,337</u>	<u>-</u>	<u>3,546</u>	<u>-</u>
	<u>75,578</u>	<u>2</u>	<u>281,779</u>	<u>7</u>
<b>Gain (loss) before income tax</b>	<b>76,912</b>	<b>2</b>	<b>(535,713)</b>	<b>(13)</b>
<b>Income tax expenses (note 12)</b>	<b><u>(60,035)</u></b>	<b><u>(2)</u></b>	<b><u>(60,063)</u></b>	<b><u>(1)</u></b>
<b>Net gain (loss)</b>	<b><u>\$ 16,877</u></b>	<b><u>-</u></b>	<b><u>(595,776)</u></b>	<b><u>(14)</u></b>
			<b>Before tax</b>	<b>After tax</b>
<b>Basic gain (loss) per share of common stock (note 2(p))</b>	<b><u>\$ 0.31</u></b>		<b><u>(2.16)</u></b>	<b><u>(2.41)</u></b>
<b>Diluted gain (loss) per share of common stock (note 2(p))</b>	<b><u>\$ 0.31</u></b>		<b><u>(2.16)</u></b>	<b><u>(2.41)</u></b>
Pro forma data, assuming the Company's shares held by its subsidiaries were not treated as treasury stock (note 2(p)):				
	<b>Before</b>	<b>Net of</b>	<b>Before</b>	<b>Net of</b>
	<b>income tax</b>	<b>income tax</b>	<b>income tax</b>	<b>income tax</b>
<b>Net gain (loss)</b>	<b><u>\$ 76,866</u></b>	<b><u>16,831</u></b>	<b><u>(535,759)</u></b>	<b><u>(595,882)</u></b>
<b>Basic gain (loss) per share of common stock</b>	<b><u>\$ 0.28</u></b>	<b><u>0.06</u></b>	<b><u>(1.93)</u></b>	<b><u>(2.15)</u></b>
<b>Diluted gain (loss) per share of common stock</b>	<b><u>\$ 0.28</u></b>	<b><u>0.06</u></b>	<b><u>(1.93)</u></b>	<b><u>(2.15)</u></b>

See accompanying notes to financial statements.

**TWINHEAD INTERNATIONAL CORP.**  
**Statements of Changes in Stockholders' Equity**  
**For the years ended December 31, 2007 and 2006**  
**(expressed in thousands of New Taiwan dollars)**

	Common stock	Convertible preferred stock	Capital surplus	Unappropriated retained earnings (accumulated deficit)	Cumulative foreign currency translation adjustments	Unrealized loss on financial instrument	Treasury stock	Total
<b>Balance as of January 1, 2006</b>	\$ 2,772,809	228	1,281,598	(422,159)	(24,830)	(456,769)	(926,839)	2,224,038
Capital surplus to offset accumulated deficits (note 13)	-	-	(422,159)	422,159	-	-	-	-
Net loss for 2006	-	-	-	(595,776)	-	-	-	(595,776)
Cumulative foreign currency translation adjustments	-	-	-	-	(2,112)	-	-	(2,112)
Unrealized loss on financial instrument (note 6)	-	-	-	-	-	(8,106)	-	(8,106)
Investees' unrealized gain on available-for-sale financial assets (note 6)	-	-	-	-	-	249	-	249
Transfer of the Company's shares held by its subsidiaries to treasury stock (note 6)	-	-	-	-	-	-	(30)	(30)
<b>Balance as of December 31, 2006</b>	<u>2,772,809</u>	<u>228</u>	<u>859,439</u>	<u>(595,776)</u>	<u>(26,942)</u>	<u>(464,626)</u>	<u>(926,869)</u>	<u>1,618,263</u>
Capital surplus to offset accumulated deficits (note 13)	-	-	(595,776)	595,776	-	-	-	-
Net income for 2007	-	-	-	16,877	-	-	-	16,877
Cumulative foreign currency translation adjustments	-	-	-	-	(1,141)	-	-	(1,141)
Unrealized loss on financial instrument (note 6)	-	-	-	-	-	(1,528)	-	(1,528)
Investees' unrealized gain on available-for-sale financial assets (note 6)	-	-	-	-	-	(249)	-	(249)
<b>Balance as of December 31, 2007</b>	<u><u>\$ 2,772,809</u></u>	<u><u>228</u></u>	<u><u>263,663</u></u>	<u><u>16,877</u></u>	<u><u>(28,083)</u></u>	<u><u>(466,403)</u></u>	<u><u>(926,869)</u></u>	<u><u>1,632,222</u></u>

See accompanying notes to financial statements.

**TWINHEAD INTERNATIONAL CORP.**  
**Statements of Cash Flows**  
**For the years ended December 31, 2007 and 2006**  
**(expressed in thousands of New Taiwan dollars)**

	2007	2006
<b>Cash flows from operating activities:</b>		
Net income (loss)	\$ 16,877	(595,776)
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	43,265	67,271
Loss on inventory devaluation and obsolescence (Gain from price recovery of inventory)	(1,694)	50,745
Recovery of doubtful accounts	(1,553)	(21,671)
Gain on disposal of investment	-	(16,325)
Investment gain under equity method	23,276	116,263
Gain on inter-company sales	(588)	(5,559)
Gain on other investment	(13,230)	(21,142)
Loss on disposal of fixed assets	159	3,569
Impairment loss (Gain on reversal of impairment loss)	(60,000)	80,000
Fixed assets transferred to expense	1,183	1,396
Deferred income tax expense	60,000	60,000
Decrease (increase) in notes and accounts receivable	221,785	(137,777)
Decrease (increase) in accounts receivable and long-term accounts receivable from related parties	(94,314)	109,829
Decrease (increase) in other receivables from related parties	(7,442)	12,685
Decrease (increase) in inventories	(3,214)	264,364
Decrease in other financial assets – current	11,134	3,161
Decrease (increase) in prepaid expenses and other current assets	64,888	(42,509)
Decrease in other assets – other	-	1,280
Increase (decrease) in notes and accounts payable	13,454	(172,700)
Decrease in accounts payable to related parties	-	(141,935)
Increase (decrease) in other payable to related parties	5,369	(2,024)
Increase (decrease) in accrued expenses and other current liabilities	(64,954)	79,755
Reversal of royalty payables	(95,799)	-
Reversal of estimated warranty liabilities	(12,386)	-
Net changes in prepaid pension cost	61,507	(1,911)
<b>Net cash provided by (used in) operating activities</b>	<u>167,723</u>	<u>(309,011)</u>
<b>Cash flows from investing activities:</b>		
Increase in long-term equity investments	-	(150,000)
Proceeds from disposal of long-term equity investment	-	94,911
Acquisition of fixed assets	(7,699)	(19,031)
Proceeds from disposal of fixed assets	226	80
Decrease (increase) in refundable deposits	(8,997)	160
Increase in deferred charges	(12,579)	(28,298)
<b>Net cash provided by investing activities</b>	<u>(29,049)</u>	<u>(102,178)</u>
<b>Cash flows from financing activities:</b>		
Increase (decrease) in short-term borrowings	(5,729)	61,818
Increase in other notes payable	34,191	-
Increase in guarantee deposits received	259	344
<b>Net cash provided by financing activities</b>	<u>28,721</u>	<u>62,162</u>
<b>Net increase (decrease) in cash and cash in bank</b>	167,395	(349,027)
<b>Cash and cash in bank at beginning of year</b>	<u>484,219</u>	<u>833,246</u>
<b>Cash and cash in bank at end of year</b>	<u>\$ 651,614</u>	<u>484,219</u>
<b>Supplementary disclosures of cash flow information:</b>		
Interest paid	<u>\$ 32,894</u>	<u>27,459</u>
Income tax paid	<u>\$ 1,403</u>	<u>(1,964)</u>
<b>Investing activities not affecting cash flows:</b>		
Cumulative foreign currency translation adjustments	<u>\$ (1,141)</u>	<u>(2,112)</u>
Long-term investment loss in excess of investment cost offset against receivables from related parties	<u>\$ 17,183</u>	<u>(48,338)</u>
Long-term investment transferred to treasury stock	<u>\$ -</u>	<u>30</u>
Unrealized loss on financial instrument	<u>\$ (1,777)</u>	<u>(7,857)</u>
Long-term accounts receivable transferred to financial assets carried at cost – noncurrent	<u>\$ 63,609</u>	<u>-</u>
<b>Proceeds from liquidation of long-term investments:</b>		
<b>Acquisition of fixed assets:</b>		
Acquisition of fixed assets	\$ 7,699	18,466
Accrued payables on equipment at the beginning of the year	-	565
	<u>\$ 7,699</u>	<u>19,031</u>

See accompanying notes to financial statements.

## **TWINHEAD INTERNATIONAL CORP.**

### **Notes to Financial Statements**

**December 31, 2007 and 2006**

**(expressed in thousands of New Taiwan dollars, unless otherwise stated)**

#### **(1) Organization**

Twinhead International Corp. (the Company) was incorporated on February 27, 1984, as a company limited by shares under the laws of the Republic of China (ROC). The shares of the Company are traded on the Taiwan Stock Exchange. The Company is engaged in the design, manufacture, sale and development of computers, computer components, peripherals, software, ASIC chips and workstations, and operation of telecommunication-related business.

As of December 31, 2007 and 2006, the number of the Company's employees were 320 and 340, respectively.

#### **(2) Summary of Significant Accounting Policies**

The financial statements are the English translation of the Chinese version prepared and used in the Republic of China. If there is any conflict between, or any difference in the interpretation of, the English and Chinese language financial statements, the Chinese version shall prevail.

The Company prepared the accompanying financial statements in accordance with the Regulations Governing Financial Reporting for Issuers of stock certificates, the "Business Entity Accounting Act", the "Regulation on Business Entity Accounting Handling", and ROC generally accepted accounting principles. Unless specified otherwise, the preparation of the financial statements is based on historical cost. A summary of significant accounting policies and valuations is as follows:

##### **(a) Accounting estimates**

The Company made accounting estimates, valuations and assumptions that affect the reported amounts of assets, liabilities, revenues, expenses and contingencies. These estimates were disclosed and evaluated by the Company. However, the actual results could differ from these estimates.

##### **(b) Principles of classifying assets and liabilities as current and non-current**

Cash or cash equivalents that are not restricted in use, assets held for the purpose of trading, and assets that will be held short-term and are expected to be converted to cash within 12 months of the balance sheet date are listed as current assets; otherwise, they are listed as non-current assets.

Liabilities that must be fully liquidated within 12 months after the balance sheet date are listed as current liabilities; otherwise, they are listed as non-current liabilities.

##### **(c) Foreign currency transactions and translation of foreign financial statements**

The Company maintains its books in New Taiwan dollars. Foreign currency transactions are recorded at exchange rates prevailing on the transaction dates. All assets and liabilities denominated in foreign currencies are translated at the exchange rates on the balance sheet date. The realized and unrealized exchange gain or loss on settlement of foreign currency-denominated assets and liabilities and adjustments to such assets and liabilities are recorded as non-operating income or expense.

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**TWINHEAD INTERNATIONAL CORP.****Notes to Financial Statements**

The financial statements of the Company's foreign subsidiaries are measured by using the local currency as the functional currency. Foreign currency financial statements are translated into New Taiwan dollars according to the following principles:

- i) Assets and liabilities are translated at the current exchange rate prevailing at the balance sheet date.
- ii) Stockholders' equity is translated at the historical rate, with the exception that the beginning retained earnings in New Taiwan dollars are brought forward. Dividends are translated at the exchange rate on the declaration date.
- iii) Income statement accounts are translated at the average exchange rate of the year involved.

The resulting translation differences are accounted for as translation adjustments and are included in the financial statements as a component of stockholders' equity.

(d) Allowance for doubtful accounts

Allowance for doubtful accounts is based on the age of the accounts, and the collectibility of individual accounts.

(e) Inventories

Inventories are stated at the aggregate lower of cost or market value. Cost is determined by using the weighted-average method. Market value is determined by the replacement cost for raw materials and net realizable value for finished goods and work in process.

(f) Long-term equity investments

i) Long-term investment under equity method

Long-term equity investments are accounted for by the equity method when the Company owns 20% or more of an investee's voting stock or less than 20% of an investee's voting stock but is able to exercise significant influence over the investee's operating and financial policies. Unrealized gains or losses from inter-company transactions are deferred, and deferred credit or debit and unrealized gain or loss are adjusted accordingly. Unrealized gains or losses resulting from depreciable or amortizable assets are deferred and amortized over the estimated useful lives of the assets concerned. Unrealized gains or losses from other assets are recognized when realized.

Effective January 1, 2006, the difference between the acquisition cost of an investment and the underlying equity of the investee is accounted for according to the newly revised R.O.C. SFAS No. 5 "Long-term Investments under Equity Method". Differences generated from depreciation, amortization, or amortizable assets are amortized over the estimated remaining years since the acquisition year. When the differences are generated from the book value over or under the fair value of the net assets, the unamortized amounts are written off at once when the fair value is equal to the book value. Goodwill is recognized when the acquisition cost of an investment is higher than the fair value of the identifiable assets. On the contrary, when the fair value of identifiable assets is higher than the acquisition cost of an investment, the difference will initially be credited to non-current assets on a pro rata basis. If there are still differences after all non-current assets are credited, the residual amount would be recorded as extraordinary gain or loss.

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**TWINHEAD INTERNATIONAL CORP.****Notes to Financial Statements**

When an investee incurs losses which result in a credit balance of the long-term investment accounted for under equity method, if the Company is able to exercise significant influence over the investee, losses exceeding the original equity in the investee are recognized by the Company in full, unless the minority shareholders have obligations to bear the loss incurred.

The long-term investment under the equity method will be credited first when recognizing investment losses, and remaining losses exceeding such investment, if any, will be credited to accounts receivable from the investee. However, if the accounts receivable are still insufficient to cover the excess, the long-term investment under the equity method should be credited for the remaining amount and recorded under other liabilities.

Consolidated financial statements for the half-year and the year are prepared, and the consolidation entities include all investees over which the Company may exercise significant influence.

ii) Financial assets carried at cost

Financial assets under cost method refer to investments in non-listed companies in which the Company has no control or significant influence over the investee. They are recognized at acquisition cost, as measurement of their fair value is difficult. If any objective evidence exists suggesting impairment loss, this loss shall not be reversed. The stock dividends issued by investees shall be treated as an increase in shares instead of investment gain. Cost upon sale of long-term investments under the cost method is determined using the weighted-average method.

iii) Available-for-sale financial assets

The Company adopted SFAS No. 34 "Financial Instruments: Recognition and Measurement". Financial instrument transactions are recognized on the date of transaction. Available-for-sale financial assets are investment in stocks of listed companies and are recognized at fair value plus transaction cost.

Available-for-sale financial assets are subsequently recognized at fair value, and the difference between the carrying value and fair value is recognized as a separate component of stockholders' equity as "unrealized loss on financial instrument". The fair value of listed stocks is the net closing price on the balance sheet date. Any objective evidence suggesting impairment is recognized as impairment loss. If any subsequent event should cause the impairment loss to decrease, the amount is to be reversed and recognized in the income statements.

(g) Fixed assets and related depreciation

Fixed assets are stated at cost. Major additions, betterments and replacements are capitalized. Interest on loans incurred in connection with the construction of the plant or the acquisition of equipment is capitalized as part of the cost of the respective assets. Except for land, depreciation is provided over the estimated useful lives of the respective assets using the straight-line method. For an asset reaching its original estimated useful life that continues to be used, depreciation is provided, based on its residual value, over the additional estimated useful life using the straight-line method. The estimated useful lives of plant and equipment are as follows:

Buildings and improvement	5~61 years
Machinery and equipment	2~15 years
Transportation equipment	5 years
Office equipment	2~8 years

(Continued)

**TWINHEAD INTERNATIONAL CORP.****Notes to Financial Statements**

## (h) Assets leased to others

Assets leased to others are stated at cost, and depreciation is provided over 5~61 years using the straight-line method and included in non-operating expenses.

## (i) Deferred charges

Purchases of molds, test expenses and office decoration are amortized using the straight-line method over 1 to 5 years.

## (j) Asset impairment

The Company adopted Statement of Financial Accounting Standards No. 35 (SFAS 35) "Impairment of Assets". In accordance with SFAS 35, the Company assesses at each balance sheet date whether there is any indication that an asset other than goodwill (individual asset or cash-generating unit) may have been impaired. If any such indication exists, the Company estimates the recoverable amount of the asset. The Company recognizes impairment loss for an asset whose carrying value is higher than the recoverable amount.

An impairment loss recognized in prior periods is reversed for assets other than goodwill if there is any indication that the impairment loss recognized no longer exists or has decreased. The carrying value after the reversal should not exceed the recoverable amount or the depreciated or amortized balance of the assets assuming no impairment loss was recognized in prior periods.

## (k) Retirement plan

The original employee retirement plan of the Company was established in accordance with the Labor Standards Law. The Company made monthly contributions to the pension fund at a rate prescribed by the Labor Standards Law.

Starting July 1, 2005, the Labor Pension Act (the "New Act") came into effect. On August 31, 2007, the Company settled its vested benefit obligation with employees transferred to be subject to the defined contribution plan under this New Act. According to this New Act, an employer is required to contribute monthly to an individual labor pension fund account at the rate of not less than 6% of the employee's monthly wages.

The Company has adopted the provisions of Statement of Financial Accounting Standards (SFAS) No. 18, "Accounting for Pensions". The end of each fiscal year is used as the measurement date for the actuarial assessment. The amount of the accumulated benefit obligation exceeding pension plan assets is recognized as a minimum pension liability on the balance sheet date. Furthermore, the Company recognizes net periodic pension cost, including service cost, transition assets, prior service cost, and gain or loss on the pension plan, which is amortized over employees' remaining service years. Prior to (including) 2006, the Company contributed 2% of salaries and wages paid in accordance with the requirements of the R.O.C. Labor Standards Law, and deposited it in Bank of Taiwan (originally the Central Trust of China) each month. The settlement gain or loss resulting from settling its vested benefit obligation was recognized as net periodic pension cost.

In accordance with the New System, the rate of contribution by an employer to an individual pension fund account per month shall not be less than 6% of the employee's monthly wages. The contributions are expensed as incurred.

**TWINHEAD INTERNATIONAL CORP.****Notes to Financial Statements**

## (l) Provision for product warranties

Provision for product warranties is determined by estimating after-sales service cost based on past experience and recognized as operating expense at the time of sales.

## (m) Revenue recognition

Revenue from sale of goods is recognized when the significant risks and rewards of ownership have been transferred; cost of goods sold is recognized when related revenue is recognized.

## (n) Treasury stock

In accordance with Statement of Financial Accounting Standards (SFAS) No. 30, "Accounting for Treasury Stock", the Company uses the cost method to account for treasury stock. Under the cost method, the treasury stock account is debited for the cost of the Company's shares purchased. When the disposal price of treasury stock is greater than the cost, the difference is credited to capital surplus—treasury stock; otherwise, the excess of the cost over the price is debited to capital surplus generated from other treasury stock transactions. If the capital surplus—treasury stock account is insufficient to cover the excess of the cost over the price, retained earnings should be debited for the remaining amount. The book value of each share of treasury stock is equal to its weighted-average cost and is calculated by each group according to the reason for purchase.

When treasury stock is retired, capital surplus and common stock are debited according to the ratio of retiring treasury stock to total issued stock. When the book value of the retiring treasury stock is higher than the sum of its par value and capital surplus, the difference is debited to capital surplus—treasury stock. If the capital surplus—treasury stock account is insufficient to cover the difference, retained earnings should be debited for the remaining amount. When the book value of the retiring treasury stock is lower than the sum of its par value and capital surplus, the difference is credited to capital surplus—treasury stock.

In accordance with the regulations of the Securities and Futures Commission, ROC Ministry of Finance (SFC), starting from January 1, 2002, the Company adopted the provisions of SFAS No. 30, "Accounting for Treasury Stock". As a result, a subsidiary's shareholding of the parent company will be recorded as treasury stock with no retroactive adjustment needed when recognizing gain (loss) on investment or issuing financial statements.

## (o) Income tax

In accordance with Statement of Financial Accounting Standard (SFAS) No. 22 "Income Taxes", deferred income tax is determined based on temporary differences between the financial reporting and tax basis of assets and liabilities, and is measured by applying the effective tax rates for the taxable years in which the differences are expected to be reversed. Deferred tax liabilities are recognized for the future tax consequences attributable to taxable temporary differences. Deferred tax assets are recognized for the future tax consequences attributable to deductible temporary differences and investment tax credits, with the measurement of deferred tax assets being reduced by estimated amounts of tax benefits not likely to be realized. Deferred tax assets and liabilities should be classified as current or noncurrent based on the classification of the related asset or liability for financial reporting. Deferred tax assets or liabilities that are not related to an asset or liability for financial reporting should be classified according to the expected reversal date of the temporary differences.

## TWINHEAD INTERNATIONAL CORP.

## Notes to Financial Statements

Income tax credits due to purchase of equipment, technical know-how, research and development, and employees' training are recognized in the current period.

The 10% income tax surtax on unappropriated earnings is recorded as expense on the date the stockholders decide the distribution of earnings.

The "Income Basic Tax Act" was promulgated and became effective in 2006. In accordance with the act, if the amount of alternative minimum tax is greater than the income tax payable pursuant to the Income Tax Act, the difference should be recognized as current income tax expenses. 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 IBTA on its current tax liabilities.

(p) Gain (loss) per share of common stock

The Company has a complex capital structure. According to the regulations, the basic gain (loss) per share is therefore computed and diluted. The basic gain (loss) per share is calculated by dividing net gain (loss) adjusted after issuing preferred stock dividends by the weighted-average number of shares outstanding. An increase in number of shares outstanding due to an employee stock option plan shall be added to the shares outstanding retroactively. The increase in capital due to an employee stock option plan shall be recalculated retroactively if the effective date is before the issuing date of the financial statements. The diluted gain (loss) per share is calculated using the same method as that for the basic gain (loss) per share; moreover, the effect of potential dilutive common stock shall also be included.

As of December 31, 2007 and 2006, the weighted-average number of shares outstanding was 247,653 thousand shares. As of December 31, 2007 and 2006, if the shares of the Company's stock held by the subsidiaries were not treated as treasury stock, the weighted-average number of shares outstanding would be 277,281 thousand shares.

The basic and diluted gain (loss) per share were computed as follows:

	2007		2006	
	Before income tax	After income tax	Before income tax	After income tax
Net gain (loss) (less preferred stock dividend of 46 thousand dollars)	\$ <u>76,866</u>	<u>16,831</u>	<u>(535,759)</u>	<u>(595,822)</u>
Weighted-average number of shares outstanding (thousands of shares)	<u>247,653</u>	<u>247,653</u>	<u>247,653</u>	<u>247,653</u>
Basic and diluted gain (loss) per share (dollars)	\$ <u>0.31</u>	<u>0.07</u>	<u>(2.16)</u>	<u>(2.41)</u>

With their anti-dilutive effect, the Company's preferred stock issued was not included in the weighted-average number of shares outstanding for the calculation of diluted gain (loss) per share.

(3) Reason for and Effect of Accounting Changes

Effective January 1, 2007, the Company adopted ROC SFAS No. 37 "Intangible Assets". The abovementioned changes in accounting policies did not affect the financial statements.

(Continued)

**TWINHEAD INTERNATIONAL CORP.**

**Notes to Financial Statements**

Effective January 1, 2006, the Company adopted ROC SFAS No. 34 "Financial Instruments: Recognition and Measurement" and SFAS No. 36 "Financial Instruments: Disclosure and Presentation" to account for financial instruments. The Company reclassified the financial assets, which were long-term equity investment originally recorded under the lower-of-cost-or-market-value method, according to the purposes for holding, and recognized the financial instruments at fair value. The effect of the abovementioned changes in accounting policies is not significant to the financial statements.

**(4) Cash and Cash in Bank**

As of December 31, 2007 and 2006, the components of cash were as follows:

	<b>2007</b>	<b>2006</b>
Petty cash	\$ 160	160
Savings accounts	651,454	434,279
Time deposits	-	49,780
	<u>\$ 651,614</u>	<u>484,219</u>

**(5) Inventories**

As of December 31, 2007 and 2006, the details of inventories were as follows:

	<b>2007</b>	<b>2006</b>
Finished goods	\$ 41,039	64,394
Work in process	4,034	15,264
Raw material and supplies	<u>345,306</u>	<u>444,250</u>
	390,379	523,908
Less: provision for decline in market value	<u>174,830</u>	<u>313,268</u>
	<u>\$ 215,549</u>	<u>210,640</u>

(Continued)

**TWINHEAD INTERNATIONAL CORP.**  
**Notes to Financial Statements**

**(6) Long-term Equity Investments**

(a) As of December 31, 2007 and 2006, the details were as follows

		<b>2007</b>		
	<b>Percentage of ownership</b>	<b>Investment cost</b>	<b>Book value</b>	<b>Contra of long-term investment recorded under other liabilities</b>
Under equity method:				
Gammatech Computer Corporation	45.000	\$ 29,391	62,097	-
Twinhead GmbH	100.000	169,266	-	-
Twinhead (Asia) Pte. Ltd.	100.000	533,550	183,301	-
Lun Yang Technology Co., Ltd.	99.983	867,850	-	64,215
Lun Shiang Technology Co., Ltd.	99.969	325,900	2,818	-
Yu Feng Technology Co., Ltd.	99.975	397,900	28,898	-
Fiberlogic Inc.	16.260	<u>32,527</u>	<u>25,180</u>	-
		<u>2,356,384</u>	<u>302,294</u>	<u>64,215</u>
Financial assets carried at cost – noncurrent:				
EUROC Venture Capital Corp.	10.000	80,000	80,000	-
II. Com	2.149	30,800	30,800	-
Trigem Computer, Inc.	0.004	63,609	63,609	-
Printec Japan Co., Ltd.	9.000	<u>2,715</u>	<u>2,715</u>	-
		<u>177,124</u>	<u>177,124</u>	-
Available-for-sale financial assets – noncurrent:				
Tekom Technologies Inc.	2.010	26,296	26,296	-
Less: unrealized loss on financial instrument		-	22,243	-
		<u>26,296</u>	<u>4,053</u>	-
		<u>\$ 2,559,804</u>	<u>483,471</u>	<u>64,215</u>

(Continued)

## TWINHEAD INTERNATIONAL CORP.

## Notes to Financial Statements

		2006		
	Percentage of ownership	Investment cost	Book value	Contra of long-term investment recorded under other liabilities
Under equity method:				
Gammatech Computer Corporation	45.000	\$ 29,391	59,300	-
Twinhead GmbH	100.000	169,266	-	-
Twinhead (Asia) Pte. Ltd.	100.000	533,550	183,094	-
Lun Yang Technology Co., Ltd.	99.983	867,850	-	51,872
Lun Shiang Technology Co., Ltd.	99.969	325,900	2,921	-
Yu Feng Technology Co., Ltd.	99.975	397,900	28,052	-
Fiberlogic Inc.	16.260	<u>32,527</u>	<u>24,067</u>	-
		<u>2,356,384</u>	<u>297,434</u>	<u>51,872</u>
Financial assets carried at cost – noncurrent:				
EUROC Venture Capital Corp.	10.000	80,000	80,000	-
II. Com	2.176	30,800	30,800	-
Printec Japan Co., Ltd.	9.000	<u>2,715</u>	<u>2,715</u>	-
		<u>113,515</u>	<u>113,515</u>	-
Available-for-sale financial assets – noncurrent:				
Tekom Technologies Inc.	2.699	26,296	26,296	-
Less: unrealized loss on financial instrument		-	20,715	-
		<u>26,296</u>	<u>5,581</u>	-
		<u>\$ 2,496,195</u>	<u>416,530</u>	<u>51,872</u>

In the fourth quarter of 2007, because Trigem Computer, Inc. modified its organization restructuring plan, the Company converted its debts from Trigem Computer, Inc. to common stock of Trigem Computer, Inc., which was approved by the Korean court. Therefore, the Company converted its long-term receivables amounting to \$63,609 to financial assets carried at cost – noncurrent.

(Continued)

## TWINHEAD INTERNATIONAL CORP.

## Notes to Financial Statements

In 2006, the Company sold part of its holding of shares of Gammatech Computer Corporation to Lun Yang Technology Co., Ltd. and Yu Feng Technology Co., Ltd. Please refer to note 15(b)(vii).

In the fourth quarter of 2006, the Company sold all its shares of common stock of Printech International Corp., and the proceeds from the sale were \$697. Therefore, the Company reversed its long-term investment offset of \$38,076, notes receivable of \$79,039, accounts receivable of \$898, and allowance for doubtful accounts—accounts receivable of \$60,000. The investment loss in 2006 amounted to \$3,990, and the gain on disposal of long-term investment after recognizing the investment loss amounted to \$18,836, which is recorded in gain on disposal of investments, net, in the accompanying income statements.

In 2006, the Company sold 625 thousand shares of common stock of Perfect Source Technology Corp., and the proceeds from the sale were \$3,739. The resulting loss amounted to \$2,511 and was recorded in gain on disposal on investments, net, in the accompanying income statements.

In 2006, the carrying value of the Company's investments in Asia Pacific Broadband Telecom Co. Ltd., accounted for as financial assets carried at cost amounting to \$50,000, was recognized as impairment loss after evaluating its operating situation and net value of equity.

The Company's accumulated investment loss recognized in excess of investment cost would be offset against receivables from related parties, other receivables from related parties, and long-term receivables from related parties. Due to the capital increase and collection of other receivables, the increase in offset amounted to \$17,183 in 2007; the decrease in offset amounted to \$48,338 in 2006.

In 2002, the Company invested in Twinhead Kunshan Technology Ltd. through Twinhead (Asia) Pte. Ltd. by machinery, equipment and inventories. As of December 31, 2007 and 2006, the values of the above machinery, equipment and inventories, as examined by the local certified agent, were equivalent to \$200,689. The difference resulting from the above investment and underlying equity in net assets was amortized in the amount of \$13,230 in 2007 and \$21,142 in 2006, and was recorded as other investment loss contra accounts in the accompanying income statements. As of December 31, 2007 and 2006, the unamortized amount was \$4,794 and \$18,024, respectively, and was recorded as deferred credits.

A subsidiary's shareholding of the parent company will be recorded as treasury stock to decrease long-term investment and increase treasury stock. The details are as follows:

	2007	2006
Lun Yang Technology Co., Ltd.	\$ 820,924	820,924
Lun Shaing Technology Co., Ltd.	55,144	55,144
Yu Feng Technology Co., Ltd.	<u>50,801</u>	<u>50,801</u>
Total	<u>\$ 926,869</u>	<u>926,869</u>

## (b) Unrealized loss on financial instrument

Since 2006, the Company has adopted ROC SFAS No. 34 "Financial Instruments: Recognition and Measurement". Unrealized loss on devaluation of its investments in Tekom Technologies Inc. was \$22,243 in 2007 and \$20,715 in 2006, and was recorded as unrealized loss on financial instrument under stockholders' equity.

(Continued)

## TWINHEAD INTERNATIONAL CORP.

## Notes to Financial Statements

As of December 31, 2007 and 2006, the Company recognized, on a pro rata basis, unrealized gain on the available-for-sale financial assets held by investees accounted for under the equity method amounting to \$0 and \$249, respectively.

In 2007 and 2006, the Company recognized, on a pro rata basis, unrealized loss on valuation of a subsidiary's financial instrument investments in the parent company of \$47,394 and unrealized gain of \$42,359, respectively. The ending balance of unrealized loss on devaluation of financial instrument investments was \$729,278 and \$681,884, respectively.

In accordance with the regulations of the SFC, starting from January 1, 2002, a subsidiary's shareholding of the parent company will be recorded as treasury stock. As of December 31, 2007 and 2006, unrealized loss on devaluation of long-term equity investments was \$444,160, and was recorded as a reduction of stockholders' equity.

- (c) The movements of unrealized loss on available-for-sale financial assets in 2007 and 2006 are listed below:

	2007	2006
Beginning balance	\$ 20,715	-
Add: effect of first-time adoption	-	12,609
unrealized loss recognized this year	<u>1,528</u>	<u>8,106</u>
Ending balance	<u>\$ 22,243</u>	<u>20,715</u>

**(7) Fixed Assets**

As of December 31, 2007 and 2006, the accumulated asset impairment amounted to \$10,593 and \$70,593, respectively. The above loss was recognized based on the carrying value of the factory building at Da Fa Industrial exceeding its estimated recoverable amount. The gain on reversal of impairment loss and the impairment loss recognized on December 31, 2007 and 2006, amounted to \$60,000 and \$30,000, respectively. The discount rates in use were 14.67% and 14.38%, respectively.

**(8) Assets Leased to Others**

	2007	2006
Land	\$ 95,830	95,830
Building	<u>151,559</u>	<u>87,010</u>
	247,389	182,840
Less: accumulated depreciation	<u>30,751</u>	<u>19,156</u>
	<u>\$ 216,638</u>	<u>163,684</u>

The major terms of the lease contracts are as follows:

- (a) The contract period is 1 to 6 years.
- (b) The lessee has usage rights during the leasehold period. The leased assets cannot be lent to others, sub-leased, or used by others.

(Continued)

## TWINHEAD INTERNATIONAL CORP.

## Notes to Financial Statements

In 2007 and 2006, the total rental revenues amounted to \$15,766 and \$12,279, respectively, and were recorded as other income. The lease revenues for subsequent years are as follows:

Period	Amount
2008	\$ 16,521
2009	9,274
2010	6,056
2011	<u>2,255</u>
	<u><u>\$ 34,106</u></u>

**(9) Short-term Bank Borrowings**

	2007	2006
Credit loan	\$ 100,000	-
Secured bank loans	421,000	434,500
Usance letters of credit	<u>222,759</u>	<u>314,988</u>
	<u><u>\$ 743,759</u></u>	<u><u>749,488</u></u>

Annual interest rates on short-term borrowings were 1.4191%~6.7231% and 2.00%~7.027% in 2007 and 2006, respectively. The aforementioned loans were due within 365 days.

As of December 31, 2007 and 2006, unused credit lines amounted to approximately \$447,682 and \$416,272, respectively.

**(10) Long-term Notes Payable**

The Company has recognized long-term notes payable generated from sales with buy-back agreement with Chailease Finance Co., Ltd. The details are as follows:

Financing institution	Description	Period	Repayment term	Interest rate (%)	2007	2006
Chailease Finance Co., Ltd.	Medium- to long-term operating funds	2007.7.1~2009.6.30	Monthly interest and principal repayable	4.953 in 2007	\$ 35,586	-
	Less: Discount on notes payable				<u>1,395</u>	<u>-</u>
					34,191	-
	Less: current portion				<u>22,500</u>	<u>-</u>
					<u><u>\$ 11,691</u></u>	<u><u>-</u></u>

As of December 31, 2007, the repayment schedule for long-term notes payable was as follows:

Period	Amount
2008	\$ 22,500
2009	<u>11,691</u>
	<u><u>\$ 34,191</u></u>

(Continued)

## TWINHEAD INTERNATIONAL CORP.

## Notes to Financial Statements

## (11) Pension

On August 31, 2007, the Company settled its vested benefit obligation with its employees, and those employees began to be subject to the defined contribution plan under the New Act. The measurement date of actuarial assessments was December 31, 2006. The reconciliation between funded status and accrued pension liabilities as of December 31, 2006, was as follows:

	<b>2006</b>
Benefit obligation:	
Vested benefit obligation	\$ 11,040
Non-vested benefit obligation	<u>35,305</u>
Accumulated benefit obligation	46,345
Additional benefits based on future salaries	<u>22,188</u>
Projected benefit obligation	68,533
Fair value of plan assets	<u>(133,244)</u>
Funded status	(64,711)
Unrecognized amortization of net transition obligation	(798)
Unrecognized pension loss	<u>4,002</u>
Prepaid pension cost	<u><u>\$ (61,507)</u></u>
Vested benefit	<u><u>\$ (11,040)</u></u>

The components of net periodic pension income for the years ended December 31, 2006, were as follows:

	<b>2006</b>
Service cost	\$ 911
Interest cost	1,730
Actual return on plan assets	(3,344)
Net amortization	<u>(1,208)</u>
Net periodic pension income	<u><u>\$ (1,911)</u></u>

The actuarial assumptions used in accounting for the retirement plan as of December 31, 2006, were as follows:

	<b>2006</b>
Discount rate	2.50 %
Rate of increase in compensation	3.00 %
Expected long-term rate of return on plan assets	2.50 %

In 2007, the Company incurred pension expense amounting to \$1,029 resulting from settling its vested benefit obligation with its employees.

The Company incurred pension expense under the defined contribution plan for 2007 and 2006 of \$10,907 and \$10,478, respectively.

(Continued)

## TWINHEAD INTERNATIONAL CORP.

## Notes to Financial Statements

## (12) Income Tax

The maximum statutory income tax rate applicable to the Company is 25%. Effective January 1, 2006, the Income Basic Tax Act has been applied to the calculation of the Company's income tax. The components of income tax expense for the years ended December 31, 2007 and 2006, were as follows:

	2007	2006
Current income tax expense	\$ (35)	(63)
Deferred income tax expense	<u>(60,000)</u>	<u>(60,000)</u>
Income tax expense	<u><u>\$ (60,035)</u></u>	<u><u>(60,063)</u></u>

The differences between "expected" income tax at the statutory income tax rate and estimated income tax as reported in the accompanying financial statements for years 2007 and 2006 were as follows:

	2007	2006
"Expected" income tax expense (benefit)	\$ (19,228)	133,928
Nondeductible expenses	(2,805)	-
Loss from long-term investments	(5,819)	(23,780)
Gain on disposal of domestic investments	-	4,081
Loss carryforwards expired	(74,846)	(160,032)
Investment tax credits expired	(29,299)	(26,128)
Security transaction gain and separately taxed interest income	(35)	(63)
Underestimate of prior year's investments tax credits	26,640	31,809
Underestimate (Overestimate) of prior year's loss carryforwards	(27,580)	166,055
Overestimate of prior year's deferred income tax	(44,520)	-
Others	3,308	(21,173)
Valuation allowance—deferred income tax assets	<u>114,149</u>	<u>(164,760)</u>
Income tax expense	<u><u>\$ (60,035)</u></u>	<u><u>(60,063)</u></u>

(Continued)

## TWINHEAD INTERNATIONAL CORP.

## Notes to Financial Statements

The components of deferred income tax benefit (expense) for the years ended December 31, 2007 and 2006, were as follows:

	2007	2006
Loss carryforwards	\$ (119,184)	75,075
Investment tax credits	(2,660)	5,681
(Reversal of) reserve for inventory loss	(34,610)	6,317
Pension	15,377	(478)
Unrealized gain on sales to related parties	(147)	(1,390)
Unrealized foreign exchange loss (gain)	(18,471)	18,213
Allowance for repairs and maintenance reserve	(4,172)	1,099
Allowance for doubtful account	(10,282)	243
Valuation allowance — deferred income tax assets	<u>114,149</u>	<u>(164,760)</u>
	<u><u>\$ (60,000)</u></u>	<u><u>(60,000)</u></u>

As of December 31, 2007 and 2006, deferred income tax assets (liabilities) were as follows:

	2007	2006
Current:		
Deferred income tax assets	\$ 248,533	262,716
Valuation allowance	<u>(158,536)</u>	<u>(134,699)</u>
Net deferred income tax assets	89,997	128,017
Deferred income tax liabilities	<u>(12,483)</u>	<u>-</u>
Net deferred income tax assets — current	<u><u>\$ 77,514</u></u>	<u><u>128,017</u></u>
Noncurrent:		
Deferred income tax assets	\$ 294,113	456,973
Valuation allowance	<u>(162,716)</u>	<u>(300,702)</u>
Net deferred income tax assets	131,397	156,271
Deferred income tax liabilities	<u>-</u>	<u>(15,377)</u>
Net deferred income tax assets — noncurrent	<u><u>\$ 131,397</u></u>	<u><u>140,894</u></u>
Total deferred income tax assets	<u><u>\$ 542,646</u></u>	<u><u>719,689</u></u>
Total deferred income tax liabilities	<u><u>\$ 12,483</u></u>	<u><u>15,377</u></u>
Total valuation allowance for deferred income tax assets	<u><u>\$ 321,252</u></u>	<u><u>435,401</u></u>

(Continued)

## TWINHEAD INTERNATIONAL CORP.

## Notes to Financial Statements

As of December 31, 2007 and 2006, the temporary differences, loss carryforwards, tax credits and respective tax effects related to the deferred income tax assets (liabilities) were as follows:

	2007		2006	
	Amount	Tax effect	Amount	Tax effect
Deferred income tax assets (liabilities):				
Investment tax credits	\$ 95,738	95,738	98,398	98,398
Loss carryforwards	1,427,643	356,911	1,904,382	476,095
Reserve for inventory revaluation loss	174,830	43,707	313,268	78,317
Pension	-	-	(61,507)	(15,377)
Unrealized gain on sales to related parties	7,621	1,905	8,209	2,052
Unrealized foreign exchange loss (gain)	(49,933)	(12,483)	23,953	5,988
Allowance for repairs and maintenance reserve	10,415	2,604	27,104	6,776
Balance of allowance for bad debts exceeding tax limit	167,122	41,781	208,252	52,063
Valuation allowance—deferred income tax assets		(321,252)		(435,401)
		<u>\$ 208,911</u>		<u>268,911</u>

In accordance with the ROC Statute for Upgrading Industries, the Company had investment tax credits resulting from purchases of machinery and equipment, research and development expense, and employee training expense that may be used to offset, to the extent of 50%, income tax payable in the current year. The unused balances can be carried forward to offset future income tax payable for five years. The tax credits may be fully utilized only in the year of expiration. As of December 31, 2007, the amount and the expiry year of the Company's unused investments tax credits were as follows:

Year	Amount	Year of Expiration
2004	\$ 33,822	2008
2005	28,654	2009
2006	<u>33,262</u>	2010
	<u>\$ 95,738</u>	

(Continued)

## TWINHEAD INTERNATIONAL CORP.

## Notes to Financial Statements

In accordance with the ROC Income Tax Act, a company's losses can be carried forward to offset its future taxable income for a period of five years. As of December 31, 2007, the amount and the expiry year of the Company's net losses were as follows:

Year	Amount	Year of Expiration
2003	\$ 498,854	2008
2004	97,177	2009
2005	665,728	2010
2006	<u>165,884</u>	2011
	<u><u>\$ 1,427,643</u></u>	

The ROC tax authorities have examined the Company's tax credits through 2005.

As of December 31, 2007 and 2006, the related imputation tax information was as follows:

	2007	2006
Balance of imputation credit account	\$ <u>15,875</u>	<u>15,840</u>

As of December 31, 2007 and 2006, the accumulated earnings after 1998 were deficits. Therefore, there is no the imputation tax credit.

The components of unappropriated retained earnings (accumulated deficit) were as follows:

	2007	2006
1997 and before	\$ 137,988	137,988
1998 and after	<u>(121,111)</u>	<u>(733,764)</u>
	<u><u>\$ 16,877</u></u>	<u><u>(595,776)</u></u>

**(13) Stockholders' Equity**

## (a) Capital stock

According to the Company's articles of incorporation, the rights and obligations of the 20% cumulative convertible preferred stockholders are summarized as follows:

- i) Annual earnings, after making up accumulated deficits and appropriating legal reserve, are distributed, at 20% of par value, as dividends to the 20% cumulative convertible preferred stockholders.
- ii) Dividends are paid annually after being approved and declared in the annual common stockholders' meeting. Dividends are calculated based on the prior year's outstanding days; however, upon conversion into common stock, the 20% cumulative convertible preferred stockholders waive their rights to the current year's profit distribution.

(Continued)

**TWINHEAD INTERNATIONAL CORP.****Notes to Financial Statements**

- iii) Dividends in arrears must be made up in a later year before profits are distributed to common stockholders. Upon conversion into common stock, dividends in arrears should be paid in full, and a 20% cumulative convertible preferred stockholder is precluded from sharing in prior years' profit distribution with the common stockholders. Except for the differences in dividend distribution, a 20% cumulative convertible preferred stockholder shares the same rights or obligations as the common stockholders.
- iv) One year after issuance, the 20% cumulative convertible preferred stockholders may, at their option, in June of every year, exchange their convertible preferred shares for common shares at a 1:1 ratio.
- v) A 20% cumulative convertible preferred stockholder has preference over the common stockholders to the remaining assets in the event of the Company's liquidation, and is limited to the issuance amount of the 20% cumulative convertible preferred stock. Unless otherwise stipulated in the articles of incorporation, a 20% cumulative preferred stockholder has no other rights or obligations.

**(b) Treasury stock**

None of the shares of the Company were purchased by its subsidiaries during the years 2007 and 2006. As of December 31, 2007 and 2006, subsidiaries held 29,628 thousand shares of common stock of the Company, and market value amounted to \$127,398 and \$174,802, respectively.

**(c) Capital surplus**

The ROC Company Act stipulates that only realized capital surplus, after making up a deficit and transferring to share capital, can be used to increase share capital, and should not be used for distribution of cash dividends. The aforementioned realized capital surplus includes paid-in capital in excess of par value and donation income. In accordance with the Enforcement Rules of the Securities and Exchange Law, the per-year amount transferred to increase common stock cannot exceed 10% of issued share capital. Issuance of new stock from capital surplus of cash subscription in excess of par value of common stock can be made only once per year, and cannot be made in the same year as cash subscription.

The shareholders' meetings held on June 8, 2007, and June 16, 2006, decided to use legal reserve of \$595,776 and \$422,159, respectively, to offset the accumulated deficit.

**(d) Legal reserve**

The ROC Company Act stipulates that the Company must retain 10% of its after-tax annual earnings as legal reserve until such retention equals the amount of total capital. Legal reserve can only be used to offset deficits, and cannot be distributed as cash dividends. Up to one-half of legal reserve can be converted to share capital when it reaches an amount equal to one-half of issued share capital. When the Company has no earnings and legal reserve is in excess of one-half of capital, the part that exceeds one-half of capital can be issued as cash dividends.

**TWINHEAD INTERNATIONAL CORP.****Notes to Financial Statements**

## (e) Appropriation of retained earnings

The Company's articles of incorporation stipulate that annual earnings, after making up accumulated deficit and appropriating legal reserve, are to first make up convertible preferred stock dividends in arrears, then 12.5% is distributed as employees' bonuses according to the employee bonus plan and 2% is distributed as directors' and supervisors' remuneration. The remainder is distributed in consideration of the overall industry circumstances, the Company's financial structure, and the investors' best interest, but no less than 50%. Such distribution, based on the capital surplus, retained earnings, future profitability, and maintenance of the dividend distribution level, shall be no more than 40% in cash and the rest in stock dividend.

In 2006 and 2005, the Company did not distribute any retained earnings.

The Company's 2007 appropriation of earnings is subject to the Company's directors' and stockholders' resolutions. After their resolutions, the related information can be obtained from the Market Observation Post System Website.

**(14) Financial Instruments**

## (a) Derivative financial instruments

In 2007 and 2006, there was no derivative contract transaction.

## (b) Fair value of non-derivative financial instruments

Methods and assumptions for estimating the fair value of financial instruments are as follows:

## i) Short-term financial instruments

The fair value of short-term financial instruments is estimated based on the carrying amount, due to their short maturities. The applicable accounts include cash and cash in banks, notes and accounts receivable (including receivables from related parties), other receivables—related parties, other financial assets, short-term borrowings, notes and accounts payable (including payables to related parties), and accrued expenses.

## ii) Available-for-sale financial assets—noncurrent: Stocks of listed companies. The fair value of stocks of listed companies is determined by the closing price on the balance sheet date.

## iii) Financial assets carried at cost: As there were no open market prices, it was not practicable to estimate the fair value of the non-listed companies. Therefore, the book value is used as their fair value.

## iv) Long-term notes payable (including current portion of other notes payable): The fair value is the present value of estimated future cash flows. The Company used the discount rate from long-term notes with similar terms it received; however, since the interest rate of long-term notes was mostly floating rate, the carrying value is regarded as its fair value.

## v) Long-term account receivable from related parties, and returnable and refundable deposits: The fair values were based on their carrying amounts at the balance sheet date.

## vi) Guarantees, standby letters of credit, and issuance letters of credit: The fair values were based on the respective contract prices.

(Continued)

## TWINHEAD INTERNATIONAL CORP.

## Notes to Financial Statements

vii) As of December 31, 2007 and 2006, the fair value of the Company's financial instruments determined by open market prices amounted to \$4,053 and \$5,581, respectively.

## (c) Financial risks

## i) Market risk

Market risk represents the potential loss due to a decrease in the value of a financial instrument caused primarily by changes in interest rates or foreign exchange rates. The Company maintains its foreign currency positions within prescribed limits in order to manage market risk.

The Company's foreign currency assets and liabilities are influenced by foreign exchange rates. However, the amount is not significant after offsetting the assets against the liabilities. Therefore, market risk is maintained within prescribed limits.

## ii) Credit risk

Credit risk represents the potential accounting loss due to possible non-performance by obligors and counterparties under the terms of their contracts. The Company's credit risk involving accounts and notes receivable—related parties, other receivables—related parties, and other financial assets—current was assessed by evaluating financial contracts with positive fair value on the balance sheet date.

Concentration of credit risk refers to the significant concentrations of credit risks from all financial instruments, whether the risks are from an individual counter-party or groups of counter-parties. Concentration of credit risk exists if a number of counter-parties are engaged in similar activities or activities in the same region or have similar economic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions.

The Company's notes and accounts receivable were concentrated on a few customers as follows:

Customer Name	Amount	2007
		% of notes and accounts receivable
Subsidiary (including transferred long-term receivable, refer to note 15)	\$ 338,092	45
I	129,131	17
D	99,938	13
		2006
Customer Name	Amount	% of notes and accounts receivable
Subsidiary (including transferred long-term receivable, refer to note 15)	\$ 253,519	27
D	283,374	30
I	201,076	21

(Continued)

**TWINHEAD INTERNATIONAL CORP.****Notes to Financial Statements**

To reduce credit risk, the Company assesses customers' financial status continuously, and an allowance for bad debt is provided by considering the collectibility of receivables periodically.

## iii) Liquidity risk

The Company's current assets are greater than current liabilities, and it satisfied its cash requirement through financial planning. Therefore, the Company has no potential loss due to the possible inability of the Company to settle its contracts by the expiration date.

## iv) Cash flow risk arising from interest rate change

The Company's short-term borrowings and long-term notes payable are exposed to fluctuating market interest rates. Hence, cash flow risk resulted from the changes in interest rates. Nevertheless, the fluctuation range is not significant, and the Company does not significantly rely on the borrowings. For the above reasons, the Company is not exposed to significant cash flow risk arising from changes in interest rates.

**(15) Transactions with Related Parties**

## (a) Name and relationship

Name	Relationship
Gammatech Computer Corporation (Gammatech Computer)	The Company and its subsidiaries hold 100% of Gammatech's common stock
Twinhead GmbH	Subsidiary of the Company
Twinhead Beijing Technology Co., Ltd. (Twinhead Beijing)	Subsidiary of a Company subsidiary (Twinhead (Asia) Pte. Ltd.)
Twinhead Kunshan Technology Co., Ltd. (Twinhead Kunshan)	Subsidiary of a Company subsidiary (Twinhead (Asia) Pte. Ltd.)
Twinhead Huazong Technology Co., Ltd. (Twinhead Huazong)	A Company subsidiary (Twinhead (Asia) Pte. Ltd.) holds 50% of Twinhead Huazong's common stock
Printech International Corp. (Printech)	The Company held 41.34% of Printech's common stock, which was disposed of in November 2006
Lun Yang Technology Co., Ltd. (Lun Yang)	Subsidiary of the Company
Lun Shiang Technology Co., Ltd. (Lun Shiang)	Subsidiary of the Company
Yu Feng Technology Co., Ltd. (Yu Feng)	Subsidiary of the Company
Pinnacle Corp. Ltd. (Pinnacle)	The chairman is the Company's general manager

(Continued)

## TWINHEAD INTERNATIONAL CORP.

## Notes to Financial Statements

## (b) Significant transactions with related parties

## i) Sales

Sales to related parties were as follows:

	2007		2006	
	Amount	% of net sales	Amount	% of net sales
Gammatech Computer	\$ 268,135	9	357,433	8
Twinhead GmbH	74,241	2	108,107	3
Lun Yang	32,033	1	120,066	3
Twinhead Beijing	<u>247</u>	<u>-</u>	<u>3,839</u>	<u>-</u>
	<u>\$ 374,656</u>	<u>12</u>	<u>589,445</u>	<u>14</u>

The selling prices for related parties were same as those for other customers. The payment can be offset with accounts payable from purchases or be O/A 60 to 180 days. However, since the subsidiaries had not achieved a stable stream of profits, the subsidiaries were not bound by the payment terms from the 4th quarter of 2004. The credit period for related parties was longer than for third parties (ranging from 30 to 60 days). In consideration of the subsidiaries' financial structure, the Company grants a longer credit period for its subsidiary companies.

## ii) Receivables

Receivables resulting from the above transactions are summarized as follows:

	2007		2006	
	Amount	% of net receivables	Amount	% of net receivables
Account receivable:				
Twinhead Huazong	\$ 184,918	25	178,027	19
Twinhead GmbH	130,356	17	128,469	14
Gammatech Computer	111,191	15	98,302	10
Twinhead Beijing	83,443	11	87,726	9
Lun Yang	<u>28,090</u>	<u>4</u>	<u>22,263</u>	<u>2</u>
	<u>537,998</u>	<u>72</u>	<u>514,787</u>	<u>54</u>

(Continued)

## TWINHEAD INTERNATIONAL CORP.

## Notes to Financial Statements

	2007		2006	
	Amount	% of net receivables	Amount	% of net receivables
Deduct: investment loss offset against receivables				
Twinhead GmbH	\$ 104,378	14	100,464	11
Lun Yang	<u>28,090</u>	<u>4</u>	<u>22,263</u>	<u>2</u>
	<u>132,468</u>	<u>18</u>	<u>122,727</u>	<u>13</u>
	405,530	54	392,060	41
Deduct: allowance for bad debt	143,403	19	138,541	15
Deduct: receivables reclassified to long- term receivables	124,958	17	138,533	14
	<u>\$ 137,169</u>	<u>18</u>	<u>114,986</u>	<u>12</u>

The Company provided allowance for bad debt after evaluating the collectibility of accounts receivable from Twinhead Huazong. In 2007 and 2006, the Company provided allowance for bad debt of \$143,403 and \$138,541, respectively. Additionally, as of December 31, 2007 and 2006, the aforementioned accounts receivable exceeding their normal credit period amounted to \$124,958 and \$138,533, respectively, and were recorded under long-term receivables. Please refer to note 15(b)(viii)(ii).

## iii) Purchases

Purchases from related parties were as follows:

	2007		2006	
	Amount	% of net purchases	Amount	% of net purchases
Twinhead Kunshan	\$ 1,903,661	72	1,260,050	34
Lun Yang	<u>479</u>	<u>-</u>	<u>920</u>	<u>-</u>
	<u>\$ 1,904,140</u>	<u>72</u>	<u>1,260,970</u>	<u>34</u>

The purchase price was determined based on related parties' cost, and the repayment was offset with accounts receivable from sales or was 60 days after purchase.

## iv) Assembly charges

In 2007 and 2006, the charges resulting from the product assembly provided by Twinhead Kunshan amounted to \$26,374 and \$118,643, respectively, and were recorded as cost of goods sold.

As of December 31, 2007, the Company's accounts receivable—related parties from Twinhead Kunshan amounted to \$75,965 resulting from the purchases by the Company on Twinhead Kunshan's behalf. The balance of the account was zero as of December 31, 2006.

(Continued)

## TWINHEAD INTERNATIONAL CORP.

## Notes to Financial Statements

## v) Advance payments for purchases

As of December 31, 2006, the Company's advance payment amounted to \$63,382 resulting from the purchases on Twinhead Kunshan's behalf. The balance of the account was zero as of December 31, 2007.

## vi) Unrealized gain on sales to related parties

Inventory the Company sold to investee companies and that was resold to others included unrealized gain on sales. As of December 31, 2007 and 2006, the amount decreased by \$588 and \$5,559, respectively. As of December 31, 2007 and 2006, unrealized gain on sales was \$7,621 and \$8,209, respectively, and was recorded as deferred credits.

## vii) Property transactions

In the third quarter of 2006, Lung Yang and Yu Feng agreed to sell their 40% and 15%, respectively, of shares of common stock of Twinhead Corporation to the Company, and the proceeds of the above transactions amounted to \$65,800 and \$24,675, respectively. The difference between the proceeds and the book value of the original investment amounted to \$15,041 and was recorded as unrealized gain on inter-company sales.

## viii) Other transactions

## i. Receivables from advance payments and collections

The receivable (recorded as other receivables—related parties) from the Company's accepting and paying royalties and other miscellaneous expenses for related parties was as follows:

## 1) Other receivable from related parties

	2007	2006
Lun Yang	\$ 7,601	159
Deduct: investment loss offset against receivables	7,601	159
	<u>\$ -</u>	<u>-</u>

As of December 31, 2007 and 2006, the accumulated investment loss recognized in excess of investment cost offset against receivables from Lun Yang amounted to \$7,601 and \$159, respectively.

## 2) Other payable to related parties

	2007	2006
Twinhead Kunshan	\$ 10,363	3,023
Twinhead GmbH	-	1,988
Gammatech Computer	17	-
	<u>\$ 10,380</u>	<u>5,011</u>

(Continued)

## TWINHEAD INTERNATIONAL CORP.

## Notes to Financial Statements

## ii. Reclassification of accounts receivable to long-term receivable

	2007	2006
Twinhead Huazong	\$ 184,918	178,027
Twinhead GmbH	66,474	117,761
Twinhead Beijing	<u>83,443</u>	<u>81,750</u>
	334,835	377,538
Less: allowance for bad debt	<u>143,403</u>	<u>138,541</u>
	<u>191,432</u>	<u>238,997</u>
Less: investment loss offset against receivables		
— Twinhead GmbH	<u>66,474</u>	<u>100,464</u>
	<u><u>\$ 124,958</u></u>	<u><u>138,533</u></u>

The abovementioned accounts receivable were receivables from related parties. Since these accounts receivables exceeded the regular credit period given by the Company, they were reclassified to long-term receivables (refer to Note 15(b)(ii)). As of December 31, 2007 and 2006, the above overdue accounts receivable ranging from six to nine months were 4% and 16%, respectively, ranging from nine to twelve months were 0%, and over twelve months were 96% and 84%, respectively.

## iii. Guarantees

	2007	2006
Lun Yang	\$ 200,000	200,000
Twinhead Kunshan	<u>-</u>	<u>109,862</u>
Total	<u><u>\$ 200,000</u></u>	<u><u>309,862</u></u>

## ix) Service charges

In 2007 and 2006, Pinnacle charged service fees to the Company totaling \$2,800 and \$3,352, respectively. The service fees were included in operating expenses. The fees had been paid before the year-end.

**(16) Pledged Assets**

As of December 31, 2007 and 2006, the details and net book value of pledged assets were as follows:

Pledged assets	Pledged for	Book value	
		2007	2007
Account receivable	Short-term borrowings	\$ 126,099	223,261
Land	Guarantee for bank loans	118,424	118,424
Buildings and improvements	Guarantee for bank loans	168,138	226,821
Assets leased to others	Guarantee for bank loans	<u>216,638</u>	<u>163,684</u>
Total		<u><u>\$ 629,299</u></u>	<u><u>732,190</u></u>

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## TWINHEAD INTERNATIONAL CORP.

## Notes to Financial Statements

## (17) Commitments and Contingencies

- (a) As of December 31, 2007 and 2006, the Company had outstanding letters of credit for purchase of material totaling approximately \$83,742 and \$119,206, respectively.
- (b) In 2005, the laptop department of IBM was acquired by LENOVO. Therefore, the Company signed a contract with LENOVO for royalties for producing a compatible operating system. According to the contract, from February 2005 to December 2006, the royalty payable to LENOVO was USD600 thousand, and the Company shall pay USD200 thousand in May 2007, January 2008 and January 2009. Nevertheless, starting from January 2007, the royalty payment is calculated by the models and quantity of the sales made by the Company. After negotiation, royalty payment amounting to \$95,799 under the Company's original contract with IBM was reversed in the first half of 2007 and recorded as other income.
- (c) The Company signed an accounts receivable non-recourse factoring contract with Mega International Commercial Bank. As of December 31, 2007 and 2006, the accounts receivable factored amounted to \$126,099 and \$223,261, respectively. The Company has not used the its factoring credit facility in advance.
- (d) As of December 31, 2007, the Company had issued a promissory note amounting to \$45,000 resulting from sales with buy-back agreement with Chailease Finance Co., Ltd..
- (e) In November 2005, the Company entered into an operating lease for 10 years for its office rental, with refundable deposits of \$10,608. The rental payment schedule for the next five years is as follows:

	<b>Amount</b>
2008	\$ 33,929
2009	34,268
2010	35,965
2011	36,324
After 2012	<u>150,710</u>
	<u><u>\$ 291,196</u></u>

(Continued)

## TWINHEAD INTERNATIONAL CORP.

## Notes to Financial Statements

**(18) Others**

A summary of employment, depreciation, and amortization expenses is as follows:

Function Account	2007			2006		
	Cost of goods sold	Operating expense	Total	Cost of goods sold	Operating expense	Total
Employment expenses						
Salaries	27,346	193,142	220,488	25,940	197,538	223,478
Labor and health insurance	3,050	12,161	15,211	3,080	12,189	15,269
Pension	1,519	10,417	11,936	964	7,603	8,567
Depreciation expense (Note)	18,117	14,040	32,157	29,878	13,866	43,744
Amortization expense	-	8,924	8,924	-	21,993	21,993

(Note) Depreciation of assets leased to others and to be leased was \$2,184 and \$1,534 in 2007 and 2006, respectively, and was recorded as nonoperating expenses — other loss.

**(19) Segment Information**

## (a) Business segment information

The Company is involved in one industry — the electronics industry.

## (b) Geographic information

The Company has no foreign operating segment. As a result, geographic information is not required.

## (c) Information on export sales

The Company's export sales in 2007 and 2006 are summarized as follows:

Region	2007	2006
Americas	\$ 1,587,506	2,085,345
Europe	728,406	1,186,404
Asia	631,372	776,647
Other	<u>30,982</u>	<u>62,007</u>
	<u>\$ 2,978,266</u>	<u>4,110,403</u>

(Continued)

**TWINHEAD INTERNATIONAL CORP.****Notes to Financial Statements**

## (d) Information on major customers

Individual customers who accounted for 10% or more of the Company's net sales in 2007 and 2006 were as follows:

	<b>Name of customer</b>	<b>Amount</b>	<b>%</b>
2007	I	\$ 1,077,889	34
	D	392,798	13
2006	I	1,112,565	26
	D	843,723	20
	T	816,110	19