CHUNGHWA TELECOM CO LTD
Form 6-K
March 31, 2005

1934 Act Registration No. 1-31731

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 6-K

REPORT OF FOREIGN PRIVATE ISSUER

PURSUANT TO RULE 13a-16 OR 15d-16 OF

THE SECURITIES EXCHANGE ACT OF 1934

Dated March 31, 2005

Chunghwa Telecom Co., Ltd.

(Translation of Registrant s Name into English)

21-3 Hsinyi Road Sec. 1,

Taipei, Taiwan, 100 R.O.C.

(Address of Principal Executive Office)

(Indicate by check mark whether the registrant files or will file annual reports under cover of form 20-F or Form 40-F.)

Form 20-F x Form 40-F ¨

(Indicate by check mark whether the registrant by furnishing the information contained in this form is also thereby furnishing the information to the Commission pursuant to Rule 12g3-2(b) under the Securities Exchange Act of 1934.)

Yes ¨ No x

(If Yes is marked, indicated below the file number assigned to the registrant in connection with Rule 12g3-2(b): Not applicable)

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant Chunghwa Telecom Co., Ltd. has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Date: 2005/03/31

Chunghwa Telecom Co., Ltd.

By: /s/ Tan HoChen
Name: Tan HoChen

Title: Chairman & CEO

Exhibit

Exhibit	Description
1.	Financial Statements for the Years Ended December 31, 2004 and 2003 and Independent Auditors Report -ROC GAAP
2.	Financial Statements for the Years Ended December 31, 2003 and 2004, and for Each of the Years in the Three Year Period Ended December 31, 2004-US GAAP
3.	Press Release on 3/31/2005

Chunghwa Telecom Co., Ltd.

Financial Statements for the

Years Ended December 31, 2004 and 2003 and

Independent Auditors   Report

INDEPENDENT AUDITORS REPORT

The Board of Directors and Stockholders

Chunghwa Telecom Co., Ltd.

We have audited the accompanying balance sheets of Chunghwa Telecom Co., Ltd. as of December 31, 2004 and 2003, and the related statements of operations, changes in stockholders equity and cash flows for the years then ended, all expressed in New Taiwan dollars. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the Regulations for Audit of Financial Statements by Certified Public Accountants and auditing standards generally accepted in the Republic of China. Those regulations and standards required that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements. An audit includes examining, on a test basis, evidences 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 Company as of December 31, 2004 and 2003, and the results of its operations and its cash flows for the years then ended in conformity with relevant regulations, regulations governing the preparation of financial statements of public companies and accounting principles generally accepted in the Republic of China.

As stated in Notes 2 and 3 to the financial statements, the Company s accounts are subject to examination by the Executive Yuan and by the Ministry of Audit of the Control Yuan. The accounts as of and for the year ended December 31, 2003 have been examined by these government agencies, and adjustments from this examinations have been recognized in the accompanying financial statements.

March 4, 2005

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.

CHUNGHWA TELECOM CO., LTD.

BALANCE SHEETS

DECEMBER 31, 2004 AND 2003

(Amounts in New Taiwan Thousand Dollars, Except Par Value Data)

	2004		2003 (As Adjusted Note 3)	
	Amount	**%**	**Amount**	**%**
ASSETS				
CURRENT ASSETS				
Cash and cash equivalents (Notes 2 and 4)	$ 29,282,811	6	$ 13,553,029	3
Short-term investments (Notes 2 and 5)	9,114,513	2		
Trade notes and accounts receivable, net of allowance for doubtful accounts of $ 2,585,089 in 2004 and $2,345,601 in 2003 (Notes 2 and 6)	13,555,006	3	13,982,456	3
Other current monetary assets	1,516,204	1	1,665,917	
Inventories, net (Notes 2 and 7)	1,438,997		1,219,459	
Deferred income taxes (Notes 2 and 16)	12,289,961	3	12,070,690	3
Other current assets (Note 8)	695,533		532,234	
Total current assets	67,893,025	15	43,023,785	9
INVESTMENTS IN UNCONSOLIDATED COMPANIES AND FUNDS (Notes 2, 9 and 20)				
Funds	2,000,000		2,000,000	
Investments accounted for using the equity method	1,429,035		1,419,482	
Investments accounted for using the cost method	2,605,956	1	2,076,603	1
Total investment in unconsolidated companies and funds	6,034,991	1	5,496,085	1
PROPERTY, PLANT AND EQUIPMENT (Notes 2, 10 and 19)				
Cost				
Land	101,835,826	22	101,756,249	22
Land improvements	1,455,683		1,392,265	
Buildings	56,050,758	12	53,750,744	12
Machinery and equipment	21,661,260	5	22,466,397	5
Telecommunications network facilities	620,949,036	133	614,501,192	133
Miscellaneous equipment	2,097,365		2,131,065	1
Total cost	804,049,928	172	795,997,912	173
Revaluation increment on land	5,951,368	1	5,951,540	1
	810,001,296	173	801,949,452	174
Less: Accumulated depreciation	461,797,504	99	447,098,909	97
	348,203,792	74	354,850,543	77
Construction in progress and advances related to acquisitions of equipment	31,279,696	7	43,106,304	10
Property, plant and equipment, net	379,483,488	81	397,956,847	87
INTANGIBLE ASSETS				
3G concession (Note 2)	10,179,000	2	10,179,000	2

Deferred pension cost (Notes 2 and 18)	1,243,465	1	427,551	
Patents and computer software, net (Note 2)	207,661		251,361	
Total intangible assets	11,630,126	3	10,857,912	2
OTHER ASSETS				
Refundable deposits	1,357,219		2,018,235	1
Overdue receivables, net of allowance for losses of $ 1,888,344 in 2004 and $5,440,436 in 2003 (Notes 2 and 6)	435,363		991,871	
Deferred income taxes non-current (Notes 2 and 16)			14,256	
Other	334,485		465,650	
Total other assets	2,127,067		3,490,012	1
TOTAL	$ 467,168,697	100	$ 460,824,641	100
LIABILITIES AND STOCKHOLDERS EQUITY				
CURRENT LIABILITIES				
Trade notes and accounts payable	$ 14,483,688	3	$ 11,712,596	3
Income tax payable (Notes 2 and 16)	5,031,996	1	4,928,052	1
Accrued expenses (Note 11 and 19)	14,353,770	3	14,162,063	3
Accrued pension liabilities (Notes 2 and 18)	2,016,930	1	3,608,836	1
Dividends payable (Notes 3)			43,414,762	9
Long-term loans current portion (Note 13)	200,000			
Other current liabilities (Notes 12 and 19)	19,126,724	4	21,181,189	5
Total current liabilities	55,213,108	12	99,007,498	22
LONG-TERM LIABILITIES				
Long-term loans (Note 13)	500,000		700,000	
Deferred income	361,129		419,037	
Total long-term liabilities	861,129		1,119,037	
RESERVE FOR LAND VALUE INCREMENTAL TAX (Note 10)	211,182		211,182	
OTHER LIABILITIES				
Customers deposits	6,176,863	1	5,606,588	1
Other	203,298		243,115	
Total other liabilities	6,380,161	1	5,849,703	1
Total liabilities	62,665,580	13	106,187,420	23
STOCKHOLDERS EQUITY				
Capital stock $10 par value; authorized, issued and outstanding 9,647,725 thousand shares	96,477,249	21	96,477,249	21
Capital surplus:				
Paid-in capital in excess of par value	214,538,597	46	214,538,597	47
Capital surplus from revaluation of land	5,740,185	1	5,740,358	1
Donations	13,170		13,170	
Total capital surplus	220,291,952	47	220,292,125	48
Retained earnings:				
Legal reserve	34,286,147	7	34,286,147	7
Special reserve	2,675,941	1	2,675,941	1

Unappropriated earnings	50,776,593	11	906,281	
Total retained earnings	87,738,681	19	37,868,369	8
Cumulative translation adjustments	(4,765)		(522)	
Total stockholders equity	404,503,117	87	354,637,221	77
TOTAL	$ 467,168,697	100	$ 460,824,641	100

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

(With Deloitte & Touche audit report dated March 4, 2005)

CHUNGHWA TELECOM CO., LTD.

STATEMENTS OF OPERATIONS

FOR THE YEARS ENDED DECEMBER 31, 2004 AND 2003

(Amounts in New Taiwan Thousand Dollars, Except Basic Net Income Per Share Data)

	2004		2003 (As Adjusted Note 3)	
	Amount	%	Amount	%
SERVICE REVENUES	$ 182,562,682	100	$ 179,148,543	100
COSTS OF SERVICES (Note 19)	92,951,836	51	90,720,133	50
GROSS PROFIT	89,610,846	49	88,428,410	50
OPERATING EXPENSES				
Marketing	24,035,219	13	24,282,804	14
General and administrative	2,767,721	1	2,718,777	1
Research and development	3,145,013	2	3,093,454	2
Total operating expenses	29,947,953	16	30,095,035	17
INCOME FROM OPERATIONS	59,662,893	33	58,333,375	33
OTHER INCOME				
Penalties income	1,011,479	1	1,071,382	1
Income from sale of scrap	576,694		306,774	
Interest income	223,454		99,800	
Foreign exchange gain, net	140,542		18,708	
Equity in net income of unconsolidated companies	69,796		3,403	
Dividends income	29,357		123,005	
Other income	691,715		577,449	
Total other income	2,743,037	1	2,200,521	1
OTHER EXPENSES				
Losses on disposal of property, plant and equipment	186,422		221,603	
Losses arising from natural calamities	182,981		84,231	
Interest expense	4,449		43,071	
Other expense	1,270,196	1	1,306,329	1
Total other expenses	1,644,048	1	1,655,234	1
INCOME BEFORE INCOME TAX	60,761,882	33	58,878,662	33
INCOME TAX (Notes 2 and 16)	10,891,570	6	10,377,914	6
NET INCOME	$ 49,870,312	27	$ 48,500,748	27

(Continued)

	2004		2003 (As Adjusted Note 3)	
	Income Before Income Tax	Net Income	Income Before Income Tax	Net Income
BASIC NET INCOME PER SHARE (Notes 2 and 17)	$ 6.30	$ 5.17	$ 6.10	$ 5.03

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

(With Deloitte & Touche audit report dated March 4, 2005) (Concluded)

CHUNGHWA TELECOM CO., LTD.

STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY

FOR THE YEARS ENDED DECEMBER 31, 2004 AND 2003

(Amounts in New Taiwan Thousand Dollars, Except Dividend Per Share Data)

	Common Capital Stock		Capital Surplus (Notes 10 and 14)				Retained Earnings (Note 14)					
	Shares (Thousands)	Amount	Paid-in Capital in Excess of Par Value	Capital Surplus from Revaluation of Land	Donations	Total	Legal Reserve	Special Reserve	Unappropriated Earnings	Total	Cumulative Translation Adjustments	Total Stockholders Equity
ALANCE, ANUARY 1, 003 (AS DJUSTED)	9,647,725	$ 96,477,249	$ 214,546,263	$ 5,749,909	$ 13,170	$ 220,309,342	$ 29,436,072	$ 2,675,419	$ 670,892	$ 32,782,383	$ 300	$ 349,569,27
eclassification of pital surplus om revaluation oon disposal of nd to income				(8,249)		(8,249)						(8,249
et transfer of operty, plant and uipment to ational operties Bureau d other overnment gencies			(7,666)	(1,302)		(8,968)						(8,968
et income in 003									48,500,748	48,500,748		48,500,748
ppropriation of 003 earnings												
egal reserve							4,850,075		(4,850,075)			
pecial reserve								522	(522)			
ividends $4.5 per are									(43,414,762)	(43,414,762)		(43,414,76
umulative anslation justment for reign-currency vestments in nconsolidated mpanies											(822)	(822
ALANCE, ECEMBER 31, 003 (AS DJUSTED Note	9,647,725	96,477,249	214,538,597	5,740,358	13,170	220,292,125	34,286,147	2,675,941	906,281	37,868,369	(522)	354,637,22
eclassification of pital surplus om revaluation oon disposal of				(173)		(173)						(17

nd to income												
et income in the 004									49,870,312	49,870,312		49,870,31
umulative anslation justment for reign-currency vestments												
unconsolidated ompanies											(4,243)	(4,24
ALANCE, ECEMBER 31, 004	9,647,725	$ 96,477,249	$ 214,538,597	$ 5,740,185	$ 13,170	$ 220,291,952	$ 34,286,147	$ 2,675,941	$ 50,776,593	$ 87,738,681	$ (4,765)	$ 404,503,11

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

(With Deloitte & Touche audit report dated March 4, 2005)

CHUNGHWA TELECOM CO., LTD.

STATEMENTS OF CASH FLOWS

FOR THE YEARS ENDED DECEMBER 31, 2004 AND 2003

(Amounts in New Taiwan Thousand Dollars)

	2004	2003
		(As Adjusted Note 3)
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$ 49,870,312	$ 48,500,748
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for doubtful accounts	1,564,781	3,239,187
Depreciation and amortization	41,123,162	41,980,125
Unrealized loss on reduction of short-term investments to market	12,416	
Gain on sale of short-term investments	(34,264)	
Reversal of allowance for losses on inventories	(1,297)	(15,093)
Net loss on disposal of property, plant and equipment	169,025	220,175
Equity in net income of unconsolidated companies	(69,796)	(3,403)
Cash dividend received from equity	56,000	
Deferred income taxes	(205,015)	387,336
Changes in operating assets and liabilities:		
Decrease (increase) in:		
Trade notes and accounts receivable	170,489	912,682
Other current monetary assets	106,588	105,744
Inventories	(326,357)	(1,704,570)
Other current assets	(80,324)	33,246
Overdue receivables	(708,187)	(1,580,626)
Increase (decrease) in:		
Trade notes and accounts payable	2,879,208	2,159,063
Income tax payable	103,944	(1,130,430)
Accrued expenses	191,707	525,911
Accrued pension liabilities	(2,407,820)	875,614
Other current liabilities	925,532	1,315,026
Deferred income	(57,908)	25,855
Net cash provided by operating activities	93,282,196	95,846,590
CASH FLOWS FROM INVESTING ACTIVITIES		
Acquisition of short-term investment, net	(9,092,665)	
Proceeds from disposal of investments in unconsolidated companies	10	233,700
Acquisitions of investments in unconsolidated companies	(529,363)	
Proceeds from disposal of property, plant and equipment	213,647	6,150
Acquisitions of property, plant and equipment	(22,888,985)	(32,247,702)
Acquisitions of patents and computer software	(122,028)	(194,344)
Decrease (increase) in other assets	742,578	(1,224,559)
Net cash used in investing activities	(31,676,806)	(33,426,755)

(Continued)

	2004	2003
		(As Adjusted Note 3)
CASH FLOWS FROM FINANCING ACTIVITIES		
Payment on principal of long-term loans	$	$ (17,000,000)
Decrease in customers deposits	(2,421,029)	(1,017,890)
Increase (decrease) in other liabilities	(39,817)	89,824
Cash dividends paid	(43,414,762)	(38,590,900)
Net cash used in financing activities	(45,875,608)	(56,518,966)
NET INCREASE IN CASH AND CASH EQUIVALENTS	15,729,782	5,900,869
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	13,553,029	7,652,160
CASH AND CASH EQUIVALENTS, END OF YEAR	$ 29,282,811	$ 13,553,029
SUPPLEMENTAL INFORMATION		
Interest paid	$ 4,449	$ 112,113
Less: Capitalized interest		45,890
Interest paid, excluding capitalized interest	$ 4,449	$ 66,223
Income tax paid	$ 10,992,642	$ 11,121,008
NON-CASH FINANCING ACTIVITIES		
Current portion of long-term loans	$ 200,000	$

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

(With Deloitte & Touche audit report dated March 4, 2005) (Concluded)

CHUNGHWA TELECOM CO., LTD.

NOTES TO FINANCIAL STATEMENTS

FOR THE YEARS ENDED DECEMBER 31, 2004 AND 2003

(Amounts in Thousands of New Taiwan Dollars, Unless Stated Otherwise)

1. GENERAL

Chunghwa Telecom Co., Ltd. (Chunghwa or the Company) was incorporated on July 1, 1996 in the Republic of China (ROC) pursuant to the Telecommunications Act No. 30. The Company is a company limited by shares and, prior to August 2000, was wholly owned by the Ministry of Transportation and Communications (MOTC). Prior to July 1, 1996, the current operations of Chunghwa were carried out under the Directorate General of Telecommunications (DGT). The DGT was established by the MOTC in June 1943 to take primary responsibility in the development of telecommunications infrastructure and to formulate policies related to telecommunications. On July 1, 1996, the telecom operations of the DGT were spun-off to form Chunghwa and the DGT continues to be the industry regulator.

As a dominant telecommunications service provider of fixed-line and cellular telephone services, within the meaning of applicable telecommunications regulations of the ROC, the Company is subject to additional requirements imposed by the MOTC.

The MOTC is in the process of privatizing the Company by reducing the government ownership to below 50% in various stages. In July 2000, the Company received approval from the Securities and Futures Commission (the SFC) for a domestic initial public offering and its common shares were listed and traded on the Taiwan Stock Exchange (the TSE) on October 27, 2000. Certain of the Company s common shares were sold by an auction, in connection with the foregoing privatization plan, in domestic public offerings in June 2001, December 2002, March 2003, April 2003 and July 2003. Certain of the Company s common shares were also sold in an international offering of securities in the form of American Depository Shares (ADS) in July 17, 2003 and were listed and traded on the New York Stock Exchange (the NYSE). The MOTC intends to continue to sell certain of the Company s common shares and throughout the privatization process to the Company s employees. The MOTC has sold 35.11% shares of the Company as of December 31, 2004.

The number of employees as of December 31, 2004 and 2003 are 28,526 and 29,070, respectively.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The financial statements are prepared in conformity with relevant regulations, regulations governing the preparation of financial statements of public companies and accounting principles generally accepted in the Republic of China. The preparation of financial statements requires management to make certain estimates and assumptions that affect the recorded amounts of assets, liabilities, revenues and expenses of the Company. The Company continually evaluates these estimates, including those related to allowances for doubtful accounts, valuation allowances on inventories, useful lives of long term assets, pension plans and income tax. The Company bases its estimates on historical experience and other assumptions, which it believes to be reasonable under the circumstances. Actual results may differ from these estimates. The significant accounting policies are summarized as follows:

Basis of Presentation

As a state-owned company, the Company maintains statutory accounts in accordance with the laws and regulations issued by the Executive Yuan, the MOTC, the Ministry of Audit (the MOA) of the Control Yuan and, in the absence of any specific laws and regulations applicable to a particular transaction or account, the regulations governing the preparation of financial statements of public companies and generally accepted accounting principles in the Republic of China. The accounts are subject to annual

examinations by the Executive Yuan and by the MOA (the Executive Yuan and MOA are hereinafter referred to as government agencies). The objective of these examinations is to evaluate the Company s performance against the budget approved by the Legislative Yuan. The accounts are considered final only after adjustments, if any, based on the annual examinations, are recorded. The accounts for the year ended December 31, 2003 have been examined by these government agencies and the resulting adjustments were recorded retroactively.

Current Assets and Liabilities

Current assets are commonly identified as those which are reasonably expected to be realized in cash, or sold or consumed within one year. Current liabilities are obligations which mature within one year.

Cash Equivalents

Cash equivalents are commercial paper purchased with maturities of three months or less from the date of acquisition.

Short-term Investments

The investments are carried at the lower of cost or market value. An allowance for decline in value is provided when the aggregate carrying value of the investments exceeds the aggregate market value. A reversal of the allowance will result from a subsequent recovery of the carrying value.

The cost of short-term investment sold are determined using the moving weighted-average method.

Allowance for Doubtful Accounts

Allowance for doubtful accounts is provided on the basis of a review of the collectibility of individual receivables.

Inventories

Inventories are stated at the lower of cost (weighted-average cost method) or market value (replacement cost or net realizable value).

Investments in Unconsolidated Companies

Investments in shares of stock in companies where the Company exercises significant influence in their operating and financial policy decisions are accounted for using the equity method. Under the equity method, the investment is initially stated at cost and subsequently adjusted for its proportionate share in the net earnings of investee companies. Any cash dividends received are recognized as a reduction in the carrying value of the investments. Unrealized profits arising from downstream transactions to equity investees are deferred in the Company s portion of equity income or loss. Profits and losses arising from equipment purchased from equity investees are eliminated and recognized over the estimated remaining useful life of the equipment.

Investments in shares of stock with no readily determinable market values are accounted for using the cost method when the ownership is less than 20%. Reductions in carrying value of those investments for decline in value are charged to stockholder s equity. Reductions which are determined to be other than temporary are charged to current income. Cash dividends received are recorded as income.

Stock dividends received are accounted for as increases in the number of shares held and are not recognized as income.

The costs of investments sold are determined using the weighted-average method.

Property, Plant and Equipment

Property, plant and equipment are stated at cost plus a revaluation increment, if any, less accumulated depreciation. The interest costs that are directly attributable to the acquisition, construction of a qualifying asset are capitalized as property, plant and equipment. Major renewals and betterments are capitalized, while maintenance and repairs are expensed currently.

An impairment loss is recognized when the recoverable amount of an asset is less than its carrying amount. A reversal of the impairment loss is recognized if there is a subsequent recovery in the value of the asset. The recoverable amount cannot exceed the original cost less accumulated depreciation. An impairment loss on a revalued asset is recognized directly against capital surplus from revaluation for the asset to the extent that the impairment loss does not exceed the amount in the capital surplus from revaluation for that same asset. A reversal of an impairment loss on a revalued asset is credited directly to capital surplus from revaluation under the heading capital surplus from revaluation. However, to the extent that an impairment loss on the same revalued asset was previously recognized in profit or loss, a reversal of that impairment loss is also recognized in profit or loss.

Depreciation expense is determined based upon the asset s estimated useful life using the straight-line method. The estimated useful lives are as follows: land improvements, 10 to 30 years; buildings, 10 to 60 years; machinery and equipment, 6 to 10 years; telecommunication network facilities, 6 to 15 years; and miscellaneous equipment, 3 to 10 years.

Upon sale or disposal of property, plant and equipment, the related cost and accumulated depreciation are removed from the accounts, and any gain or loss is credited or charged to income.

Intangible Assets

The amount recorded for the 3G Concession will be amortized upon the MOTC approval of using the straight-line method over the lower of the legal useful life or estimated useful life. Patents are amortized using the straight-line method over the estimated useful lives ranging from 12 to 20 years. Computer software costs are capitalized and amortized using the straight-line method over the estimated useful lives of three years.

An impairment loss is recognized when the recoverable amount of an intangible asset other than goodwill is less than its carrying amount. A reversal of the impairment loss is recognized if there is a subsequent recovery in the value of the asset. The recoverable amount cannot exceed the original cost less accumulated amortization.

Pension Costs

Pension costs are recognized according to the budget approved by the Legislative Yuan and the actuarial report. In addition, the DGBAS issued instructions that the pension costs of all state-owned companies to be privatized should be measured and recognized on the assumption that there is no privatization and that an additional amount should be calculated on the basis of the employees service years if the additional amount does not reduce the budgeted net income. An additional minimum liability is recognized, if an unfunded accumulated benefit obligation exists, and an equal amount is recognized as an intangible asset, provided that the asset recognized does not exceed the amount of unrecognized net transition

obligation and unrecognized prior service cost.

Revenue Recognition

Revenues are recognized when revenues are realized or realizable and earned. Related costs are expensed as incurred.

Service revenue is based on the fair value of the sales price, after business discount and quantity discount, between the Company and customer. The sales price of service revenue is the amount which matures within one year. The difference between fair value and maturity value is not material and the transactions occur frequently so the interest factor is not included in calculating fair value.

Usage revenues from fixed-line services (including local, domestic long distance and international long distance), cellular services, Internet and data services, and interconnection and call transfer fees from other telecommunications companies and carriers are billed in arrears and are recognized based upon minutes of traffic processed when the services are provided in accordance with contract terms.

Other revenues are recognized as follows: (a) one-time subscriber connection fees are recognized upon activation, (b) fixed-monthly fees (on fixed-line services, wireless, internet and data services) are accrued every month, and (c) prepaid services (fixed line, cellular and Internet) are recognized as income based upon actual usage by customers or when the right to use those services expire.

Expense Recognition

Expenses including commissions paid to agencies and handset subsidy costs paid to vendors that sell handsets to customers who subscribe to the service (as an inducement to enter into a service contract) are charged to income as incurred.

Income Tax

The Company accounts for income tax using the asset and liability method. Under this method, deferred income tax is recognized for investment tax credits and tax consequences of differences between financial statement carrying amounts and their respective tax bases. A valuation allowance is recognized if, available evidence indicates it is more likely than not that a portion or the entire deferred tax asset will not be realized. A deferred tax asset or liability should be classified as current or noncurrent according to the classification of its related asset or liability. However, if a deferred asset or liability cannot be related to an asset or liability in the financial statements, it should be classified as current or non-current depending on the expected reversal date of the temporary difference.

Investment tax credits utilized are recognized as reduction of income tax expense.

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

Income taxes (10%) on undistributed earnings are recorded as expense in the year when the stockholders have resolved that the earnings shall be retained.

Earnings Per Share

Earnings per share is computed by dividing net income by the weighted-average number of common shares outstanding during the period.

Foreign-currency Transactions

The functional currency of the Company is the local currency, the New Taiwan dollar. Thus, the transactions of the Company that are denominated in currencies other than the New Taiwan dollars (the foreign currency) are recorded in New Taiwan dollars at the exchange rates prevailing on the transaction dates. Gains or losses realized upon the settlement of a foreign currency transaction are included in the period in which the transaction is settled. The balances, at the balance sheet dates, of the foreign currency assets and liabilities are adjusted to reflect the prevailing exchange rates, and the resulting differences are recorded as follows:

a. Long-term stock investments accounted for by the equity method as cumulative translation adjustment under stockholders equity; and

b. Other assets and liabilities credited or charged to current income.

Foreign Currency Forward Exchange Contracts

The Company enters into foreign currency forward contracts to manage currency exposures in foreign currency-denominated assets and liabilities. The differences in the New Taiwan dollar amounts translated using the current rate and the amounts translated using the contracted forward rates on the contract date are amortized over the terms of the forward contracts using the straight-line method. At the balance sheet dates, the receivables or payables arising from forward contracts are restated using the prevailing current rate at the balance sheet date and the resulting differences are recognized and charged to income. Also the receivables and payables related to the forward contract are netted with the resulting amount presented as either other current monetary asset or other current liability. Any resulting gain or loss upon settlement is charged to income in the period of settlement.

3. ADJUSTMENTS OF FINANCIAL STATEMENTS

For the Year Ended December 31, 2003

The Company s financial statements for the year ended December 31, 2003 had been examined by the government agencies, and the resulting adjustments had been recorded retroactively as of December 31, 2003. The effects of these adjustments are summarized as follows:

	As Previously Reported	Adjustment Increase (Decrease)	As Adjusted
Balance sheet			
Assets			
Current assets	$ 43,022,523	$ 1,262	$ 43,023,785
Investments in unconsolidated companies and funds	5,496,085		5,496,085
Property, plant and equipment, net	397,956,847		397,956,847
Intangible assets	10,857,912		10,857,912
Other assets	3,490,012		3,490,012
Total assets	$ 460,823,379	$ 1,262	$ 460,824,641
Liabilities			
Current liabilities	$ 55,604,332	$ 43,403,166	$ 99,007,498
Long-term liabilities	1,119,037		1,119,037
Reserve for land value incremental tax	211,182		211,182
Other liabilities	5,849,703		5,849,703
Total liabilities	62,784,254	43,403,166	106,187,420
Total stockholders equity	398,039,125	(43,401,904)	354,637,221
Total liabilities and stockholders equity	$ 460,823,379	$ 1,262	$ 460,824,641

(Continued)

	As Previously Reported	Adjustment Increase (Decrease)	As Adjusted
Statement of income			
Service revenues	$ 179,148,543	$	$ 179,148,543
Costs of services	90,722,628	(2,495)	90,720,133
Operating expenses	30,109,684	(14,649)	30,095,035
Other income	2,200,521		2,200,521
Other expenses	1,655,234		1,655,234
Income before income tax	58,861,518	17,144	58,878,662
Income tax	10,373,628	4,286	10,377,914
Net income	48,487,890	12,858	48,500,748

The adjustments made by the government agencies that increased income before income tax of $17,144 thousand were due to the different bases of estimates used by the MOA in determining certain accruals. Increased current liabilities of $43,403,166 thousand and decreased total stockholders equity of $43,401,904 thousand were due to the appropriations of 2003 earnings recorded at December 31, 2003 by the MOA.

4. CASH AND CASH EQUIVALENTS

	December 31	
	2004	2003
Cash		
Cash on hand	$ 103,415	$ 108,905
Cash in banks	1,854,464	2,003,431
Negotiable Certificate of Deposit, annual yield rate ranging from 1.13%-1.27%	8,900,000	
	10,857,879	2,112,336
Cash equivalents		
Commercial paper, annual yield rate ranging from 1.00%-1.10% and 0.83%-0.93% for the years ended December 31, 2004 and 2003, respectively	18,424,932	11,440,693
	$ 29,282,811	$ 13,553,029

5. SHORT-TERM INVESTMENTS

	December 31, 2004
Open-end bond mutual funds	$ 8,900,000
Repurchaseable bond	226,929
	9,126,929
Less: Allowance for losses	12,416
	$ 9,114,513

Market value	$ 9,114,513

The market value of open-end bond mutual funds were based on the net asset value of the funds as of December 31, 2004.

The repurchaseable bond was sold at the amount of US$6,744 thousand on January 18, 2005.

6. ALLOWANCE FOR DOUBTFUL ACCOUNTS

	Year Ended December 31	
	2004	2003
Notes and accounts receivable		
Balance, beginning of year	$ 2,345,601	$ 1,491,907
Provision for doubtful accounts	256,961	863,197
Accounts receivable written off	(17,473)	(9,503)
Balance, end of year	$ 2,585,089	$ 2,345,601
Overdue receivable		
Balance, beginning of year	$ 5,440,436	$ 6,012,517
Provision for doubtful accounts	1,264,695	2,295,180
Accounts receivable written off	(4,816,787)	(2,867,261)
Balance, end of year	$ 1,888,344	$ 5,440,436

7. INVENTORIES, NET

	December 31	
	2004	2003
Supplies	$ 1,111,580	$ 1,125,333
Work in process	1,689	740
Materials in transit	325,728	94,683
	1,438,997	1,220,756
Less: Allowance for losses		1,297
	$ 1,438,997	$ 1,219,459

The insurance coverage on inventories as of December 31, 2004 amounted to $1,146,192 thousand.

8. OTHER CURRENT ASSETS

	December 31	
	2004	**2003**
Prepaid expenses	$ 602,247	$ 494,295
Other	93,286	37,939
	$ 695,533	$ 532,234

9. INVESTMENTS IN UNCONSOLIDATED COMPANIES AND FUNDS

	December 31			
	2004		2003	
	Carrying Value	% of Owner-ship	Carrying Value	% of Owner-ship
Funds				
Fixed Line Funds	$ 1,000,000		$ 1,000,000	
Piping Funds	1,000,000		1,000,000	
	2,000,000		2,000,000	
Investments in unconsolidated companies				
Equity investees:				
Chunghwa Investment (CHI)	929,801	49	986,698	49
Taiwan International Standard Electronics (TISE)	499,234	40	432,784	40
	1,429,035		1,419,482	
Cost investees				
Taipei Financial Center (TFC)	2,529,206	12	1,999,843	12
RPTI International (RPTI)	71,500	12	71,500	12
Siemens Telecommunication Systems (Siemens)	5,250	15	5,250	15
International Telecommunication Development (ITD)			10	
	2,605,956		2,076,603	
Total investments in unconsolidated companies	4,034,991		3,496,085	
	$ 6,034,991		$ 5,496,085	

The carrying values of the investments in unconsolidated companies and the related equity in net income of an equity-accounted unconsolidated company are based on audited financial statements.

The equity ownership in the net assets of investments in unconsolidated companies accounted for using the cost method, which were computed by the percentage of ownership, were $2,401,412 thousand and $1,998,567 thousand as of December 31, 2004 and 2003, respectively.

As part of the government s effort to upgrade the existing telecommunications infrastructure, the Company and other public utility companies were required to contribute to a Fixed Line Fund managed by the Ministry of Interior Affairs and a Piping Fund administered by the Taipei City Government. These funds will be used to finance various telecommunications infrastructure projects, and any deficiency of the funds will be reimbursed by the companies.

10. PROPERTY, PLANT AND EQUIPMENT

	December 31	
	2004	**2003**
Cost		
Land	$ 101,835,826	$ 101,756,249
Land improvements	1,455,683	1,392,265
Buildings	56,050,758	53,750,744
Machinery and equipment	21,661,260	22,466,397

(Continued)

	December 31	
	2004	2003
Telecommunications network facilities	$ 620,949,036	$ 614,501,192
Miscellaneous equipment	2,097,365	2,131,065
	804,049,928	795,997,912
Revaluation increment on land	5,951,368	5,951,540
	810,001,296	801,949,452
Accumulated depreciation		
Land improvements	694,748	634,267
Buildings	12,242,637	11,301,777
Machinery and equipment	15,298,966	15,831,266
Telecommunications network facilities	431,790,829	417,573,124
Miscellaneous equipment	1,770,324	1,758,475
	461,797,504	447,098,909
Construction in progress and advances related to acquisition of equipment	31,279,696	43,106,304
Property, plant and equipment-net	$ 379,483,488	$ 397,956,847

Pursuant to the related regulation, the Company revalued its land owned as of April 30, 2000 based on the publicly announced value on July 1, 1999. These revaluations which were approved by the MOA resulted in increases in the carrying values of property, plant and equipment of $5,986,074 thousand, long-term liabilities for land value incremental tax of $211,182 thousand, and capital surplus of $5,774,892 thousand.

On July 1, 1996, pursuant to the guidance on the incorporation of the Company and as instructed by the ROC s Executive Yuan (executive branch), the ROC Government (through the MOTC) transferred to the Company certain land and buildings with a carrying value of $120,957,303 thousand. Those properties, as of that date, were registered in the name of the ROC s National Properties Bureau (NPB). On September, 2004, all the properties had been registered in the name of the Company.

Depreciation on property, plant and equipment for the years ended December 31, 2004 and 2003 amounted to $40,840,195 thousand and $41,710,486 thousand, respectively. No interest expense was capitalized for the year ended December 31, 2004. Capitalized interest expense aggregated to $45,890 thousand for the year ended December 31, 2003. The rate of capitalized interest was from 0.56%-1.67%.

The insurance coverages on property, plant and equipment as of December 31, 2004 aggregated $1,801,943 thousand.

11. ACCRUED EXPENSES

	December 31	
	2004	2003

Accrued compensation	$ 9,206,961	$ 8,993,797
Accrued franchise fees	2,500,028	2,435,419
Other accrued expenses	2,646,781	2,732,847
	$ 14,353,770	$ 14,162,063

12. OTHER CURRENT LIABILITIES

	December 31	
	2004	**2003**
Payables to equipment suppliers	$ 4,150,304	$ 3,229,909
Advances from subscribers	3,896,655	3,104,573
Amounts collected from subscribers in trust for others	3,467,379	3,610,204
Deposit from subscribers	3,085,342	6,076,646
Payables to contractors	2,317,819	3,080,981
Miscellaneous	2,209,225	2,078,876
	$ 19,126,724	$ 21,181,189

13. LONG-TERM LOANS (INCLUDING CURRENT PORTION)

The loan from the Common Tunnel Fund was obtained pursuant to a long-term loan agreement with the Common Tunnel Fund managed by Ministry of Interior that allows the Company to obtain unsecured interest-free credit until March 12, 2007. The outstanding principal amounts as of December 31, 2003 are payable in three annual installments (NT$0.2 billion, NT$0.2 billion and NT$0.3 billion) starting on March 12, 2005.

As of December 31, 2004, the Company had unused credit lines totaling approximately $190,000,000 thousand, which are available for short-term and long-term borrowings.

14. STOCKHOLDERS EQUITY

Under the Company s Articles of Incorporation, authorized capital is divided into 9,647,724,900 common shares (at $10 par value per share), all of which are issued and outstanding. The Company s Articles of Incorporation and the Republic of China Telecommunications Act provide that the MOTC has the right to purchase two redeemable preferred shares (NT$10 par value) in the event its ownership in the Company falls below 50% of the outstanding common shares.

For the purpose of privatizing the company, the MOTC sold 1,109,750 common shares of the Company in an international offering of securities in the form of American Depositary Shares (ADS) amounting to 110,975 thousand units (one ADS represents ten common shares) on the New York Stock Exchange in July 17, 2003.

The ADS holders generally have the same rights and obligations as other common shareholders, subject to the provision of relevant laws. The exercise of such rights and obligations shall comply with the related regulations and deposit agreement, which stipulate, among other things, that ADS holders can, through deposit agents:

a. Exercise their voting rights;

b. Sell their ADSs; and

c. Receive dividends declared and subscribe to the issuance of new shares.

As of December 31, 2004, the outstanding ADSs were 110,975 thousand units, which equaled approximately 1,109,749 thousand common shares and represented 11.50% of the Company s total outstanding common shares.

The MOTC, as the holder of those preferred shares is entitled to the same rights as holders of common shares and certain additional rights as specified in the Company s Articles of Incorporation as follows:

a. The holder of the preferred shares, or its nominated representative, will act as a director and/or supervisor during the entire period in which the preferred shares are outstanding.

b. The holder of preferred shares has the same option as holders of common shares when the Company raises capital by issuing new shares.

c. The holder of the preferred shares will have the right to vote on any change in the name of the Company or the nature of its business and any transfer of a substantial portion of the Company s business or property.

d. The holder of the preferred shares may not transfer the ownership. The Company must redeem all outstanding preferred shares within three years from the date of their issuance.

Under the ROC Company Law, capital surplus can only be utilized to offset deficits or be declared as stock dividends. Also, such capital surplus and donations can only be declared as a stock dividend by the Company at an amount calculated in accordance with the provisions of existing regulations.

In addition, before distributing a dividend or making any other distribution to stockholders, the Company must pay all outstanding taxes, recover any past losses and set aside a legal reserve equal to 10% of its net income, and depending on its business needs or requirements, may also set aside a special reserve. The cash dividends to be distributed shall not be less than 10% of the total amount of the dividends to be distributed. In addition, if the cash dividend to be distributed is less than $0.10 per share, such cash dividend shall be distributed in the form of common shares.

Telecommunications service is a Taiwan s capital-intensive industry and the Corporation requires capital expenditures to sustain its competitive position in high-growth market. Thus, the Company s dividend policy takes into account future capital expenditure outlays. In this regard, a portion of the earnings may be retained to finance these capital expenditures. The remaining earnings can then be distributed as dividends if approved by the stockholders in the following year and will be recorded in the financial statements of that year.

Furthermore, under the ROC Company Law, the appropriation for legal reserve shall be made until the accumulated reserve equals the aggregate par value of the outstanding capital stock of the Company. This reserve can only be used to offset a deficit, or when the balance is 50% of the aggregate par value of the outstanding capital stock of the Company, the Company may, at its option, declare 50% of the reserve as a stock dividend and transfer the amount to capital.

The appropriations and distributions of the 2004 earnings of the Company have not been approved by the board of directors and stockholders as of March 4, 2005. Related information can be accessed through the Market Observation Post System on the Web site of the Taiwan Stock Exchange Corporation. The Company did not distribute bonuses for employees and remunerations of directors and supervisors for the 2003 earnings.

Under the Integrated Income Tax System that became effective on July 1, 1998, non-corporate stockholders are allowed a tax credit for the income tax paid by the Company on earnings generated in 1999 and onwards. An Imputation Credit Account (ICA) is maintained by the Company for such income tax and the tax credit is allocated to each stockholder.

15. COMPENSATION, DEPRECIATION AND AMORTIZATION EXPENSES

	Year Ended December 31, 2004		
	Cost of Services	Operating Expenses	Total
Compensation expense			
Salaries	$ 14,955,483	$ 8,932,878	$ 23,888,361
Insurance	649,713	411,242	1,060,955
Pension	2,107,149	1,278,560	3,385,709
Other compensation	6,040,523	3,536,474	9,576,997
	23,752,868	14,159,154	37,912,022
Depreciation expense	38,608,374	2,231,821	40,840,195
Amortization expense	153,524	121,815	275,339
	$ 62,514,766	$ 16,512,790	$ 79,027,556

	Year Ended December 31, 2003		
	Cost of Services	Operating Expenses	Total
Compensation expense			
Salaries	$ 15,034,611	$ 8,726,680	$ 23,761,291
Insurance	708,233	344,114	1,052,347
Pension	661,707	399,385	1,061,092
Other compensation	6,028,593	3,377,836	9,406,429
	22,433,144	12,848,015	35,281,159
Depreciation expense	39,426,072	2,284,414	41,710,486
Amortization expense	145,347	124,154	269,501
	$ 62,004,563	$ 15,256,583	$ 77,261,146

16. INCOME TAX

a. A reconciliation between income tax expense computed by applying the statutory income tax rate of 25% to income before income tax and income tax payable shown in the statements of income is as follows:

	Year Ended December 31	
	2004	2003
Income tax expense computed at statutory income tax rate of 25% to income before income tax	$ 15,190,461	$ 14,719,655
Add (deduct) tax effects of:		
Permanent differences	(78,429)	(49,888)
Temporary differences	(724,453)	(460,878)
Investment tax credits	(3,378,713)	(4,347,786)
Income tax payable	$ 11,008,866	$ 9,861,103

b. Income tax expense consisted of the following:

	Year Ended December 31	
	2004	2003
Income tax payable	$ 11,008,866	$ 9,861,103
Income tax separated	38,407	14,964
Income tax deferred	(205,015)	387,336
Adjustments of prior years income tax	49,312	
Income tax on undistributed earnings		114,511
	$ 10,891,570	$ 10,377,914

The balance of income tax payable as of December 31, 2004 and 2003 was shown net of prepaid income tax, respectively.

c. Net deferred income tax assets consisted of the following:

	December 31	
	2004	2003
Current		
Deferred income tax assets:		
Provision for doubtful accounts	$ 684,839	$ 1,614,307
Accrued pension cost	12,203,142	12,011,188
Other	98,844	60,133
	12,986,825	13,685,628
Less: Valuation allowance	(684,839)	(1,614,307)
	12,301,986	12,071,321
Deferred income tax liability:		
Unrealized foreign exchange gain	(12,025)	(631)
Net deferred income tax assets	$ 12,289,961	$ 12,070,690
Noncurrent deferred income tax assets:		
Unrealized losses on disposal of property, plant and equipment	$	$ 14,256

d. The related information under the Integrated Income Tax System is as follows:

	December 31	
	2004	2003
Balance of Imputation Credit Account (ICA)	$ 6,324,278	$ 8,671,428

The estimated ICA rate for the 2004 earnings as of December 31, 2004 and the actual ICA rate for 2003 earnings were 12.44% and 27.68%, respectively. The credit available for allocation to the stockholders is calculated on the basis of the balance of ICA on the date of distribution of

dividends. Accordingly, the estimated rate as of December 31, 2004 may differ from the actual rate determined based on the balance of the ICA on the dividend distribution date.

e. Undistributed earnings information

As of December 31, 2004 and 2003, the Company s undistributed earnings generated in June 30, 1998 and onward was $32,336 thousand for 2004 and 2003.

Income tax returns through the year ended December 31, 2003 had been examined by the tax authorities.

17. BASIC NET INCOME PER SHARE

	Amount (Numerator)		Weighted-average Number of Common Shares Outstanding	Net Income Per Share (Dollars)	
	Income Before Income Tax	Net Income		Income Before Income Tax	Net Income
Year ended December 31, 2004					
Net income	$ 60,761,882	$ 49,870,312			
Basic net income per share			9,647,725	$ 6.30	$ 5.17
Year ended December 31, 2003					
Net income	$ 58,878,662	$ 48,500,748			
Basic net income per share			9,647,725	$ 6.10	$ 5.03

18. PENSION PLAN

The Company has different pension plans for its employees depending on their classifications. In general, the employees pension entitlement is based on MOTC regulations, Labor Standards Law and/or the private pension plan of the Company.

The funding of the pension plan for employees classified as staff is based on the budget approved by the Legislative Yuan and a supplementary budget approved by the Executive Yuan. The staff pension fund is administered by a pension fund committee and deposited in its name in a commercial bank. The pension plan for employees classified as workers is funded monthly at 15% or less of their wages and is also administered by a pension committee and deposited in its name in the Central Trust of China Company.

The Labor Pension Act of ROC will be effective beginning July 1, 2005 and this pension mechanism is considered as a defined contribution plan. The employees who were subject to the Labor Standards Law prior to the enforcement of this Act may choose to be subject to the pension mechanism under this Act or continue to remain to be subject to the pension mechanism under the Labor Standards Law. For those employees who were subject to the Labor Standards Law prior to July 1, 2005 and still work for the same company after July 1, 2005 and choose to be subject to the pension mechanism under this Act, their seniority as of July 1, 2005 shall be maintained. The rate of contribution by an employer to the Labor Pension Fund per month shall not be less than 6% of each employee s monthly salary or wage.

Pension information is summarized as follows:

a. Reconciliation between the fund status and accrued pension cost is summarized as follows:

	December 31	
	2004	**2003**
Staff		
Benefit obligation		
Vested benefit obligation	$ (53,377,588)	$ (51,074,298)
Non-vested benefit obligation	(33,843,822)	(34,347,712)
Accumulated benefit obligation	(87,221,410)	(85,422,010)
Additional benefit obligation	(1,816,642)	(427,110)
Projected benefit obligation	(89,038,052)	(85,849,120)
Fair values of plan assets	84,924,329	81,813,174
Funded status	(4,113,723)	(4,035,946)
Unrecognized net transition obligation	3,060,107	854,661
Additional liability (deferred pension costs)	(1,243,465)	(427,551)
Accrued pension cost	$ (2,297,081)	$ (3,608,836)
Worker		
Benefit obligation		
Vested benefit obligation	$ (338,629)	$ (207,619)
Non-vested benefit obligation		
Accumulated benefit obligation	(338,629)	(207,619)
Additional benefit obligation	(10,159)	(1,038)
Projected benefit obligation	(348,788)	(208,657)
Fair values of plan assets	946,248	765,299
Funded status	597,460	556,642
Unrecognized net transition asset	(317,309)	(556,642)
Prepaid pension cost (deducted from accrued pension cost)	$ 280,151	$

b. Vested benefit

Staff	$ 54,178,252	$ 51,840,413
Worker	343,708	209,592

c. Actuarial assumptions

	Before Privatization	**After Privatization**
Years ended December 31, 2004		

Discount rate used in determining present value	1.5%	3.2%
Rate of compensation increase		
All employees	3.5%	2.0%
Annuity increase for retirees	3.0%	2.0%
Rate of return on plan assets		
Staff retirement fund account	1.5%	
Labor retirement fund account	1.5%	3.2%

(Continued)

	Before Privatization	After Privatization
Years ended December 31, 2003		
Discount rate used in determining present value	1.5%	3.2%
Rate of compensation increase		
All employees	0.5%	3.5%
Annuity increase for retirees		2.0%
Rate of return on plan assets		
Staff retirement fund account	1.5%	
Labor retirement fund account	1.5%	3.2%

d. Contributions and payments

	Year Ended December 31	
	2004	2003
Contributions		
Staff	$ 5,697,698	$
Worker	224,583	222,947
Payments		
Staff	3,273,261	2,553,524
Worker	53,147	31,590

Pension costs amounted to $3,514,461 thousand and $1,098,561 thousand for the years ended December 31, 2004 and 2003, respectively. The privatization of the Company was not completed on December 31, 2004, and the new target privatization date is expected to be December 31, 2005. Therefore, based on the assumption that the timing of the privatization is December 31, 2005, the accrued pension cost for staff was $2,297,081 thousand and prepaid pension cost for worker was $280,151 thousand as of December 31, 2004, as a result of net accrued pension cost of $2,016,930 thousand.

19. TRANSACTIONS WITH RELATED PARTIES

As the Company is a state-owned enterprise, the ROC Government is one of the Company s customers. The Company provides fixed-line services, wireless services, Internet and data and other services to the various departments and agencies of the ROC Government and other state-owned enterprises in the normal course of business and at arm s-length prices. The information on service revenues from government bodies and related organizations have not been provided because details of the type of users were not maintained by the Company. The Company believes that all costs of doing business are reflected in the financial statements and that no additional expenditures will be incurred as a result of the privatization being completed.

a. The Company engages in business transactions with the following related parties:

Company	Relationship
Taiwan International Standard Electronics (TISE)	Equity-accounted investee
Chunghwa System Integration (CSI)	Subsidiary of equity - accounted investee

b. Significant transactions with the above related parties are summarized as follows:

	December 31			
	2004		2003	
	Amount	%	Amount	%
1) Payables				
Accrued expenses				
TISE	$ 58,219		$	
CSI			29,750	
	$ 58,219		$ 29,750	
Payable to construction supplier (included in other current liabilities)				
TISE	$ 76,946		$ 631,799	4
CSI	17,236		21,360	
	$ 94,182		$ 653,159	4

	Year Ended December 31			
	2004		2003	
	Amount	%	Amount	%
2) Cost of services				
TISE	$ 192,733		$	
CSI	120,842		96,158	
	$ 313,575		$ 96,158	
3) Acquisition of properties				
TISE	$ 878,582	4	$ 4,471,429	14
CSI	155,444	1	48,439	
	$ 1,034,026	5	$ 4,519,868	14

The foregoing acquisitions were conducted under normal commercial terms.

20. COMMITMENTS AND CONTINGENT LIABILITIES

As of December 31, 2004, the Company s remaining commitments under non-cancelable contracts with various parties were as follows:

a. Acquisitions of buildings of $3,391,411 thousand.

b. Acquisitions of telecommunications equipment of $12,125,769 thousand.

c. Unused letters of credit of about $6,147,272 thousand.

d. Contract to print billing, envelops and telephone directories of approximately $342,862 thousand.

e. The Company also has non-cancelable operating leases covering certain buildings, computers, computer peripheral equipment and operation system software under contracts that expire in various years. Minimum rental commitments under those leases are as follows:

Year	Rental Amount
2005	$ 1,226,033
2006	983,677
2007	636,168
2008	332,509
2009 and thereafter	135,922

f. A commitment to contribute $2,500,000 thousand to a Fixed Line Fund administered by the Ministry of Interior Affairs and Taiwan Power Company, of which $1,000,000 thousand has been contributed by the Company on June 30, 1995. If the balance of the Fixed Line Fund is not sufficient for its purpose, the above three parties will determine when to raise additional funds and the contribution amounts from each party.

g. A commitment to contribute $2,000,000 thousand to a Piping Fund administered by the Taipei City Government, of which $1,000,000 thousand was contributed by the Company on August 15, 1996.

21. FAIR VALUE OF FINANCIAL INSTRUMENTS

a. Derivative financial instruments

The Company entered into derivative financial instrument transactions to manage exposures related to foreign-currency denominated payable fluctuation. There were no foreign currency forward exchange contracts outstanding as of December 31, 2004.

1) Transaction risk

a) Credit risk

The Company is exposed to credit risk in the event of non-performance of the counter parties to forward contracts on maturity. In order to manage this risk, the Company conducts transactions only with financial institutions with good credit ratings. As a result, no material losses resulting from counter party defaults are anticipated.

b) Market risk

Market risk is the exposure created by potential exposures to changes of foreign exchange rate related to its foreign-currency-denominated assets and/or liabilities and changes on interest rates related to its obligations.

c) Liquidation risk and cash flow risk

The Company entered into foreign currency forward exchange contracts to hedge its exposure to the effect of exchange rate fluctuations on net liabilities. At the maturity of the contracts, the Company has sufficient cash to cover the cash out, therefore the Company believes there are no significant liquidation risk and cash flow risk.

2) Transaction gains and losses

Net foreign exchange loss for the year ended December 31, 2004 was $26,784 thousand.

b. Fair value of financial instruments:

	December 31			
	2004		2003	
	Carrying Amount	**Fair Value**	**Carrying Amount**	**Fair Value**
Nonderivative financial instruments				
Assets				
Cash and cash equivalents	$ 29,282,811	$ 29,282,811	$ 13,553,029	$ 13,553,029
Short-term investments	9,114,513	9,114,513		
Trade notes and accounts receivable, net	13,555,006	13,555,006	13,982,456	13,982,456
Other current monetary assets	1,516,204	1,516,204	1,665,917	1,665,917
Investments in unconsolidated companies and funds	6,034,991	6,168,577	5,496,085	5,855,359
Overdue receivables, net	435,363	435,363	991,871	991,871
Refundable deposits (included in other assets others)	1,357,219	1,357,219	2,018,235	2,018,235
Liabilities				
Trade notes and accounts payable	14,483,688	14,483,688	11,712,596	11,712,596
Accrued expense	14,353,770	14,353,770	14,162,063	14,162,063
Current portion of long-term loans	200,000	200,000		
Long-term loans	500,000	500,000	700,000	700,000
Customers deposits	6,176,863	6,176,863	5,606,588	5,606,588

The Company s basis for determining the fair values is as follows:

1) Financial instruments except those mentioned in b) and c) above the carrying values reported in the balance sheet approximate the fair values of these assets.

2) Fair values of investments in unconsolidated companies and funds are based on the net asset values of the investments in unconsolidated companies, if quoted market prices are not available.

3) Long-term loans (including current portion). The fair value is discounted value based on projected cash flow. The projected cash flows were discounted using the maturity dates of long-term loans.

22. ADDITIONAL DISCLOSURES

Following are the additional disclosures required by the SFC for the Company and its investees:

a. Financing provided: None.

b. Endorsement/guarantee provided: None.

c. Marketable securities held: Please see Table 1.

d. Marketable securities acquired and disposed of at costs or prices of at least $100 million or 20% of the paid-in capital: Please see Table 2.

e. Acquisition of individual real estate of at least $100 million or 20% of the paid-in capital: Please see Table 3.

f. Disposal of individual real estate of at least $100 million or 20% of the paid-in capital: None.

g. Total purchase from or sale to related parties amounting to at least $100 million or 20% of the paid-in capital: None.

h. Receivables from related parties of $100 million or 20% of the paid-in capital: None.

i. Names, locations, and other information of investees on which the Company exercises significant influences: Please see Table 4.

j. Derivative financial transaction: Please see Note 21.

k. Investment in Mainland China: None.

23. SEGMENT INFORMATION

a. Industry

The financial information of the Company by industry: Please see Table 5.

b. Geographic

The Company had no foreign operations as of December 31, 2004.

c. Foreign revenue

The foreign revenue of the Company is less than 10% of total sales.

d. Major customers

No single customer accounts for more than 10% of total revenues.

TABLE 1

CHUNGHWA TELECOM CO., LTD.

MARKETABLE SECURITIES HELD

DECEMBER 31, 2004

(Amounts in Thousands of New Taiwan Dollars)

pany	Marketable Securities Type and Name	Relationship with the Company	Financial Statement Account	December 31, 2004 Shares (Thousands/ Thousand Units)	Carrying Value	Percentage of Ownership
ecom	Common stock					
	Chunghwa Investment Co., Ltd.	Equity method investee	Investments in unconsolidated companies	98,000	$ 929,801	49
	Taiwan International Standard Electronics	Equity method investee	Investments in unconsolidated companies	1,760	499,234	40
	Taipei Financial Center		Investments in unconsolidated companies	288,211	2,529,206	12
	RPTI International		Investments in unconsolidated companies	9,234	71,500	12
	Siemens Telecommunication Systems		Investments in unconsolidated companies	75	5,250	15
	Beneficiary certificates					
	JF (Taiwan) First Bond Fund		Short-term investment	43,812	600,000	
	JF (Taiwan) Taiwan Bond Fund		Short-term investment	33,652	500,000	
	Dresdner Bond DAM Fund		Short-term investment	79,876	900,000	
	Invesco ROC Bond Fund		Short-term investment	68,986	1,000,000	
	ABN AMRO Bond Fund		Short-term investment	47,725	700,000	
	ABN AMRO Select Bond Fund		Short-term investment	63,451	700,000	
	PCA Well Pool Fund		Short-term investment	106,401	1,300,000	
	HSBC Taiwan Dragon Fund		Short-term investment	19,967	300,000	
	HSBC NTD Money Management Fund 2		Short-term investment	36,468	500,000	
	FUBON Ju-I III Fund		Short-term investment	75,498	900,000	
	Shinkong Chi-Shin Fund		Short-term investment	107,498	1,500,000	
estment	Common stock					
	Chunghwa System Integration Co., Ltd.	Subsidiary	Investments in unconsolidated companies	60,000	623,920	100
	Chunghwa Telecom Global	Subsidiary	Investments in unconsolidated companies	6,000	123,627	100
	Chunghwa Investment Holding Company	Subsidiary	Investments in unconsolidated companies	589	14,641	100
	PandaMonium Company Ltd.	Equity method investee	Investments in unconsolidated companies	602	19,677	43
	Wayia Com Inc.		Investments in unconsolidated companies	4,000	40,000	19
	TVbean Co. Ltd.		Investments in unconsolidated companies	1,200	12,000	9
	Vantech Software Company		Investments in unconsolidated companies	1,223	12,960	7
	Digimax Production Center		Investments in unconsolidated companies	2,000	60,000	5
	Beneficiary certification					
	APIT Bond Fund		Short-term investment	8,330	103,710	
	Homerun Bond Fund		Short-term investment	5,199	71,064	
	Prudential Bond Fund		Short-term investment	6,665	101,013	
	The First Global Investment Trust The Duoli-2 Bond Fund		Short-term investment	3,510	50,000	
	HSBC Taiwan Dragon Fund		Short-term investment	3,434	51,602	

Cathay Capital Income Growth Bond Fund	Short-term investment	8,523	90,655

(Continued)

ld Company Name	Marketable Securities Type and Name	Relationship with the Company	Financial Statement Account	December 31, 2004 Shares (Thousands/ Thousand Units)	Carrying Value	Percentage of Ownership	Market Value or Net Asset Value
	Cathay Bond Fund		Short-term investment	5,339	$ 60,000		$ 60,009
	Mega Diamond Bond Fund		Short-term investment	13,415	150,000		150,031
	SmarTeam ECB1		Short-term investment	374	37,400		26,049
unghwa System	Beneficiary certification						
egration Co., Ltd.	Fubon Global Fixed Income Bond Fund		Short-term investment	4,430	50,776		50,782
	Homerun Bond Fund		Short-term investment	6,135	83,859		83,873
	Prudential Financial Bond Fund		Short-term investment	2,492	35,471		35,476
	Cathay Capital Income Growth Bond Fund		Short-term investment	5,860	62,327		62,337
	APIT Bond Fund		Short-term investment	881	10,974		10,975
	Albatross Fund		Short-term investment	2,830	31,000		31,005
	Fuh-Hwa Bond Fund		Short-term investment	3,239	42,000		42,006
	President James Bond Fund		Short-term investment	3,967	40,275		40,277
	HSBC Taiwan Dragon Fund		Short-term investment	1,997	30,000		30,001
unghwa Investment	Common stock						
lding Company	Donghua Telecom Co., Limited	Subsidiary	Investments in unconsolidated companies	4,590	14,729	100	14,729
	Chunghwa Telecom (ASIA) Company	Subsidiary	Investments in unconsolidated companies		(54)	100	(54)

Note 1: The net asset values of unconsolidated companies are based on audited financial statements.

Note 2: The net asset values of unconsolidated companies are based on unaudited financial statements.

Note 3: The market value of short-term investments is based on the net asset values of the funds as of December 31, 2004.

Note 4: The market value of short-term investments is based on the monthly average closing price as of December 31, 2004.

TABLE 2

CHUNGHWA TELECOM CO., LTD.

MARKETABLE SECURITIES ACQUIRED AND DISPOSED OF AT COSTS OR PRICES OF AT LEAST NT$100 MILLION OR 20% OF THE PAID-IN CAPITAL

FOR THE YEAR ENDED DECEMBER 31, 2004

(Amounts in Thousands of New Taiwan Dollars)

	Marketable Securities Type and Name	Financial Statement Account	Counter-party	Nature of Relationship	Beginning Balance		Acquisition		Disposal				
					Shares (Thousands/ Thousand Units)	Amount	Shares (Thousands/ Thousand Units)	Amount	Shares (Thousands/ Thousand Units)	Amount	Carrying Value	Gain (Loss) on Disposal	S (The Th U
om	Beneficiary certificates												
	JF (Taiwan) First Bond Fund	Short-term investment				$	131,804	$ 1,800,000	87,992	$ 1,203,087	$ 1,200,000	$ 3,087	
	JF (Taiwan) Taiwan Bond Fund	Short-term investment					101,279	1,500,000	67,627	1,003,165	1,000,000	3,165	
	Dresdner Bond DAM Fund	Short-term investment					222,759	2,500,000	142,883	1,606,368	1,600,000	6,368	
	Invesco ROC Bond Fund	Short-term investment					172,883	2,500,000	103,897	1,504,397	1,500,000	4,397	
	ABN AMRO Bond Fund	Short-term investment					109,288	1,600,000	61,563	902,292	900,000	2,292	
	ABN AMRO Select Bond Fund	Short-term investment					172,730	1,900,000	109,279	1,203,843	1,200,000	3,843	
	PCA Well Pool Fund	Short-term investment					254,222	3,100,000	147,821	1,804,242	1,800,000	4,242	
	HSBC Taiwan Dragon Fund	Short-term investment					53,367	800,000	33,400	501,135	500,000	1,135	
	HSBC NTD Money Management Fund 2	Short-term investment					72,992	1,000,000	36,524	500,760	500,000	760	
	FUBON Ju-I III Fund	Short-term investment					151,128	1,800,000	75,630	901,565	900,000	1,565	
	Shinkong Chi-Shin Fund	Short-term investment					215,224	3,000,000	107,726	1,503,195	1,500,000	3,195	
	Common stock												
	Taipei Financial Center	Investments in unconsolidated companies			199,984	1,999,843	88,227	529,363					
	Beneficiary certificates												
	APIT Bond Fund	Short-term investment			8,330	100,891	8,330	103,710	8,330	103,710	100,891	2,819	
	Homerun Bond Fund	Short-term investment			7,564	100,779	7,103	97,064	9,468	129,064	126,779	2,285	
	Prudential Financial Bond Fund	Short-term investment			8,704	121,040	1,416	20,000	10,120	143,739	141,040	2,699	
	Cathay Capital Income Growth Bond Fund	Short-term investment			1,925	20,000	17,005	180,655	10,407	110,655	110,000	655	
	The Forever Fund	Short-term investment			6,557	90,949	2,506	35,000	9,063	126,884	125,949	935	
	Beneficiary certificates												

m

Homerun Bond Fund	Short-term investment	7,394	99,504	6,867	93,859	8,126	110,760	109,504	1,256

TABLE 3

CHUNGHWA TELECOM CO., LTD.

ACQUISITION OF INDIVIDUAL REAL ESTATES AT COSTS OF AT LEAST NT$100 MILLION OR 20% OF THE PAID-IN CAPITAL FOR THE YEAR ENDED DECEMBER 31, 2004

(Amounts in Thousands of New Taiwan Dollars)

							Prior Transactions with Related Counter-party				
Company Name	Property	Transaction Date	Transaction Amount	Payment Term	Counter-Party	Nature of Relationship	Owner	Relationship	Transfer Date	Amount	Price Reference
Chunghwa Telecom. Co., Ltd.	Building	2004.2.25	$ 133,611	Paid	Da-Cheng Construction Co., Ltd. and others	None					Bidding
	Building	2004.8.02	197,456	Paid	Guo-Chi Construction Co., Ltd. and others	None					Bidding
	Building	2004.10.20	1,651,775	Paid	Kung-Sing Engineering Co., Ltd. and others	None					Bidding

TABLE 4

CHUNGHWA TELECOM CO., LTD.

NAMES, LOCATIONS, AND OTHER INFORMATION OF INVESTEES ON WHICH THE COMPANY EXERCISES SIGNIFICANT INFLUENCE

FOR THE YEAR ENDED DECEMBER 31, 2004

(Amounts in Thousands of New Taiwan Dollars, Unless Otherwise Specified)

				Original Investment Amount		Balance as of December 31, 2004					
Investor Company	Investee Company	Location	Main Businesses and Products	December 31, 2004	Dec. 31, 2003	Shares (Thousands)	Percentage of Ownership (%)	Carrying Value	Net Income (Loss) of the Investee	Recognized Gain (Loss)	N
Chunghwa Telecom Co., Ltd.	Chunghwa Investment Co., Ltd.	24F, No. 456, Hsinyi Rd., Sec. 4, Taipei	Investment	$ 980,000	$ 980,000	98,000	49	$ 929,801	$ (107,456)	$ (52,654) (Note 1)	Equity-a investee
	Taiwan International Standard Electronics	No. 4, Min Sheng St., Tu-Chen Taipei Hsien	Manufacturing, selling, designing and maintaining of telecommunications systems and equipment	164,000	164,000	1,760	40	499,234	58,174	122,450 (Note 2)	Equity-a investee
Chunghwa Investment Co., Ltd.	Chunghwa System Integration Co., Ltd.	24F, No. 458, Hsinyi Rd., Sec. 4, Taipei	Integrated communication and information services	600,000	600,000	60,000	100	623,920	15,767	15,767 (Note 1)	Subsidia
	Chunghwa Telecom Global	United States	Multinational enterprise data service, Internet gateway and voice wholesale, mobile commerce value-added services, and content services	204,271 (US$ 6,000 thousand)	154,086 (US$ 4,500 thousand)	6,000	100	123,627 (US$ 3,899 thousand)	(62,245) US$ (1,863 thousand)	(62,245) (Note 1)	Subsidia
	Chunghwa Investment Holding Company	Brunei	Investment	20,000 (US$ 589 thousand)		589	100	14,641 (US$ 462 thousand)	(4,238) US$ (127 thousand)	(4,238)	Subsidia
	PandaMomum Company	British Virgin Island	Develop PandaMomum project and provide multimedia services	20,000 (¥$ 65,094 thousand)		602	43	19,677 (¥$ 63,617 thousand)	(1,069) ¥$ (3,470 thousand)	(455)	Equity-a investee
Chunghwa Investment Holding Company	Donghua Telecom CO., Ltd	Hong Kong	Engage in telecom related investments, provide international private leased circuits (IPLC), internet protocol virtual private	20,000 (US$ 589 thousand)		4,590	100	14,729 (US$ 465 thousand)	(4,146) HK$ (1,002 thousand)	(4,146) US$ (125 thousand)	Subsidia

		network (IPVPN), and internet transit						
Chunghwa Telecom (ASIA) Company	Hong Kong		(HK$ 1)	100	(54) US$ (2 thousand)	(56) HK$ (14 thousand)	(56) US$ (2 thousand)	Subsidia

Note 1: The equity in net income (net loss) of unconsolidated companies is based on audited financial statements.

Note 2: The equity in net income of an unconsolidated company amounting to $23,269 thousand is calculated from the audited financial statements plus a gain on realized upstream transactions of $141,652 thousand less a gain on unrealized upstream transactions of $42,471 thousand.

TABLE 5

CHUNGHWA TELECOM CO., LTD.

INDUSTRY FINANCIAL INFORMATION

FOR THE YEARS ENDED DECEMBER 31, 2004 AND 2003

(Amount in Thousands of New Taiwan Dollars)

	Local Telephone Service	Domestic Long Distance Call Service	International Long Distance Call Service	Cellular Service	Paging Service	Internet and Data Service	All Other	Adjustment	Total
Year ended December 31, 2004									
Service revenues from external customers	$ 42,517,702	$ 11,907,447	$ 15,156,121	$ 70,135,081	$ 297,971	$ 39,310,130	$ 3,238,230	$	$ 182,562,682
Intersegment service revenues	17,451,661	2,417,003	3,359	1,080,766	1,348	10,842,714	16,585	(31,813,436)	
Total service revenues	$ 59,969,363	$ 14,324,450	$ 15,159,480	$ 71,215,847	$ 299,319	$ 50,152,844	$ 3,254,815	$ (31,813,436)	$ 182,562,682
Segment income before income tax	$ 4,770,301	$ 8,372,056	$ 3,760,295	$ 32,581,138	$ (279,854)	$ 13,894,708	$ 809,636	$	$ 63,908,280
Interest income									223,454
Equity in net gain of unconsolidated companies									69,796
Other income									2,449,787
Interest expense									(4,449)
General expense									(4,245,387)
Other expense									(1,639,599)
Income before tax									$ 60,761,882
Assets for reportable assets	$ 199,037,825	$ 6,406,768	$ 13,834,139	$ 65,830,559	$ 647,747	$ 106,363,871	$ 15,375,857	$	$ 407,496,766
Investment in unconsolidated companies and funds									6,034,991
Other assets									53,636,940
Total assets									$ 467,168,697
Depreciation expenses	$ 20,167,342	$ 834,146	$ 668,285	$ 5,908,732	$ 306,591	$ 12,324,660	$ 480,469		
	$ 4,474,586	$ 308,676	$ 255,087	$ 5,512,310	$	$ 11,571,760	$ 722,421		

Expenditures for segment assets							

(Continued)

	Local Telephone Service	Domestic Long Distance Call Service	International Long Distance Call Service	Cellular Service	Paging Service	Internet and Data Service	All Other	Adjustment	Total
Year ended December 31, 2003									
Service revenues from external customers	$ 45,666,183	$ 13,399,506	$ 15,617,961	$ 65,672,112	$ 592,216	$ 35,577,042	$ 2,623,523	$	$ 179,148,543
Intersegment service revenues	18,144,578	2,599,996	1,701	987,376	3,541	8,582,142	131,706	(30,451,040)	
Total service revenues	$ 63,810,761	$ 15,999,502	$ 15,619,662	$ 66,659,488	$ 595,757	$ 44,159,184	$ 2,755,229	$ (30,451,040)	$ 179,148,543
Segment income before income tax	$ 8,085,257	$ 8,143,635	$ 3,944,883	$ 27,843,865	$ (197,855)	$ 13,333,784	$ 1,038,750	$	$ 62,192,319
Interest income									99,800
Equity in net gain of unconsolidated companies									3,403
Other income									2,097,318
Interest expense									(43,071)
General expense									(3,858,944)
Other expense									(1,612,163)
Income before tax									$ 58,878,662
Assets for reportable assets	$ 218,735,414	$ 8,867,882	$ 14,507,202	$ 65,295,999	$ 1,103,445	$ 105,092,500	$ 12,814,299	$	$ 426,416,741
Investment in unconsolidated companies and funds									5,496,085
Other assets									28,911,815
Total assets									$ 460,824,641
Depreciation expenses	$ 22,232,745	$ 1,327,261	$ 615,385	$ 5,562,378	$ 311,033	$ 10,803,631	$ 708,776		
Expenditures for segment assets	$ 7,544,592	$ 1,313,891	$ 415,098	$ 7,937,694	$	$ 14,302,570	$ 666,331		

Note: The Company organizes its business segments based on the various types of telecommunications services provided to customers. The major business segments operated by the Company are local telephone service, domestic long distance call service, international long distance call service, cellular service, paging service, Internet and data service and other service.

-35-

Chunghwa Telecom Co., Ltd.

Financial Statements for the

Years Ended December 31, 2003 and 2004, and for

Each of the Years in the Three Year Period Ended

December 31, 2004

CHUNGHWA TELECOM CO., LTD.

BALANCE SHEETS

(Amounts in Millions, Except Shares and Par Value Data)

	Notes	December 31		
		2003	2004	
		NT$	NT$	US$ (Note 3)
ASSETS				
CURRENT ASSETS				
Cash and cash equivalents	2,4,19	$ 13,553	$ 29,283	$ 923
Short-term investments	2,5,19		9,115	287
Trade notes and accounts receivable, net	2,6	14,813	13,673	431
Inventories, net	2,7	1,220	1,439	45
Prepaid expenses		494	602	19
Deferred income taxes	2,15	16,983	17,283	544
Other current assets		1,703	1,609	51
Total current assets		48,766	73,004	2,300
INVESTMENTS IN UNCONSOLIDATED COMPANIES	2,8,19	3,496	4,035	127
PROPERTY, PLANT AND EQUIPMENT, NET	2,9,16	329,678	311,638	9,819
INTANGIBLE ASSETS				
Deferred pension cost	2,14	29,940	33,222	1,047
3G concession	2	10,179	10,179	321
Patents and computer software, net	2	251	207	6
Total intangible assets		40,370	43,608	1,374
OTHER ASSETS				
Deferred income taxes non-current	2,15	2,901	2,444	77
Other	19	4,484	3,692	116
Total other assets		7,385	6,136	193
TOTAL		$ 429,695	$ 438,421	$ 13,813

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

	Notes	December 31 2003	2004	
		NT$	NT$	US$ (Note 3)
LIABILITIES AND STOCKHOLDERS EQUITY				
CURRENT LIABILITIES				
Trade notes and accounts payable		$ 11,713	$ 14,484	$ 456
Income tax payable	2,15	4,923	5,032	159
Accrued expenses	10	14,206	14,368	453
Accrued pension liabilities	2,14	42,199	44,252	1,394
Current portion of deferred income	2	3,186	2,633	83
Current portion of long-term loans	12,19		200	6
Customers deposits	19	10,957	9,262	292
Other current liabilities	11,16	19,203	18,966	598
Total current liabilities		106,387	109,197	3,441
OTHER LIABILITIES				
Deferred income, net of current portion	2	11,610	9,778	308
Long-term loans	12,19	700	500	16
Other		243	203	6
Total other liabilities		12,553	10,481	330
Total liabilities		118,940	119,678	3,771
COMMITMENTS AND CONTINGENT LIABILITIES	17			
STOCKHOLDERS EQUITY	13			
Capital stock NT$10 (US$0.32) par value; authorized, issued and outstanding 9,647,724,900 common shares		96,477	96,477	3,040
Capital surplus		135,873	136,362	4,296
Retained earnings		78,405	85,909	2,706
Cumulative translation adjustments			(5)	
Total stockholders equity		310,755	318,743	10,042
TOTAL		$ 429,695	$ 438,421	$ 13,813

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

CHUNGHWA TELECOM CO., LTD.

STATEMENTS OF OPERATIONS

(Amounts in Millions, Except Shares and Per Share and Per ADS Data)

	Notes	Year Ended December 31			
		2002	2003	2004	
		NT$	NT$	NT$	US$ (Note 3)
SERVICE REVENUES	2	$ 179,361	$ 182,466	$ 185,163	$ 5,834
OPERATING COSTS AND EXPENSES	2				
Costs of services, excluding depreciation and amortization		58,120	59,633	60,256	1,899
Marketing, excluding depreciation and amortization	2	20,167	19,992	19,298	608
General and administrative, excluding depreciation and amortization		2,647	2,726	2,550	80
Research and development, excluding depreciation and amortization	2	2,428	2,581	2,476	78
Depreciation and amortization cost of services		37,890	39,170	38,358	1,209
Depreciation and amortization operating expense		2,408	2,399	2,345	74
Total operating costs and expenses		123,660	126,501	125,283	3,948
INCOME FROM OPERATIONS		55,701	55,965	59,880	1,886
OTHER INCOME					
Interest		187	100	224	7
Equity in net income of unconsolidated companies			3	70	2
Other income		2,294	2,098	2,423	77
Total other income		2,481	2,201	2,717	86
OTHER EXPENSES					
Interest		171	43	5	
Equity in net loss of unconsolidated companies	2,8	232			
Other expense		852	509	415	13
Total other expenses		1,255	552	420	13
INCOME BEFORE INCOME TAX		56,927	57,614	62,177	1,959
INCOME TAX	2,15	12,839	10,299	11,259	355
NET INCOME		$ 44,088	$ 47,315	$ 50,918	$ 1,604
NET INCOME PER SHARE	2	$ 4.57	$ 4.90	$ 5.28	$ 0.17

WEIGHTED AVERAGE NUMBER OF COMMON SHARES OUTSTANDING		9,647,724,900	9,647,724,900	9,647,724,900	9,647,724,900
NET INCOME PER EQUIVALENT ADS	2	$ 45.70	$ 49.04	$ 52.78	$ 1.66
WEIGHTED AVERAGE NUMBER OF EQUIVALENT ADSs OUTSTANDING		964,772,490	964,772,490	964,772,490	964,772,490

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

CHUNGHWA TELECOM CO., LTD.

STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY

(Amounts in Millions, Except Shares Data)

	Capital Stock			Retained Earnings				Cumulative	
	Common Shares	Amount	Capital Surplus	Legal Reserve	Special Reserve	Unappropriated Earnings	Total	Translation Adjustments Equity	Total Stockholders Equity
		NT$	NT$	NT$	NT$	NT$	NT$	NT$	NT$
BALANCE, DECEMBER 31, 2001 (IN NT$)	9,647,724,900	$ 96,477	$ 133,820	$ 21,379	$ 2,675	$ 35,306	$ 59,360	$	$ 289,657
Additional capital contributed by government			42						42
Appropriations and distributions of 2001 earnings:									
Legal reserve				3,727		(3,727)			
Dividends						(33,767)	(33,767)		(33,767)
Net income						44,088	44,088		44,088
BALANCE, DECEMBER 31, 2002 (IN NT$)	9,647,724,900	96,477	133,862	25,106	2,675	41,900	69,681		300,020
Additional capital contributed by government			80						80
Additional capital contributed by the MOTC through selling shares to employees at a discounted price			1,931						1,931
Appropriations and distributions of 2002 earnings:									
Legal reserve				4,331		(4,331)			
Dividends						(38,591)	(38,591)		(38,591)
Net income						47,315	47,315		47,315
BALANCE, DECEMBER 31, 2003 (IN NT$)	9,647,724,900	96,477	135,873	29,437	2,675	46,293	78,405		310,755
Additional capital contributed by government			32						32
Additional capital contributed by the MOTC through selling shares to employees at a discounted price			457						457
Appropriations and distributions of 2003 earnings:									
Legal reserve				4,850		(4,850)			
Special reserve					1	(1)			
Dividends declared						(43,414)	(43,414)		(43,414)
Net income						50,918	50,918		50,918
Cumulative translation adjustment for foreign-currency investments in unconsolidated companies								(5)	(5)
BALANCE, DECEMBER 31, 2004 (IN NT$)	9,647,724,900	$ 96,477	$ 136,362	$ 34,287	$ 2,676	$ 48,946	$ 85,909	($ 5)	$ 318,743
BALANCE, DECEMBER 31, 2004 (IN US$) (Note 3)	9,647,724,900	$ 3,040	$ 4,296	$ 1,080	$ 84	$ 1,542	$ 2,706	$	$ 10,042

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

CHUNGHWA TELECOM CO., LTD.

STATEMENTS OF CASH FLOWS

(Amounts in Millions)

	Year Ended December 31			
	2002	2003	2004	
	NT$	NT$	NT$	US$ (Note 3)
CASH FLOWS FROM OPERATING ACTIVITIES				
Net income	$ 44,088	$ 47,315	$ 50,918	$ 1,604
Adjustments to reconcile net income to net cash provided by operating activities:				
Provision for doubtful accounts	4,931	3,239	1,565	49
Depreciation and amortization	40,298	41,569	40,703	1,282
Net unrealized loss on short-term investments			12	
Cash dividends received from equity companies			56	2
Net loss on disposal of scrap inventories and property, plant and equipment	150	143	168	5
Equity in net loss (net income) of unconsolidated companies	232	(3)	(70)	(2)
Stock compensation for shares issued to employees at a discount		1,931	457	14
Deferred income taxes	744	425	157	5
Changes in operating assets and liabilities:				
Decrease (increase) in:				
Trade notes and accounts receivable	(1,764)	(760)	(382)	(12)
Inventories	(483)	(1,719)	(326)	(10)
Prepaid expenses	60	(8)	(108)	(3)
Other current assets	811	145	134	4
Other assets	1,028	(1,235)	742	24
Increase (decrease) in:				
Trade notes and accounts payable	(2,666)	2,159	2,879	91
Income tax payable	3,314	(1,249)	109	3
Accrued expenses	(422)	402	162	5
Customers deposits	(940)	(1,018)	(2,421)	(76)
Other current liabilities	1,969	1,138	464	15
Accrued pension liabilities	3,653	4,065	(1,229)	(39)
Deferred income	(3,467)	(3,016)	(2,385)	(75)
Other liabilities	(183)	90	(40)	(1)
Net cash provided by operating activities	91,353	93,613	91,565	2,885
CASH FLOWS FROM INVESTING ACTIVITIES				
Purchase and sales of short-term investments net			(9,127)	(287)
Acquisition of investments in unconsolidated companies	(2,000)		(530)	(17)
Proceeds from disposal of investments in unconsolidated companies		234		
Acquisitions of property, plant and equipment	(43,260)	(32,248)	(22,889)	(721)

(Continued)

	Year Ended December 31			
	2002	2003	2004	
	NT$	NT$	NT$	US$ (Note 3)
Proceeds from disposal of property, plant and equipment	$ 294	$ 6	$ 215	$ 7
Payment on 3G concession	(10,179)			
Acquisitions of patents and computer software	(174)	(193)	(122)	(4)
Net cash used in investing activities	(55,319)	(32,201)	(32,453)	(1,022)
CASH FLOWS FROM FINANCING ACTIVITIES				
Proceeds from long-term loans	38,700			
Payments on principal of long-term loans	(38,000)	(17,000)		
Cash dividends paid	(33,767)	(38,591)	(43,414)	(1,368)
Additional capital contributed by government	42	80	32	1
Net cash used in financing activities	(33,025))	(55,511)	(43,382)	(1,367)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	3,009	5,901	15,730	496
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	4,643	7,652	13,553	427
CASH AND CASH EQUIVALENTS, END OF YEAR	$ 7,652	$ 13,553	$ 29,283	$ 923
SUPPLEMENTAL INFORMATION				
Interest paid	$ 122	$ 66	$ 4	$
Income tax paid	$ 8,781	$ 11,121	$ 10,993	$ 346
NON-CASH FINANCING ACTIVITIES				
Current portion of long-term loans	$	$	$ 200	$ 6

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

CHUNGHWA TELECOM CO., LTD.

NOTES TO FINANCIAL STATEMENTS

(Amounts in Millions of New Taiwan Dollars, Unless Stated Otherwise)

1. GENERAL

Chunghwa Telecom Co., Ltd. (Chunghwa or the Company) was incorporated on July 1, 1996 in the Republic of China (ROC) pursuant to the Telecommunications Act No. 30. The Company is a company limited by shares and, prior to August 2000, was wholly owned by the Ministry of Transportation and Communications (MOTC). Prior to July 1, 1996, the current operations of Chunghwa were carried out under the Directorate General of Telecommunications (DGT). The DGT was established by the MOTC in June 1943 to take primary responsibility in the development of telecommunications infrastructure and to formulate policies related to telecommunications. On July 1, 1996, the telecom operations of the DGT were spun-off as Chunghwa which continues to carry out the business and the DGT continues to be the industry regulator.

As a dominant telecommunications service provider of fixed-line and cellular telephone services, within the meaning of applicable telecommunications regulations of the ROC, the Company is subject to additional requirements imposed by the MOTC.

The MOTC is in the process of privatizing the Company by reducing the government ownership to below 50% in stages. Certain of the Company s common shares were sold, in connection with the foregoing privatization plan, in domestic public offerings at various dates from August 2000 to July 2003. Certain of the Company s common shares were also sold to its employees at various dates from October 2000 to December 2003. In July 2003, the MOTC sold the Company s common shares in an international offering of securities in the form of American Depository Shares (ADS). The MOTC intends to continue to sell the Company s common shares in the ROC and throughout the process of privatization to the Company s employees. As of December 31, 2004, the MOTC owns 64.89% shares of the Company.

The Company s common shares were listed and traded on Taiwan Stock Exchange and New York Stock Exchange on October 27, 2000 and on July 17, 2003, respectively.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The Company maintains its accounting books and records based on the ROC Government regulations and accounting principles generally accepted in the ROC (ROC GAAP). The accompanying financial statements have been prepared to present its financial position, results of operations and cash flows in accordance with generally accepted accounting principles in the United States (US GAAP).

Use of Estimates

The preparation of financial statements requires management to make certain estimates and assumptions that affect the recorded amounts of assets, liabilities, revenues and expenses of the Company. The Company continually evaluates these estimates, including those related to allowances for doubtful accounts, useful lives of long term assets, pension plans, valuation allowances on deferred income taxes, customer service periods, impairment of assets and the fair value of financial instruments. The Company bases its estimates on historical experience and other assumptions, which it believes to be reasonable under the circumstances. Actual results may differ from these estimates.

Foreign Currency Transactions

The functional currency of the Company is the local currency, the New Taiwan dollar (NT$) as it is the currency of the primary economic environment. Thus, the transactions of the Company that are denominated in currencies other than the New Taiwan dollars (the foreign currency) are recorded in New Taiwan dollars at the exchange rates prevailing on the transaction dates. Gains or losses realized upon the settlement of a foreign currency transaction are included in the period in which the transaction is settled. The balances, at the balance sheet dates, of the foreign currency assets and liabilities are adjusted to reflect the prevailing exchange rates and the resulting differences are recorded as follows:

a. Long-term stock investments accounted for by the equity method as cumulative translation adjustment under stockholders equity.

b. Other assets and liabilities credited or charged to current income.

Cash Equivalents

Cash equivalents include commercial paper purchased with maturities of three months or less from the date of acquisition.

Short-term Investments

Short-term Investments include commercial paper and repurchaseable bonds purchased with original maturities greater than 90 days. The Company has classified investments as held to maturity which the Company has the ability to and intends to hold to maturity. Held-to-maturity investments are reported at amortized cost with any realized gains and losses recorded in other income and expense. Investments in mutual funds are designated as trading and are carried at their fair value with unrealized valuation gains and losses recognized in earnings.

Inventories

Inventories, consisting mainly of telecommunication cables, are stated at the lower of cost (weighted- average cost method) or market value (replacement cost or net realizable value). If the market value is below cost, the Company writes down the inventory to the market value which then becomes the new cost basis.

Investments in Unconsolidated Companies

Investments in shares of stock in companies where the Company exercises significant influence over operating and financial policy decisions are accounted for using the equity method of accounting. The difference between the investment cost and the Company s proportionate share in the net assets of the investee at the date of acquisition is amortized over the estimated useful life of any intangible assets identified. Any goodwill identified is not amortized and evaluated for impairment annually or when circumstances warrant. Any cash dividends received are recognized as a reduction in the carrying value of the investment. Unrealized profits arising from downstream transactions to equity investees are deferred in

the Company s portion of equity income or loss. Profits and losses arising from equipment purchases from equity investees are eliminated and recognized over the estimated remaining useful life of the equipment.

Investments in shares of stock with no readily determinable market values are accounted for using the cost method when the ownership is less than 20%. Cash dividends received are recorded as income and stock dividends received are accounted for as increases in the number of shares held but not recognized as income.

The costs of investments sold are determined using the weighted-average method.

Property, Plant and Equipment

Property, plant and equipment are stated at cost. Depreciation expense is determined based upon the assets estimated useful life using the straight-line method.

The estimated useful lives are as follows:

	Useful Life (Years)
Buildings and improvements	10-60
Telecommunications equipment:	
Transmission equipment	9-15
Exchange equipment	6-12
Miscellaneous equipment	3-10

Cost of maintenance and repairs, including the cost of replacing minor items not constituting substantial improvements, is charged to current income.

Losses incurred for the sale or disposal of property, plant and equipment are recorded as costs of services.

Valuation of Long-lived Assets

Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. If the total of the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the assets, a loss is recognized for the excess of the carrying amount over the fair value of the asset. No impairment charge was recorded throughout the periods presented in the accompanying financial statements.

3G Concession

3G Concession represents the amount paid by the Company to the ROC government in connection with the grant of a concession to provide various telecommunication services using spectrum assigned by the MOTC that utilizes the International Mobile Telecommunication 2000: The Global Standard for Third Generation Wireless Communications technical standards as announced by the International Telecommunications Union (the 3G concession). Licenses for 3G mobile telecommunication services are granted by the MOTC through a three-step procedure. Applicants first obtain a concession from the MOTC through a bidding process. The concession is valid from the issue date to December 31, 2004. The Company may apply to extend this date by one year with approval from the MOTC. The holder of the concession must then obtain a network construction permit from the Directorate General of Telecommunications (the DGT , the regulator of the telecommunication industry). Once the network construction is complete, the applicant may apply for a 3G license from the MOTC. The 3G license is valid through December 31, 2018. The 3G concession and any additional licensing fees will be amortized on a straight-line basis from the date operations commence through the date the license expires. The 3G Concession cost is subject to review for impairment as other long-lived assets.

Patents and Computer Software

Patents are amortized using the straight-line method over the estimated useful lives ranging from 12 to 20 years. Computer software costs are capitalized and amortized using the straight-line method over the estimated useful lives of three years. Amortization expenses for the years ended December 31, 2002, 2003 and 2004 were NT$122 million, NT$154 million and NT$166 million, respectively. Accumulated amortization was NT$813 million and NT$979 million as of December 31, 2003 and 2004, respectively.

Deferred Income

Deferred income represents one-time connection fees received from subscribers. The deferred income is recognized over the average expected customer service periods.

The average expected customer service periods (in years) are as follows:

	As of December 31	
	2003	2004
Fixed-line	13	13
Cellular	5	5
Paging	2	2
Internet	3	3

Revenue Recognition

The Company evaluates revenue recognition for its transactions using the SEC Staff Accounting Bulletin (SAB) No. 104, Revenue Recognition .

The Company records service revenues over the periods they are earned. The costs of providing services are recognized as incurred. Handset subsidy costs are paid to a vendor that sells a handset to a customer who subscribes to the service, as an inducement to enter into a service contract, and are recognized as a cost of service when incurred. Usage revenues from fixed-line services, cellular services, Internet and data services, and inter-connection and call transfer fees from other telecommunications companies and carriers are billed in arrears and are recognized based upon minutes of traffic processed when the services are provided in accordance with contract terms. The Company had accrued unbilled revenues for services provided amounting to NT$1,329 million and NT$1,383 million as of December 31, 2003 and 2004, and are included in accounts receivable in the accompanying balance sheets.

Other revenues are recognized as follows: (a) one-time subscriber connection fees are deferred and recognized over the average expected customer service periods, (b) fixed-monthly fees (on fixed-line services, wireless (cellular and paging) and Internet and data services) are accrued every month, and (c) prepaid services (fixed line, cellular and internet) are recognized as income based upon actual usage by customers or when the right to use those services expires.

Concentrations

For all periods presented, no individual customer or supplier constituted more than 10% of the Company s revenues, trade notes and accounts receivables, purchases or trade notes and accounts payable. The Company also does not have concentrations of available sources of labor, services or other rights that could, if suddenly eliminated, severely impact its operations. However, telecommunications franchises and licenses are issued solely by authority of the ROC government. The withdrawal or the revocation of the franchise and licenses by the ROC government would severely impact the Company s operations. The Company invests its cash with several high-quality financial institutions.

Pension Costs

Pension costs are recorded on the basis of actuarial calculations. As a foreign registrant, the Company adopted SFAS No. 87 on July 1, 1996 as it was not feasible for the Company to obtain the information necessary to adopt SFAS No. 87 as of July 1, 1989. The Company has allocated a portion of the transition obligation directly to equity on the date of adoption based on the ratio of: (a) the years elapsed between the effective date in SFAS No. 87 and the adoption date, to (b) the remaining service period of employees expected to receive benefits as estimated at the adoption date.

Advertising and Promotional Expenses

Advertising and promotional expenses are charged to income as incurred. These expenses were NT$1,935 million, NT$1,861 million and NT$2,526 million for the years ended December 31, 2002, 2003 and 2004, respectively.

Research and Development Costs

Research and development costs are charged to income as incurred.

Employee Stock Compensation

In connection with the privatization plan of the Company, employees may be offered to purchase shares of common stock of the Company at less than fair market value. The Company records the difference between the quoted market price of the stock on the date of purchase and the purchase price as compensation expense and charges to income in the period of the purchase.

Derivative Financial Instruments

The Company enters into forward contracts to reduce its exposure to foreign currency risk and variability in operating results due to fluctuations in exchange rates underlying the value of liabilities denominated in foreign currencies until such liabilities are paid. A forward contract obligates the Company to exchange predetermined amounts of specified foreign currencies at specified exchange rates on specified dates. These foreign currency forward exchange contracts are denominated in the same currency in which the underlying foreign currency liabilities are denominated and bear a contract value and maturity date that approximate the value and expected settlement date, respectively, of the underlying transactions. For contracts that are designated and effective as hedges, unrealized gains and losses on open contracts at the end of each accounting period, resulting from changes in the fair value of these contracts, are recognized in earnings in the same period as gains and losses on the underlying foreign denominated receivables are recognized and generally offset. Gains and losses on forward contracts and foreign denominated liabilities are included in other income (expense), net. The Company does not enter into or hold derivatives for trading or speculative purposes and only enters into contracts with highly rated financial institutions.

Derivatives are recognized at fair value and included in either other current liabilities or other current assets on the balance sheet.

Income Tax

The Company is subject to income tax in the ROC. The Company accounts for income tax using the asset and liability method. Under this method, deferred income tax is recognized for investment tax credits, losses carried forward and the future tax consequences attributable to differences between financial statement carrying amounts and their respective tax bases, using enacted laws. A valuation allowance is recognized if, based on the weight of available evidence, it is more likely than not that a portion or the entire deferred tax asset will not be realized.

Income taxes on undistributed earnings (10%) generated after 1998 are recorded as expense in the current year.

Comprehensive Income

Comprehensive income includes all changes in equity during a period from sources other than the stockholders. The balance of comprehensive income is zero for all balance sheet dates presented.

Net Income Per Share and Per Equivalent ADS

Net income per share is computed by dividing net income by the weighted-average number of common shares outstanding during the periods. Net income per equivalent ADS is calculated by multiplying the above net income per share by ten as each ADS represents ten common shares.

Recent Accounting Pronouncements

In December 2004, the FASB issued SFAS No. 123(R) Share-Based Payment. SFAS No. 123(R) requires that companies recognize compensation expense equal to the fair value of stock options or other share based payments for the annual reporting period that begins after June 15, 2005. SFAS No. 123(R) applies to all awards granted after June 15, 2005, and prior period s awards that are modified, repurchased, or cancelled after June 15, 2005. There is no impact to the Company as a result of this standard as the Company does not currently issue stock options to its employees or others.

3. U.S. DOLLAR AMOUNTS

The Company maintains its accounts and expresses its financial statements in New Taiwan dollars. For convenience only, U.S. dollar amounts presented in the accompanying financial statements have been translated at the noon buying rate for cable transfers as certified for customs purposes by the Federal Reserve Bank of New York as of December 31, 2004, which was NT$31.74 to US$1.00. The convenience translations should not be construed as representations that the New Taiwan dollar amounts have been, could have been, or could in the future be, converted into U.S. dollars at this or any other rate of exchange.

4. CASH AND CASH EQUIVALENTS

	December 31	
	2003	2004
	NT$	NT$
Cash and bank deposits	$ 2,112	$ 1,958
Negotiable Certificate of Deposit		8,900
Commercial paper	11,441	18,425
	$ 13,553	$ 29,283

5. SHORT-TERM INVESTMENT

Short-term investments comprised an open-end bond mutual fund of NT$8,901 million and a repurchaseable bond of NT$214 million. The gross unrealized gains for open-end bond mutual funds were NT$1 million, and the unrealized foreign exchange losses for repurchaseable bond were NT$13 million as of December 31, 2004.

11

6. ALLOWANCE FOR DOUBTFUL ACCOUNTS

The changes in this account are summarized as follows:

	Year Ended December 31		
	2002	2003	2004
	NT$	NT$	NT$
Balance, beginning of period	$ 5,008	$ 7,505	$ 7,786
Provision for doubtful accounts	4,931	3,158	1,522
Accounts receivable written off	(2,434)	(2,877)	(4,835)
Balance, end of period	$ 7,505	$ 7,786	$ 4,473

7. INVENTORIES, NET

	December 31	
	2003	2004
	NT$	NT$
Supplies, net	$ 1,124	$ 1,111
Work in process	1	2
Materials in transit	95	326
	$ 1,220	$ 1,439

The insurance coverage on inventories as of December 31, 2004 amounted to NT$1,146 million.

8. INVESTMENTS IN UNCONSOLIDATED COMPANIES

The investments in unconsolidated companies comprise the following:

	December 31			
	2003		2004	
	Carrying Value	% of Owner-ship	Carrying Value	% of Owner-ship

	NT$		NT$	
Equity investees:				
Chunghwa Investment (CHI)	$ 987	49	$ 930	49
Taiwan International Standard Electronics (TISE)	433	40	499	40
	1,420		1,429	
Cost investees:				
Taipei Financial Center (TFC)	2,000	12	2,530	12
RPTI International (RPTI)	71	12	71	12
Siemens Telecommunication Systems (Siemens)	5	15	5	15
	2,076		2,606	
	$ 3,496		$ 4,035	

TISE designs, manufactures and sells telecommunications equipment. It also provides maintenance services on such telecommunications equipment. Dividends amounted to NT$56 million were declared by TISE for the years ended December 31, 2004.

CHI invests in companies engaged in telecom and software businesses. No dividends were declared by CHI for the years ended December 31, 2003 and 2004, respectively.

The Company evaluated the investments in TFC, RPTI and Siemens for investment. The investments have no quoted market values and are carried at their original costs which approximate fair value based on the net asset values on the respective companies.

9. PROPERTY, PLANT AND EQUIPMENT, NET

	December 31	
	2003	**2004**
	NT$	**NT$**
Cost		
Land	$ 42,326	$ 42,407
Buildings and improvements	53,901	56,265
Telecommunications equipment	607,093	613,626
Miscellaneous equipment	28,279	27,361
	731,599	739,659
Accumulated depreciation		
Buildings and improvements	11,215	12,194
Telecommunications equipment	412,773	426,649
Miscellaneous equipment	21,140	20,579
	445,128	459,422
Construction in progress	43,159	31,360
Advances related to acquisition of equipment	48	41
Property, plant and equipment, net	$ 329,678	$ 311,638

On July 1, 1996, pursuant to the guidance on the incorporation of the Company and as instructed by the ROC s Executive Yuan (executive branch), the ROC Government (through the MOTC) transferred to the Company certain land and buildings with a carrying value of NT$53,895 million. Those properties, as of that date, were registered in the name of the ROC s National Properties Bureau (NPB). As of December 31, 2004, all the properties had been registered in the name of the Company.

No interest expense was capitalized for the year ended December 31, 2004. Capitalized interest expense aggregated to NT$302 million and NT$46 million for the years ended December 31, 2002 and 2003, respectively. The rate of capitalized interest is from 1.51% to 4.18% and 0.56% to 1.67%, respectively.

The Company carries insurance on certain buildings and certain telecom equipment with carrying value of NT$5,146 million and NT$1,802 million as of December 31, 2003 and 2004, respectively. The Company does not carry comprehensive insurance on all properties.

10. ACCRUED EXPENSES

	December 31	
	2003	2004
	NT$	NT$
Accrued compensation	$ 8,997	$ 9,207
Accrued franchise fees	2,435	2,500
Other accrued expenses	2,774	2,661
	$ 14,206	$ 14,368

11. OTHER CURRENT LIABILITIES

	December 31	
	2003	**2004**
	NT$	**NT$**
Advances from subscribers	$ 6,504	$ 6,835
Amounts collected from subscribers in trust for others	3,610	3,467
Payable to equipment suppliers	3,230	4,150
Payables to construction suppliers	3,081	2,318
Other	2,778	2,196
	$ 19,203	$ 18,966

12. LONG-TERM LOANS (INCLUDING CURRENT PORTION OF LONG-TERM LOANS)

The loan from the Common Tunnel Fund was obtained pursuant to a long-term loan agreement with the Common Tunnel Fund managed by Ministry of Interior that allows the Company to obtain unsecured interest-free credit until March 12, 2007. The outstanding principal amounts as of December 31, 2004 are payable in three annual installments (NT$0.2 billion, NT$0.2 billion and NT$0.3 billion) starting on March 12, 2005.

As of December 31, 2004, the Company has unused credit lines of approximately NT$190,000 million, which are available for short-term and long-term borrowings.

13. STOCKHOLDERS EQUITY

Under the Company s Articles of Incorporation, authorized capital is 9,647,724,900 common shares. The Company s Articles of Incorporation and the Republic of China Telecommunications Act provide that the MOTC has the right to purchase two redeemable preferred shares (NT$10 par value) in the event its ownership in the Company falls below 50% of the outstanding common shares.

The MOTC, as the holder of those preferred shares is entitled to the same rights as holders of common shares and certain additional rights as specified in the Company s Articles of Incorporation as follows:

a. The holder of the preferred shares, or its nominated representative, will act as a director and/or supervisor during the entire period in which the preferred shares are outstanding.

b. The holder of preferred shares has the same stock option as holders of common shares when the Company raises capital by issuing new shares.

c. The holder of the preferred shares will have the right to vote on any change in the name of the Company or the nature of its business and any transfer of a substantial portion of the Company s business or property.

d. The holder of the preferred shares may not transfer the ownership. The Company must redeem all outstanding preferred shares within three years from the date of their issuance.

For the purpose of privatizing the company, the MOTC sold 1,109,750 thousand common shares of the Company in an international offering of securities in the form of American Depositary Shares (ADS) amounting to 110,975 thousand units (one ADS represents ten common shares) on the New York Stock Exchange in July 17, 2003.

The ADS holders generally have the same rights and obligations as other common shareholders, subject to the provision of relevant laws. The exercise of such rights and obligations shall comply with the related regulations and deposit agreement, which stipulate, among other things, that ADS holders can, through deposit agents; exercise their voting rights, sell their ADSs, and receive dividends declared and subscribe to the issuance of new shares.

As of December 31, 2004, the outstanding ADSs were 110,975 thousand units, which equaled approximately 1,109,749 thousand common shares, and represented 11.50% of the Company s total outstanding common shares.

Under the ROC Company Law, capital surplus may only be utilized to offset deficits or be declared as stock dividends. Also, such capital surplus can only be declared as a stock dividend by the Company at an amount calculated in accordance with the provisions of existing regulations. As of December 31, 2004, the amount of retained earnings available for dividends was NT$50,776 million and was based on earnings as determined using ROC government regulations.

In addition, before distributing a dividend or making any other distribution to stockholders, the Company must pay all outstanding taxes, recover any past losses and set aside a legal reserve equal to 10% of its net income, and, depending on its business needs or requirements, may also set aside a special reserve. The cash dividends to be distributed shall not be less than 10% of the total amount of dividends to be distributed. If the cash dividend to be distributed is less than NT$0.10 per share, such cash dividend shall be distributed in the form of common shares.

Under the ROC Company Law, the appropriation for legal reserve shall be made until the accumulated reserve equals the aggregate par value of the outstanding capital stock of the Company. This reserve can only be used to offset a deficit, or when reaching 50% of the aggregate par value of the outstanding capital stock of the Company, up to 50% of the reserve may, at the option of the Company, be declared as a stock dividend and transferred to capital.

The MOTC, in connection with the privatization plan of the Company, sold shares of stock at discounted prices, to employees at various times from October 2000 to October 31, 2003. The employees purchased the common shares at discounts of 10% and 20% in consideration for their commitment to hold the common shares for two and three years (the holding periods), respectively. In circumstances wherein the employees took advantage of such discounts, the common shares are held by an escrow agent on behalf of the employees/stockholders. There are no circumstances under which the MOTC or the Company would be required to repurchase these common shares. Also, the employees are not required to remain employed with the Company during the duration of the holding periods. The Company has recognized NT$1,452 million as compensation expense for the shares purchased by employees that were subject to a discount for the year ended December 31, 2003.

The MOTC, in connection with the compensation of the employees, sold to employees 3,286,907 shares from February 27, 2004 to March 9, 2004, 14,579 shares from May 31, 2004 to June 18, 2004, 382,083 shares from June 30, 2004 to July 6, 2004 and 5,098,515 shares from November 30 to December 8, 2004 for total consideration of NT$33 million, NT$0.1 million, NT$4 million, and NT$50 million, respectively. The terms of the offers for the share purchases provided that employees purchase common shares from the above offering and hold the shares for one to three years. Such common shares, pursuant to the Enforcement Rule of the Statute Governing Privatization of State-Owned Enterprises, were sold at par value (NT$10). The employees are not required to remain employed with the Company during the duration of the holding periods. The Company has recognized NT$11 million, NT$15 million, and NT$457 million as compensation expense for the shares purchased by employees that were subject to par value for the year ended December 31, 2002, 2003, and 2004, respectively.

14. PENSION PLAN

At the time of its incorporation on July 1, 1996, the Company continued the existing two noncontributory defined benefit pension plans covering all its employees, as previously adopted by the DGT. The first plan (hereinafter referred to as Plan A) covers civil service eligible employees (i.e., employees who meet the necessary qualifications set by the ROC Government) and the second plan (hereinafter referred to as Plan B) covers all other employees of the Company (hereinafter referred to as non-civil service eligible employees). The adoption of two pension plans was necessary as different pension laws apply to civil service eligible and non-civil service eligible employees.

Plan A provides benefits equal to the sum of: (a) the lump-sum payment equivalent to one benefit unit per year for the first twenty service years rendered and one-half benefit unit per service year rendered thereafter, with one benefit unit equivalent to a portion of the salary of the employee at the time of retirement (referred to hereinafter as pensionable salary), and (b) annuity payments payable monthly equivalent to a certain percentage of the benefit unit. Plan B provides benefits equal to the lesser of: (a) forty-five benefit units, or (b) two benefit units per service year rendered for the first fifteen years, and one-half benefit unit per service year exceeding fifteen years rendered before August 1, 1984 and one benefit unit per service year for services rendered after August 1, 1984, with one benefit unit equivalent to the monthly average base salary (consisting of regular salary items plus overtime salary). Plan A is funded based on amounts included in budgets approved by the Legislative Yuan and supplementary budgets approved by the Executive Yuan while Plan B is funded at an amount equivalent to 2% to 15% of the monthly salary.

The Company adopted SFAS No. 87 on July 1, 1996 (adoption date), the date of its incorporation. The unrecognized net transition obligation recorded to shareholders equity on July 1, 1996 was NT$6,571 million which represents the difference in the net pension cost for the period from the issuance of SFAS No. 87 and the date of adoption. The remaining unrecognized net transition obligation of NT$16,790 million is amortized over the estimated remaining service period of the employees as determined on July 1, 1996, which is a period of twenty-five years and seventeen years for civil service eligible employees and non-civil service eligible employees, respectively.

On June 23, 1997, the Council for Economic Planning and Development of the ROC Government officially instructed the Company to complete its privatization by June 30, 2001. Effective on the privatization date, except for those who will have reached the mandatory retirement age (the age of 65 for Plan A participants and age 60 for Plan B participants) by that day, employees will receive pension benefit payments calculated in accordance with the Guidelines on Payments of Severance Benefits to Employees of State-Owned Enterprises (Guidelines), as required by the ROC Government for state-owned enterprises instructed to undergo privatization plans. The employees not covered by the Guidelines will continue to receive benefits either as Plan A or Plan B participants.

Under the Guidelines, the Company was to pay all benefit payments on June 30, 2001, the initial expected date of privatization, to settle all employees past service costs under the existing plans. On the actual privatization date, a replacement plan with substantially the same provisions will be put in place. The settlement benefit payments, regardless of the respective original plan participation, will be as follows: (a) employees who will voluntarily leave the Company on the privatization date (hereinafter referred to as separated employees) will receive a service clearance payment which is calculated similar to the benefit formula under the original Plan B as mentioned above plus an additional six-month salary and one-month advance notice pay (hereinafter referred to as the additional separation payments); (b) employees who opt to remain with the privatized company after the privatization date (hereinafter referred to as privatized company employees) will receive an amount equivalent to those received by the separated employees without the additional separation payments; and (c) privatized company employees who are involuntarily terminated by the Company within five years from the date of privatization (hereinafter referred to as redundant employees) will receive redundancy benefits equivalent to the amount computed based on one benefit unit for every year of service after privatization plus the additional separation payments (hereinafter referred to as redundancy benefit payments). The six-month portion of the additional separation payments and the redundancy benefit payments will be paid by the MOTC and the one-month portion will be paid by the Company.

The unrecognized prior service costs, which amounted to NT$30,018 million, related to the increased benefits provided under the plan amendment described in the preceding paragraph were amortized through June 30, 2001. The unrecognized prior service costs associated with the plan amendment exclude any costs expected to be incurred for the additional separation payments or redundancy benefit payments. The additional separation payments under the Guidelines are accounted for as special termination benefits and will be recognized in the period when the employee accepts the offer while the redundancy benefit payments will be recognized in the period management has approved a plan of termination.

In order to increase operational efficiency, the Company approved a Special Retirement Incentive Program (Program). The Program allows eligible employees who voluntarily leave the Company on February 1, 2005 to also receive benefit payments based on the respective original plan (meaning Plan A or Plan B) plus the additional separation payments. The present value of such amount over and above the lump sum amount that would have been paid to the employees had they stayed until February 1, 2005 was accounted for as special termination benefits. Accordingly, such benefits were recognized as a liability and charged to income when employees formally accepted the terms of the Program.

The privatization of the Company was not completed on December 31, 2004. The Chairman, as representative of the MOTC, approved the new target privatization date to be December 31, 2005. The Company accounted for the change in the privatization date as a change in the assumption with the resulting adjustment in the projected benefit obligation accounted for as an actuarial loss.

In addition, pursuant to a regulation issued by the Executive Yuan, the obligation related to annuity payments due after the date of privatization for Plan A participants who retire prior to that date will be borne by the MOTC. Such amounts have been included in the Company s pension computation as of December 31, 2003 and 2004. Upon privatization, the portion of liabilities that will be taken over by the MOTC will be accounted for as contributed capital and recorded in stockholders equity.

The Labor Pension Act of ROC will be effective beginning July 1, 2005 and this pension mechanism is considered as a defined contribution plan. The employees who were subject to the Labor Standards Law prior to the enforcement of this Act may choose to be subject to the pension mechanism under this Act or continue to remain subject to the pension mechanism under the Labor Standards Law. For those employees who were subject to the Labor Standards Law prior to July 1, 2005 and still work for the same company after July 1, 2005 and choose to be subject to the pension mechanism under this Act, their seniority as of July 1, 2005 shall be maintained. The rate of contribution by an employer to the Labor Pension Fund per month shall not be less than 6% of each employee s monthly salary or wage.

The components of net periodic benefit costs are as follows:

	Year Ended December 31		
	2002	**2003**	**2004**
	NT$	**NT$**	**NT$**
Service cost	$ 2,285	$ 1,970	$ 1,943
Interest cost	2,870	2,362	1,887
Expected return on plan assets	(2,196)	(1,618)	(1,226)
Termination benefit under the Program			243
Amortization of unrecognized net transition obligation	939	939	939
Amortization of unrecognized net loss	172	635	907
Net periodic benefit pension cost	$ 4,070	$ 4,288	$ 4,693

The changes in benefits obligation and plan assets and the reconciliation of funded status are as follows:

	Year Ended December 31		
	2002	2003	2004
	NT$	NT$	NT$
Change in benefits obligation:			
Projected benefits obligation, beginning of year	$ (114,289)	$ (119,822)	$ (126,126)
Services cost	(2,285)	(1,970)	(1,943)
Interest cost	(2,870)	(2,362)	(1,887)
Termination benefit under the Program			(243)
Actuarial loss	(8,347)	(4,557)	(8,038)
Benefits paid	7,969	2,585	3,326
Projected benefits obligation, end of year	$ (119,822)	$ (126,126)	$ (134,911)
Change in plan assets:			
Fair value of plan assets, beginning of year	$ 89,377	$ 83,478	$ 82,578
Actual return on plan assets	1,654	1,462	696
Employer contributions	416	223	5,922
Benefits paid	(7,969)	(2,585)	(3,326)
Fair value of plan assets, end of year	$ 83,478	$ 82,578	$ 85,870
Reconciliation of funded status			
Funded status	$ (36,344)	$ (43,548)	$ (49,041)
Unrecognized net transition obligation	10,689	9,750	8,811
Unrecognized actuarial loss	17,461	21,539	29,200
Net amount recognized	$ (8,194)	$ (12,259)	$ (11,030)
The weighted-average asset allocations:			
Asset category			
Time deposit	67%	73%	85%
Short-term notes	33%	23%	15%
Taiwan government securities	%	4%	%
	100%	100%	100%

The target asset allocations are established through an investment policy established by the Chunghwa Telecom s Employee Pension Fund Committee and agreed to by the MOF. As increased liquidity of the fund is necessary due to the privatization of the Company, the current policy for plan assets is to place funds in time deposit accounts of the financial and postal institutions, non-designated trust funds in an investing company or financial institution and government bonds. In addition, the pension fund may invest in beneficial certificates of equity securities.

The Company expects to contribute NT$6,100 million to the pension plans in 2005. Under the terms agreed upon for the privatization of the Company, the MOTC will contribute NT$45,687 million to the pension plans in 2005.

Expected benefit payments, which reflect expected future service, as appropriate, are as follows:

	Plan A	Plan B
	NT$	NT$
2005	$ 138,619	$ 350
2006		173
2007		379
2008		964
2009		836
2010-2014		8,727

The amounts recognized in the accompanying balance sheets at December 31 are as follows:

	Year Ended December 31		
	2002	2003	2004
	NT$	NT$	NT$
Amounts recognized			
Accrued pension liability	$ (32,226)	$ (42,199)	$ (44,252)
Intangible assets deferred pension cost	24,032	29,940	33,222
Net amount recognized	$ (8,194)	$ (12,259)	$ (11,030)

Information for the Company s pension plans with an accumulated benefit obligation in excess of plan assets is as follow:

	Year Ended December 31		
	2002	2003	2004
	NT$	NT$	NT$
Aggregate accumulated benefit obligation	$ (116,332)	$ (125,499)	$ (130,982)
Accumulated benefit obligation Plan A	$ (116,200)	$ (125,291)	$ (130,643)
Fair value of plan assets Plan A	$ 82,884	$ 81,813	$ 84,924

	Before Privatization	After Privatization
Actuarial assumptions:		

Year ended December 31, 2002		
Discount rate used in determining present value	1.95%	3.75%
Rate of compensation increase		
All employees	2.00%	5.00%
Annuity increase for retirees		3.00%
Rate of return on plan assets		
Plan A	1.95%	3.75%
Plan B	1.95%	3.75%

(Continued)

	Before Privatization	After Privatization
Year ended December 31, 2003		
Discount rate used in determining present value	1.50%	3.20%
Rate of compensation increase		
All employees	0.50%	3.50%
Annuity increase for retirees		2.00%
Rate of return on plan assets		
Plan A	1.50%	
Plan B	1.50%	3.20%
Year ended December 31, 2004		
Discount rate used in determining present value	1.50%	3.20%
Rate of compensation increase		
All employees	3.50%	2.00%
Annuity increase for retirees	3.00%	2.00%
Rate of return on plan assets		
Plan A	1.50%	
Plan B	1.50%	3.20%

The discount rate and expected return on plan assets presented in the table above is used to determine pension expense for the succeeding year. We select the expected rate of return on plan assets on the basis of a near term view of asset portfolio performance of our pension plans due to the privatization of the Company and the near term potential need for liquidity.

15. INCOME TAXES

The components of income taxes are as follows:

	Year Ended December 31		
	2002	2003	2004
	NT$	NT$	NT$
Current	$ 12,095	$ 10,724	$ 11,101
Deferred	744	(425)	158
	$ 12,839	$ 10,299	$ 11,259

A reconciliation between income tax expense computed by applying the statutory income tax rate of 25% to income before income tax and income tax expense shown in the statements of operations and comprehensive income is as follows:

	Year Ended December 31		
	2002	2003	2004

	NT$	NT$	NT$
Income tax expense computed at statutory tax rate	$ 14,232	$ 14,404	$ 15,544
Permanent differences	(99)	308	(65)
Investment tax credits	(2,095)	(4,348)	(3,379)
Other	801	(65)	(841)
Income tax expense	$ 12,839	$ 10,299	$ 11,259

Upon privatization in the period when the government s ownership percentage falls below 50%, the Company will continue to be subject to a 10% tax on its undistributed earnings as required by the Income Tax Law of the ROC. As the Company is currently and has historically been required under government regulations to distribute all its earnings within six months subsequent to year end, it has been required to pay a minimal amount of tax under this regulation. For ROC GAAP purposes, the 10% tax on undistributed earnings is recorded as an expense at the time shareholders resolve that its earnings shall be retained and the liability is incurred. Upon privitization, the 10% tax on undistributed earnings will be recorded as an expense in the year of the earnings.

Permanent differences consist primarily of tax-exempt income from the sale of marketable securities and interest income on commercial paper purchased, which are subject to a separate income tax rate of 20%.

Deferred income taxes arise due to temporary differences in the book and tax bases of certain assets and liabilities. Significant components of deferred income tax assets are shown in the following table:

	December 31	
	2003	**2004**
	NT$	**NT$**
Current:		
Provision for doubtful accounts	$ 1,614	$ 685
Deferred income	797	658
Accrued pension costs	15,237	15,723
Prepaid card revenues (related liability is included in other current liabilities)	850	735
Other, net	435	1,963
	18,933	19,764
Less valuation allowance	1,950	2,481
	$ 16,983	$ 17,283
Non-current:		
Deferred income	$ 2,887	$ 2,444
Other	1,828	244
	4,715	2,688
Less valuation allowance	1,814	244
	$ 2,901	$ 2,444

The above deferred income tax assets were computed based on a tax rate of 25%. A portion of the amount included in other relates to the timing differences between US GAAP reporting and the taxable base for the 10% undistributed earnings tax. These differences are computed based on a tax rate of 10%.

16. TRANSACTIONS WITH RELATED PARTIES

As the Company is a state-owned enterprise, the ROC Government is one of the Company s customers. The Company provides fixed-line services, wireless services, Internet and other services to the various departments and agencies of the ROC Government and other state-owned enterprises in the normal course of business and at arm s-length prices. The information on service revenues from government bodies and related organizations have not been provided because details of the type of users were not maintained by the Company. The Company believes that all costs of doing business are reflected in the financial statements and that no additional expenditures will be incurred as a result of the privatization being completed.

a. The Company engages in business transactions with the following related parties:

Company	Relationship
TISE	Equity investee
Chunghwa System Integration(CSI)	Subsidiary of CHI

b. Significant transactions with the above related parties are summarized as follows:

	December 31			
	2003		2004	
	Amount	%	Amount	%
Payables				
Trade notes and accounts payable				
TISE	$		$ 47	
CSI	51			
	$ 51		$ 47	
Accrued expenses				
TISE	$		$ 58	
CSI	30			
	$ 30		$ 58	
Payable to construction supplier (included in other current liabilities)				
TISE	$ 632	6	$ 77	
CSI	21		17	
	$ 653	6	$ 94	

	Years Ended December					
	2002		2003		2004	
	Amount	%	Amount	%	Amount	%

Operating cost and expenses						
TISE	$		$		$ 193	
CSI			96		121	
	$		$ 96		$ 314	
Acquisition of equipment						
TISE	$ 6,879	16	$ 4,471	14	$ 879	4
CSI			49		155	1
	$ 6,879	16	$ 4,520	14	$ 1,034	5

22

The foregoing acquisitions were conducted under normal commercial terms.

17. COMMITMENTS AND CONTINGENT LIABILITIES

As of December 31, 2004, the Company has remaining commitments under non-cancelable contracts with various parties as follows: (a) acquisitions of land and buildings of NT$3,391 million, and (b) acquisitions of telecommunications equipment of NT$12,126 million.

The Company also has non-cancelable operating leases covering certain buildings, computers, computer peripheral equipment and operating system software under contracts that expire in various years. Minimum rental commitments under those leases are as follows:

	December 31, 2004
	NT$
Within the following year	$ 1,226
During the second year	984
During the third year	636
During the fourth year	332
During the fifth year and thereafter	136
	$ 3,314

As of December 31, 2004, the Company had unused letters of credit of NT$6,147 million.

The Company has a commitment to contribute NT$2,500 million to a Fixed Line Fund administered by the Ministry of Interior Affairs and Taiwan Power Company, of which NT$1,000 million was contributed by the Company on June 30, 1995. If the balance of the Fixed Line Fund is not sufficient for its purpose, the above three parties will determine when to raise additional funds and the contribution amounts from each party. In addition, the Company has a commitment to contribute NT$2,000 million to a Piping Fund administered by the Taipei City Government, of which NT$1,000 million was contributed by the Company on August 15, 1996.

18. LITIGATION

The Company is involved in various legal proceedings of a nature considered normal to its business. It is the Company s policy to accrue for amounts related to these legal matters when it is probable that a liability has been incurred and the amount is reasonably estimable.

The Company believes that the various asserted claims and litigation in which it is involved will not materially affect its financial position, future operating results or cash flows, although no assurance can be given with respect to the ultimate outcome of any such claim or litigation.

19. INFORMATION ON FINANCIAL INSTRUMENTS

a. Derivative financial instruments

The Company enters into forward contracts to reduce its exposure to foreign currency risk and variability in operating results due to fluctuations in exchange rates underlying the value of liabilities denominated in foreign currencies until such liabilities are paid. There were no foreign currency forward exchange contracts outstanding as of December 31, 2004. The net realized exchange loss for the year ended December 31, 2004 was of NT$27 million.

b. Non-derivative financial instruments are as follows:

	December 31			
	2003		2004	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
	NT$	NT$	NT$	NT$
Assets				
Cash and cash equivalents	$ 13,553	$ 13,553	$ 29,283	$ 29,283
Short-term investments			9,115	9,115
Investments in unconsolidated companies, accounted for using the equity method	1,420	1,857	1,429	1,767
Refundable deposits (included in other assets other)	4,018	4,018	3,357	3,357
Liabilities				
Customers deposits	10,957	9,337	9,262	7,771
Long-term loans (including current portion)	700	700	700	700

The following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it is practicable to estimate that value:

1) Cash and cash equivalents. The carrying amounts approximate fair values because of the short maturity of those instruments.

2) Short-term investments. The carrying amounts approximate fair values because of the short maturity of those instruments.

3) Investments in unconsolidated companies, accounted for using the equity method. The fair value is based on net asset values of the investments in unconsolidated companies if quoted market prices are not available.

4) Refundable deposits. The carrying amounts approximate fair values as the average lease term associated with these deposits is approximately one year.

5) Customers deposits. The fair value is the discounted value based on projected cash flows. The projected cash flows were discounted using the average expected customer service periods.

6) Long-term loans (including current portion). The fair value is the discounted value based on projected cash flows. The projected cash flows were discounted using the maturity dates of long-term loans.

20. SEGMENT REPORTING

Operating segments are defined as components of an enterprise regarding which separate financial information is available for regular evaluation by the chief operating decision maker, or decision making group, in deciding how to allocate resources and in assessing performance.

The Company organizes its business segments based on the various types of telecommunications services provided to customers. The major business segments operated by the Company are classified as below:

Local operations the provision of local telephone services;

DLD operations the provision of domestic long distance call services;

ILD operations the provision of international long distance call services;

Cellular operations the provision of cellular and related services;

Paging operation the provision of paging and related services;

Internet and data operation the provision of Internet access, lease line, and related services;

All other operations the services other than the above six categories, such as carrying out project research and providing training.

The operating segments are managed separately because each operating segment represents a strategic business unit that serves different markets. All the operating segments of the Company have been aggregated into the above reportable segments.

The Company evaluates performance based on several factors using information prepared on the ROC government regulations basis. The information below is provided on this basis with a summary of US GAAP adjustments to reconcile to the amounts presented in the statement of operations. The Company does not allocate interest and other income, interest expense or taxes to operating segments, nor does the Company s chief operating decision maker evaluate operating segments on these criteria. Except as discussed above, the accounting policies for segment reporting are the same as for the company as a whole. The Company s primary measure of segment profit is based on income or loss from operations.

a. Reportable segments:

<u>As of and for the year ended December 31, 2002</u>

	Fixed-Line	Paging	All Other	Total

	Local	DLD	ILD	Cellular Service		Internet and Data		
	NT$	NT$	NT$	NT$	NT$	NT$	NT$	NT$
Service revenues for reportable segments	$ 67,950	$ 16,135	$ 15,720	$ 63,337	$ 1,059	$ 40,525	$ 2,904	$ 207,630
Elimination of intersegment amount	(18,343)	(2,103)	(1)	(867)	(5)	(9,344)	(181)	(30,844)
US GAAP adjustments	2,184	(17)	(17)	416		33	(24)	2,575
Total service revenues from external customers	$ 51,791	$ 14,015	$ 15,702	$ 62,886	$ 1,054	$ 31,214	$ 2,699	$ 179,361
Operating costs and expenses, excluding depreciation and amortization	$ 34,112	$ 7,510	$ 11,453	$ 33,150	$ 859	$ 19,130	$ 624	$ 106,838
Elimination of intersegment amount	(3,896)	(5,453)	(2,500)	(13,419)	(163)	(5,243)	(170)	(30,844)
US GAAP adjustments	2,000	72	96	233	14	676	274	3,365
	$ 32,216	$ 2,129	$ 9,049	$ 19,964	$ 710	$ 14,563	$ 728	79,359
Unallocated corporate amount								4,003
Total operating costs and expenses, excluding depreciation and amortization								$ 83,362

(Continued)

	Fixed-Line			Cellular		Internet		
	Local	**DLD**	**ILD**	**Service**	**Paging**	**and Data**	**All Other**	**Total**
	NT$	**NT$**	**NT$**	**NT$**	**NT$**	**NT$**	**NT$**	**NT$**
Depreciation and amortization	$ 23,445	$ 1,353	$ 545	$ 5,304	$ 374	$ 8,974	$ 751	$ 40,746
US GAAP adjustments	(358)	(21)	(5)	(77)	(5)	(125)	(5)	(596)
	$ 23,087	$ 1,332	$ 540	$ 5,227	$ 369	$ 8,849	$ 746	40,150
Unallocated corporate amount								148
Total depreciation and amortization								$ 40,298
Income from operations	$ 10,393	$ 7,272	$ 3,722	$ 24,883	$ (174)	$ 12,421	$ 1,529	$ 60,046
Elimination of intersegment amount	(14,447)	3,350	2,499	12,552	158	(4,101)	(11)	
US GAAP adjustments	542	(68)	(108)	260	(9)	(518)	(293)	(194)
	$ (3,512)	$ 10,554	$ 6,113	$ 37,695	$ (25)	$ 7,802	$ 1,225	59,852
Unallocated corporate amount					274	—		

Total other expenses, net	39,164	37,699	30,275
Income before income taxes	90,897	102,084	127,195
Income tax expense	(3,101)	(10,207)	(12,399)
Net income	87,796	91,877	114,796
Less: Net income attributable to noncontrolling interests	(12)	—	—
Net income attributable to common stockholders	$87,784	$91,877	$114,796
Earnings per share:			
Net income per share available to common stockholders—basic	$0.43	$0.46	$0.57
Net income per share available to common stockholders—diluted	$0.43	$0.46	$0.57
Weighted-average number of common shares outstanding:			
Basic	205,462,911	200,784,450	201,079,573
Diluted	206,131,150	201,521,468	201,676,258

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

Table of Contents

DIAMONDROCK HOSPITALITY COMPANY

CONSOLIDATED STATEMENTS OF EQUITY
Years Ended December 31, 2018, 2017 and 2016
(in thousands, except share and per share amounts)

	Common Stock						
	Shares	Par Value	Additional Paid-In Capital	Accumulated Deficit	Total Stockholders' Equity	Noncontrolling interests	Total Equity
Balance at December 31, 2015	200,741,777	$2,007	$2,056,878	$(234,280)	$1,824,605	$ —	$1,824,605
Dividends of $0.50 per common share	—	—	358	(101,096)	(100,738)	—	(100,738)
Issuance and vesting of common stock grants, net	187,362	2	4,634	—	4,636	—	4,636
Share repurchases	(728,237)	(7)	(6,505)	—	(6,512)	—	(6,512)
Net income	—	—	—	114,796	114,796	—	114,796
Balance at December 31, 2016	200,200,902	$2,002	$2,055,365	$(220,580)	$1,836,787	$ —	$1,836,787
Dividends of $0.50 per common share	—	—	424	(101,106)	(100,682)	—	(100,682)
Issuance and vesting of common stock grants, net	105,831	1	5,662	—	5,663	—	5,663
Net income	—	—	—	91,877	91,877	—	91,877
Balance at December 31, 2017	200,306,733	$2,003	$2,061,451	$(229,809)	$1,833,645	$ —	$1,833,645
Dividends of $0.50 per common share	—	$—	465	(103,705)	(103,240)	—	(103,240)
Issuance and vesting of common stock grants, net	141,165	1	4,531	110	4,642	—	4,642
Issuance of OP units	—	—	—	—	—	7,784	7,784
Sale of common stock	7,472,946	75	92,173	—	92,248	—	92,248
Distributions to noncontrolling interests	—	—	—	—	—	(100)	(100)
Common stock repurchased and retired	(3,384,359)	(34)	(32,148)	—	(32,182)	—	(32,182)
Net income	—	—	—	87,784	87,784	12	87,796
Balance at December 31, 2018	204,536,485	$2,045	$2,126,472	$(245,620)	$1,882,897	$ 7,696	$1,890,593

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

Table of Contents

DIAMONDROCK HOSPITALITY COMPANY

CONSOLIDATED STATEMENTS OF CASH FLOWS
Years Ended December 31, 2018, 2017 and 2016
(in thousands)

	2018	2017	2016
Cash flows from operating activities:			
Net income	$87,796	$91,877	$114,796
Adjustments to reconcile net income to net cash provided by operating activities:			
Real estate depreciation	104,524	99,090	97,444
Corporate asset depreciation as corporate expenses	216	95	66
Loss (gain) on sale of hotel properties, net	—	764	(10,698)
Loss on early extinguishment of debt	—	274	—
Non-cash ground rent	7,305	6,290	5,671
Non-cash amortization of financing costs and interest rate cap as interest	1,862	1,950	2,302
Impairment losses	—	43,993	—
Estimated recovery of impairment losses from insurance	—	(40,784)	—
Amortization of favorable and unfavorable contracts, net	(1,969)	(1,912)	(1,912)
Amortization of deferred income related to key money	(2,568)	(5,760)	(2,851)
Stock-based compensation	5,573	6,201	5,321
Deferred income tax expense	1,591	7,702	10,405
Changes in assets and liabilities:			
Prepaid expenses and other assets	28,657	(26,333)	17,007
Due to/from hotel managers	(5,686)	1,540	(1,056)
Accounts payable and accrued expenses	(7,997)	17,006	(20,969)
Net cash provided by operating activities	219,304	201,993	215,526
Cash flows from investing activities:			
Hotel capital expenditures	(115,171)	(97,424)	(102,861)
Hotel acquisitions	(259,883)	(93,795)	—
Proceeds from sale of properties, net	—	(764)	175,300
Proceeds from property insurance	30,742	10,042	—
Net cash (used in) provided by investing activities	(344,312)	(181,941)	72,439
Cash flows from financing activities:			
Scheduled mortgage debt principal payments	(13,612)	(12,417)	(11,198)
Repurchase of common stock and other	(33,113)	(537)	(7,197)
Proceeds from sale of common stock, net	92,679	—	—
Repayments of mortgage debt	—	(170,368)	(249,793)
Proceeds from senior unsecured term loan	50,000	200,000	100,000
Draws on senior unsecured credit facility	85,000	—	75,000
Repayments of senior unsecured credit facility	(85,000)	—	(75,000)
Payment of financing costs	(412)	(1,579)	(2,765)
Payment of cash dividends	(102,709)	(100,542)	(100,771)
Net cash used in financing activities	(7,167)	(85,443)	(271,724)
Net (decrease) increase in cash and cash equivalents, and restricted cash	(132,175)	(65,391)	16,241
Cash, cash equivalents, and restricted cash beginning of year	223,773	289,164	272,923
Cash, cash equivalents, and restricted cash, end of year	$91,598	$223,773	$289,164

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

Table of Contents

DIAMONDROCK HOSPITALITY COMPANY

CONSOLIDATED STATEMENTS OF CASH FLOWS - (CONTINUED)
Years Ended December 31, 2018, 2017 and 2016
(in thousands)

Supplemental Disclosure of Cash Flow Information:	2018	2017	2016
Cash paid for interest	$38,548	$36,288	$40,345
Cash paid for income taxes	$2,208	$3,251	$1,973
Non-cash Investing and Financing Activities:			
Unpaid dividends and distributions declared	$26,339	$25,708	$25,567
Buyer assumption of mortgage debt on sale of hotel	$—	$—	$89,486
Issuance of OP units in connection with acquisition of hotel property	$7,784	$—	$—

The following table provides a reconciliation of cash, cash equivalents, and restricted cash reported within the consolidated balance sheets to the amount shown within the consolidated statements of cash flows:

	2018	2017	2016
Cash and cash equivalents	$43,863	$183,569	$243,095
Restricted cash (1)	47,735	40,204	46,069
Total cash, cash equivalents, and restricted cash	$91,598	$223,773	$289,164

---

(1) Restricted cash primarily consists of reserves for replacement of furniture and fixtures held by our hotel managers and cash held in escrow pursuant to lender requirements.

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

Table of Contents

DIAMONDROCK HOSPITALITY COMPANY

Notes to the Consolidated Financial Statements

1. Organization

DiamondRock Hospitality Company (the “Company” or “we”) is a lodging-focused real estate company that owns a portfolio of premium hotels and resorts. Our hotels are concentrated in key gateway cities and in destination resort locations and many of our hotels are operated under a brand owned by one of the leading global lodging brand companies (Marriott International, Inc. (“Marriott”) or Hilton Worldwide (“Hilton”)). We are an owner, as opposed to an operator, of the hotels in our portfolio. As an owner, we receive all of the operating profits or losses generated by our hotels after we pay fees to the hotel managers, which are based on the revenues and profitability of the hotels.

As of December 31, 2018, we owned 31 hotels with 10,091 rooms, located in the following markets: Atlanta, Georgia; Boston, Massachusetts (2); Burlington, Vermont; Charleston, South Carolina; Chicago, Illinois (2); Denver, Colorado (2); Fort Lauderdale, Florida; Fort Worth, Texas; Huntington Beach, California; Key West, Florida (2); New York, New York (4); Phoenix, Arizona; Salt Lake City, Utah; San Diego, California; San Francisco, California (2); Sedona, Arizona (2); Sonoma, California; South Lake Tahoe, California; Washington D.C. (2); St. Thomas, U.S. Virgin Islands; and Vail, Colorado. As of December 31, 2018, the Frenchman's Reef & Morning Star Beach Resort ("Frenchman's Reef") is currently closed as a result of damage incurred from Hurricanes Irma and Maria in September 2017.

We conduct our business through a traditional umbrella partnership real estate investment trust, or UPREIT, in which our hotel properties are owned by our operating partnership, DiamondRock Hospitality Limited Partnership, or subsidiaries of our operating partnership. The Company is the sole general partner of our operating partnership and owns either directly or indirectly 99.6% of the limited partnership units ("OP units") of our operating partnership. The remaining 0.4% of the OP units are held by third parties, otherwise unaffiliated with the Company. See Note 5 for additional disclosures related to OP units.

2. Summary of Significant Accounting Policies

Basis of Presentation

Our financial statements include all of the accounts of the Company and its subsidiaries in accordance with U.S. GAAP. All intercompany accounts and transactions have been eliminated in consolidation. If the Company determines that it has an interest in a variable interest entity within the meaning of the Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) 810, Consolidation, the Company will consolidate the entity when it is determined to be the primary beneficiary of the entity. Our operating partnership meets the criteria of a variable interest entity. The Company is the primary beneficiary and, accordingly, we consolidate our operating partnership. The Company’s sole significant asset is its investment in its operating partnership, and consequently, substantially all of the Company’s assets and liabilities represent those assets and liabilities of its operating partnership. In addition, all of the Company's debt is an obligation of its operating partnership.

Use of Estimates

The preparation of the financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and

liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Risks and Uncertainties

The state of the overall economy can significantly impact hotel operational performance and thus, impact our financial position. Should any of our hotels experience a significant decline in operational performance, it may affect our ability to make distributions to our stockholders and service debt or meet other financial obligations.

Fair Value Measurements

In evaluating fair value, U.S. GAAP outlines a valuation framework and creates a fair value hierarchy that distinguishes between market assumptions based on market data (observable inputs) and a reporting entity's own assumptions about market data (unobservable inputs). The hierarchy ranks the quality and reliability of inputs used to determine fair value, which are then classified and disclosed in one of the three categories. The three levels are as follows:

Table of Contents

- •Level 1 - Inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities
- •Level 2 - Inputs include quoted prices in active markets for similar assets and liabilities, quoted prices for identical or similar assets in markets that are not active and model-derived valuations whose inputs are observable
- •Level 3 - Model-derived valuations with unobservable inputs

Property and Equipment

Following the adoption of FASB Accounting Standards Update (“ASU”) No. 2017-01, investments in hotel properties, including related land, land improvements, building and furniture, fixtures and equipment and identifiable intangible assets are generally accounted for as asset acquisitions, which are recorded at total cost and allocated based on relative fair value. Direct acquisition-related costs are capitalized as a component of the acquired assets. Property and equipment purchased after the hotel acquisition date is recorded at cost. Replacements and improvements are capitalized, while repairs and maintenance are expensed as incurred. Upon the sale or retirement of a fixed asset, the cost and related accumulated depreciation are removed from the Company’s accounts and any resulting gain or loss is included in the statements of operations.

Depreciation is computed using the straight-line method over the estimated useful lives of the assets, generally 5 to 40 years for buildings, land improvements and building improvements and 1 to 10 years for furniture, fixtures and equipment. Leasehold improvements are amortized over the shorter of the lease term or the useful lives of the related assets.

We review our investments in hotel properties for impairment whenever events or changes in circumstances indicate that the carrying value of the hotel properties may not be recoverable. Events or circumstances that may cause a review include, but are not limited to, adverse changes in the demand for lodging at the properties due to declining national or local economic conditions and/or new hotel construction in markets where the hotels are located. When such conditions exist, management performs an analysis to determine if the estimated undiscounted future cash flows from operations and the proceeds from the ultimate disposition of a hotel property and related assets exceed the carrying value. If the estimated undiscounted future cash flows are less than the carrying amount of the asset, an adjustment to reduce the carrying amount to the related hotel property's estimated fair market value is recorded and an impairment loss is recognized.

We classify a hotel as held for sale in the period that we have made the decision to dispose of the hotel, a binding agreement to purchase the property has been signed under which the buyer has committed a significant amount of nonrefundable cash and no significant financing or other contingencies exist which could cause the transaction to not be completed in a timely manner. If these criteria are met, we record an impairment loss if the fair value less costs to sell is lower than the carrying amount of the hotel and related assets and cease recording depreciation expense, and classify the assets and related liabilities as held for sale on the balance sheet.

Cash and Cash Equivalents

We consider all highly liquid investments with an original maturity of three months or less to be cash equivalents.

Revenue Recognition

Revenues from operations of the hotels are recognized when the goods or services are provided. Revenues consist of room sales, food and beverage sales, and other hotel department revenues, such as telephone, parking, gift shop sales

and resort fees. Rooms revenue is recognized over the length of stay that the hotel room is occupied by the customer. Food and beverage revenue is recognized at the point in time in which the goods and/or services are rendered to the customer, such as for restaurant dining services or banquet services. Other revenues are recognized at the point in time or over the time period that goods or services are provided to the customer. Certain ancillary services are provided by third parties and we assess whether we are the principal or agent in these arrangements. If we are the agent, revenue is recognized based upon the commission earned from the third party. If we are the principal, we recognize revenue based upon the gross sales price.

Advance deposits are recorded as liabilities when a customer or group of customers provides a deposit for a future stay or banquet event at our hotels. Advance deposits are converted to revenue when the services are provided to the customer or when a customer with a noncancelable reservation fails to arrive for part or all of the reservation. Conversely, advance deposits are generally refundable upon guest cancellation of the related reservation within an established period of time prior to the reservation.

Certain of our hotels have retail spaces, restaurants or other spaces which we lease to third parties. Lease revenue is recognized on a straight-line basis over the life of the lease and included in other operating revenues in our consolidated statements of operations.

Table of Contents

Income Taxes

We account for income taxes using the asset and liability method. Deferred tax assets and liabilities are recognized for the estimated future tax consequences attributable to the differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates in effect for the year in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities from a change in tax rates is recognized in earnings during the period in which the new rate is enacted. However, deferred tax assets are recognized only to the extent that it is more likely than not that they will be realized based on consideration of all available evidence, including the future reversals of existing taxable temporary differences, future projected taxable income and tax planning strategies. Valuation allowances are provided if, based upon the weight of the available evidence, it is more likely than not that some or all of the deferred tax assets will not be realized.

We have elected to be treated as a REIT under the provisions of the Internal Revenue Code, which requires that we distribute at least 90% of our taxable income annually to our stockholders and comply with certain other requirements. In addition to paying federal and state taxes on any retained income, we may be subject to taxes on “built-in gains” on sales of certain assets. Our taxable REIT subsidiaries will generally be subject to federal, state, local and/or foreign income taxes.

In order for the income from our hotel property investments to constitute “rents from real properties” for purposes of the gross income tests required for REIT qualification, the income we earn cannot be derived from the operation of any of our hotels. Therefore, we lease each of our hotel properties to a wholly owned subsidiary of Bloodstone TRS, Inc., our existing taxable REIT subsidiary, or TRS, except for Frenchman’s Reef, which is owned by a Virgin Islands corporation, which we have elected to be treated as a TRS, and Cavallo Point, The Lodge at the Golden Gate ("Cavallo Point"), which is leased to a wholly owned subsidiary of the Company, which we have elected to be treated as a TRS.

We had no accruals for tax uncertainties as of December 31, 2018 and 2017.

Intangible Assets and Liabilities

Intangible assets or liabilities are recorded on non-market contracts assumed as part of the acquisition of certain hotels. We review the terms of agreements assumed in conjunction with the purchase of a hotel to determine if the terms are favorable or unfavorable compared to an estimated market agreement at the acquisition date. Favorable contract assets or unfavorable contract liabilities are recorded at the acquisition date and amortized using the straight-line method over the term of the agreement. We do not amortize intangible assets with indefinite useful lives, but we review these assets for impairment annually or at interim periods if events or circumstances indicate that the asset may be impaired.

Earnings Per Share

Basic earnings per share is calculated by dividing net income by the weighted-average number of common shares outstanding during the period. Diluted earnings per share is calculated by dividing net income by the weighted-average number of common shares outstanding during the period plus other potentially dilutive securities such as stock grants or shares issuable in the event of conversion of operating partnership units. No adjustment is made for shares that are anti-dilutive during a period.

Stock-Based Compensation

We account for stock-based employee compensation using the fair value based method of accounting. We record the cost of awards with service or market conditions based on the grant-date fair value of the award. That cost is recognized over the period during which an employee is required to provide service in exchange for the award. No compensation cost is recognized for equity instruments for which employees do not render the requisite service.

Comprehensive Income

We do not have any comprehensive income other than net income. If we have any comprehensive income in future periods, such that a statement of comprehensive income would be necessary, such statement will be reported as one statement with the consolidated statement of operations.

Noncontrolling Interests

Table of Contents

The noncontrolling interest is the portion of equity in our consolidated operating partnership not attributable, directly or indirectly, to the Company. Such noncontrolling interests are reported on the consolidated balance sheets within equity, separately from the Company's equity. On the consolidated statements of operations, revenues, expenses and net income or loss from our less-than-wholly-owned operating partnership are reported within the consolidated amounts, including both the amounts attributable to the Company and noncontrolling interests. Income or loss is allocated to noncontrolling interests based on their weighted average ownership percentage for the applicable period. Consolidated statements of equity include beginning balances, activity for the period and ending balances for stockholders' equity, noncontrolling interests and total equity.

Restricted Cash

Restricted cash primarily consists of reserves for replacement of furniture and fixtures generally held by our hotel managers and cash held in escrow pursuant to lender requirements.

Deferred Financing Costs

Financing costs are recorded at cost as a component of the debt carrying amount and consist of loan fees and other costs incurred in connection with the issuance of debt. Amortization of deferred financing costs is computed using a method that approximates the effective interest method over the remaining life of the debt and is included in interest expense in the accompanying consolidated statements of operations.

Due to/from Hotel Managers

The due from hotel managers consists of hotel level accounts receivable, periodic hotel operating distributions receivable from managers and prepaid and other assets held by the hotel managers on our behalf. The due to hotel managers represents liabilities incurred by the hotel on behalf of us in conjunction with the operation of our hotels which are legal obligations of the Company.

Key Money

Key money received in conjunction with entering into hotel management or franchise agreements or completing specific capital projects is deferred and amortized over the term of the hotel management agreement, the term of the franchise agreement, or other systematic and rational period, if appropriate. Deferred key money is classified as deferred income in the accompanying consolidated balance sheets and amortized as an offset to management fees or franchise fees.

Rental Income and Expense

We record rental income and expense on leases that provide for minimum rental payments that increase in pre-established amounts over the remaining term of the lease on a straight-line basis.

Concentration of Credit Risk

Financial instruments that potentially subject the Company to significant concentrations of credit risk consist principally of our cash and cash equivalents. We maintain cash and cash equivalents with various financial institutions. We perform periodic evaluations of the relative credit standing of these financial institutions and limit the amount of credit exposure with any one institution.

Segment Reporting

Each one of our hotels is an operating segment. We evaluate each of our properties on an individual basis to assess performance, the level of capital expenditures, and acquisition or disposition transactions. Our evaluation of individual properties is not focused on property type (e.g. urban, suburban, or resort), brand, geographic location, or industry classification.

We aggregate our operating segments using the criteria established by U.S. GAAP, including the similarities of our product offering, types of customers and method of providing service. All of our properties react similarly to economic stimulus, such as business investment, changes in Gross Domestic Product, and changes in travel patterns. As such, all our operating segments meet the aggregation criteria, resulting in a single reportable segment represented by our consolidated financial results.

Accounting for Impacts of Natural Disasters

Table of Contents

Assets destroyed or damaged as a result of natural disasters or other involuntary events are written off or reduced in carrying value to their salvage value. When recovery of all or a portion of the amount of property damage loss or other covered expenses through insurance proceeds is demonstrated to be probable, a receivable is recorded and offsets the loss or expense up to the amount of the total loss or expense. No gain is recorded until all contingencies related to the insurance claim have been resolved. Income resulting from business interruption insurance is not recognized until all contingencies related to the insurance recoveries are resolved.

In September 2017, Hurricane Irma caused significant damage to Frenchman's Reef and Havana Cabana Key West. Frenchman's Reef was further impacted by Hurricane Maria. The Company has filed insurance claims for the remediation and repair of property damage and business interruption resulting from the hurricanes, as well as from the 2017 wildfires in Northern California that impacted The Lodge at Sonoma. In July 2018, the Company settled the insurance claims for Havana Cabana Key West and The Lodge at Sonoma. The Havana Cabana insurance claim was settled for $8.3 million, net of deductibles, and we recorded a gain of approximately $1.7 million related to the property damage. The Lodge at Sonoma claim was settled for $1.3 million, net of deductibles. The Frenchman’s Reef insurance claim is ongoing and we received $85.0 million and $10.0 million in insurance proceeds during the years ended December 31, 2018 and 2017, respectively.

The following table summarizes the business interruption insurance income by impacted hotel property (in thousands):

	Year Ended December 31,	
	2018	2017
Frenchman's Reef	$16,090	$3,128
Havana Cabana Key West	2,137	923
The Lodge at Sonoma	1,152	—
Total	$19,379	$4,051

For the year ended December 31, 2018, we recognized a $1.7 million gain related to the settlement of the property damage insurance claim at the Havana Cabana Key West.

Recently Issued Accounting Pronouncements

In January 2017, the FASB issued ASU No. 2017-01, Business Combinations (Topic 805): Clarifying the Definition of a Business, which clarifies the definition of a business to assist entities with evaluating whether transactions should be accounted for as acquisitions of assets or business combinations. As a result of the standard, we anticipate that the majority of our hotel acquisitions will be considered asset purchases as opposed to business combinations. However, the determination will be made on a transaction-by-transaction basis and we do not expect the determination to materially change the recognition of the assets and liabilities acquired. This standard will be applied on a prospective basis and, therefore, it does not affect the accounting for any of our previous transactions. This standard is effective for annual periods beginning after December 15, 2017. We adopted ASU No. 2017-01 effective January 1, 2018. This standard does not affect the accounting for any of our transactions prior to January 1, 2018. Refer to Note 10 for more information about our three hotel property acquisitions during the year ended December 31, 2018, which were all accounted for as asset purchases.

In November 2016, the FASB issued ASU No. 2016-18, Statement of Cash Flows (Topic 230): Restricted Cash, which requires that the statement of cash flows explain the change during the period in the total cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. This standard is

effective for annual periods beginning after December 15, 2017. We adopted ASU No. 2016-18 effective January 1, 2018. The adoption of ASU No. 2016-18 changed the presentation of the statement of cash flows for the Company and we utilized a retrospective transition method for each period presented within financial statements for periods subsequent to the date of adoption. Restricted cash reserves are included with cash and cash equivalents on our consolidated statements of cash flows for all periods presented. There was no impact to the consolidated statements of income or the consolidated balance sheets.

In August 2016, the FASB issued ASU No. 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments, which clarifies and provides specific guidance on eight cash flow classification issues with an objective to reduce the current diversity in practice. This standard is effective for annual periods beginning after December 15, 2017. We adopted ASU No. 2016-15 effective January 1, 2018 and it did not have a material impact on our consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842), which primarily changes the lessee's accounting for operating leases by requiring recognition of lease right-of-use assets and lease liabilities. This standard is effective for annual

reporting periods beginning after December 15, 2018. The primary impact of the new standard will be to the treatment of our ground leases, which represent a majority of all of our operating lease payments. We intend to adopt ASU No. 2016-02, along with its related clarifications and amendments, as of the effective date of January 1, 2019. We are finalizing our evaluation of the changes from adopting this standard to our future financial reporting and disclosures, as well as designing and implementing related processes and controls. We also intend to elect all of the new standard's available transition practical expedients. We expect the standard to result in an increase to both total assets and total liabilities of between $95 million and $125 million, before adjusting for existing deferred rent and favorable and unfavorable lease intangible amounts included on our balance sheet as of December 31, 2018. Any changes to discount rates, lease terms or other variables may have a significant effect on the calculation of this recorded amount. We do not expect the adoption of the standard to result in a cumulative effect adjustment, or that the adoption of the standard will have a material impact to our results of operations, cash flows, or liquidity.

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606). The new standard sets forth five prescribed steps to determine the timing and amount of revenue to be recognized to appropriately depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In August 2015, the FASB issued ASU No. 2015-14, Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date, which deferred the effectiveness of ASU No. 2014-09 to reporting periods beginning after December 15, 2017. We adopted the new standard effective January 1, 2018, under the cumulative effect transition method. No adjustment was recorded to the our opening balance of retained earnings on January 1, 2018, as there was no impact to net income for the Company.

3. Property and Equipment

Property and equipment as of December 31, 2018 and 2017 consists of the following (in thousands):

	2018	2017
Land	$617,695	$602,879
Land improvements	7,994	7,994
Buildings	2,682,320	2,414,216
Furniture, fixtures and equipment	491,421	423,987
Construction in progress	38,623	31,906
	3,838,053	3,480,982
Less: accumulated depreciation	(893,436)	(788,696)
	$2,944,617	$2,692,286

During the year ended December 31, 2017, we recognized a $41.7 million impairment loss for property damage at Frenchman's Reef, the Havana Cabana Key West, and the Sheraton Suites Key West in connection with Hurricanes Irma and Maria. We recorded a reduction to the impairment loss and a corresponding receivable of $40.8 million reflecting the insurance proceeds that were probable of receipt up to the amount of the loss recorded. The receivable for insurance proceeds is included in prepaid and other assets on the accompanying consolidated balance sheets. We evaluate probable recovery by considering various factors, including discussions with our insurance providers, consideration of their financial strength, and review of our insurance provisions and limits. During 2017, we determined the carrying value of $1.8 million of construction in progress was not recoverable and we recorded a corresponding $1.8 million charge within impairment losses for the year ended December 31, 2017.

As of December 31, 2018 and 2017, we had accrued capital expenditures of $12.4 million and $11.7 million, respectively.

4. Favorable Lease Assets

In connection with the acquisition of certain hotels, we have recognized intangible assets for favorable ground leases and tenant leases. Our favorable lease assets, net of accumulated amortization of $3.4 million and $2.7 million as of December 31, 2018 and 2017, respectively, consist of the following (in thousands):

F-15

Table of Contents

	2018	2017
Cavallo Point Ground Lease	$17,908	$—
Hotel Palomar Phoenix Ground Lease	19,763	—
Westin Boston Waterfront Hotel Ground Lease	17,426	17,643
Orchards Inn Sedona Annex Sublease	8,757	8,925
Lexington Hotel Tenant Leases	91	122
	$63,945	$26,690

Favorable lease assets are recorded at the acquisition date and are generally amortized using the straight-line method over the remaining non-cancelable term of the lease agreement. Amortization expense for the years ended December 31, 2018, 2017, and 2016, was $0.7 million, $0.4 million, and $0.3 million, respectively. Amortization expense is expected to total $1.1 million annually 2019 through 2023.

In connection with our acquisition of the Orchards Inn Sedona on February 28, 2017, we recorded a $9.1 million favorable lease asset. In connection with our acquisition of the Hotel Palomar Phoenix on March 1, 2018, we recorded a $20.0 million favorable lease asset. In connection with our acquisition of Cavallo Point on December 12, 2018, we recorded a $17.9 million favorable lease asset. We determined the value of these favorable lease assets using a discounted cash flow of the favorable difference between the contractual lease payments and estimated market rents. The market rents were estimated by applying a land capitalization rate to the estimated fee-simple value of the underlying land. The discount rate was estimated using a risk adjusted rate of return.

5. Equity

Common Shares

We are authorized to issue up to 400 million shares of common stock, $0.01 par value per share. Each outstanding share of common stock entitles the holder to one vote on all matters submitted to a vote of stockholders. Holders of our common stock are entitled to receive dividends out of assets legally available for the payment of dividends when authorized by our board of directors.

We have an “at-the-market” equity offering program (the “Current ATM Program”), pursuant to which we may issue and sell shares of our common stock from time to time, having an aggregate offering price of up to $200 million. Prior to the implementation of the Current ATM Program, the Company had a $200 million ATM program (the "Prior ATM Program"), which is no longer active. During the year ended December 31, 2018, we sold 7,472,946 shares of common stock at an average price of $12.56 for net proceeds of $92.9 million under the Prior ATM Program. The full amount remains available under the Current ATM Program.

Our board of directors has approved a share repurchase program authorizing us to repurchase shares of our common stock. On November 2, 2018, our board of directors increased the authorization under the share repurchase program from $150 million to $250 million of our common stock. Repurchases under this program are made in open market or privately negotiated transactions as permitted by federal securities laws and other legal requirements. This authority may be exercised from time to time and in such amounts as market conditions warrant, and subject to regulatory considerations. The timing, manner, price and actual number of shares repurchased will depend on a variety of factors including stock price, corporate and regulatory requirements, market conditions, and other corporate liquidity requirements and priorities. The share repurchase program may be suspended or terminated at any time without prior notice.

During the year ended December 31, 2018, we repurchased 3,384,359 shares of our common stock at an average price of $9.49 per share for a total purchase price of $32.2 million. Subsequent to December 31, 2018, we repurchased 3,143,922 shares of our common stock at an average price of $9.52 per share for a total purchase price of $30.0 million. We retired all repurchased shares on their respective settlement dates. As of February 26, 2019, we have $188.0 million of authorized capacity remaining under our share repurchase program.

Dividends

We have paid the following dividends to holders of our common stock for the years ended December 31, 2018 and 2017, and through the date of this report:

Table of Contents

Payment Date	Record Date	Dividend per Share
April 12, 2017	March 31, 2017	$0.125
July 12, 2017	June 30, 2017	$0.125
October 12, 2017	September 29, 2017	$0.125
January 12, 2018	December 29, 2017	$0.125
April 12, 2018	March 29, 2018	$0.125
July 12, 2018	June 29, 2018	$0.125
October 12, 2018	September 28, 2018	$0.125
January 14, 2019	January 4, 2019	$0.125

Preferred Shares

We are authorized to issue up to 10 million shares of preferred stock, $0.01 par value per share. Our board of directors is required to set for each class or series of preferred stock the terms, preferences, conversion or other rights, voting powers, restrictions, limitations as to dividends or other distributions, qualifications, and terms or conditions of redemption. As of December 31, 2018 and 2017, there were no shares of preferred stock outstanding.

Operating Partnership Units

In connection with the acquisition of Cavallo Point in December 2018, we issued 796,684 OP units to third parties, otherwise unaffiliated with the Company, at $11.76 per unit. Each OP unit is redeemable at the option of the holder beginning December 12, 2019. Holders of OP units have certain redemption rights, which enable them to cause our operating partnership to redeem their units in exchange for cash per unit equal to the market price of our common stock, at the time of redemption, or, at our option, for shares of our common stock on a one-for-one basis, subject to adjustment upon the occurrence of stock splits, mergers, consolidations or similar pro-rata share transactions. As of December 31, 2018, there were 796,684 operating partnership units held by unaffiliated third parties.

6. Stock Incentive Plans

We are authorized to issue up to 6,082,664 shares of our common stock under our 2016 Equity Incentive Plan (the “2016 Plan”), of which we have issued or committed to issue 846,517 shares as of December 31, 2018. In addition to these shares, additional shares of common stock could be issued in connection with the performance stock unit awards as further described below. The 2016 Plan replaced the 2004 Stock Option and Incentive Plan, as amended (the "2004 Plan"). We no longer make share grants and issuances under the 2004 Plan, although awards previously made under the 2004 Plan that are outstanding will remain in effect in accordance with the terms of that plan and the applicable award agreements.

Restricted Stock Awards

Restricted stock awards issued to our officers and employees generally vest over a three-year period from the date of the grant based on continued employment. We measure compensation expense for the restricted stock awards based upon the fair market value of our common stock at the date of grant. Compensation expense is recognized on a straight-line basis over the vesting period and is included in corporate expenses in the accompanying consolidated statements of operations. A summary of our restricted stock awards from January 1, 2016 to December 31, 2018 is as follows:

F-17

Table of Contents

	Number of Shares	Weighted-Average Grant Date Fair Value
Unvested balance at January 1, 2016	474,567	$ 12.72
Granted	461,281	8.94
Forfeited	(126,610)	10.08
Vested	(241,698)	11.83
Unvested balance at December 31, 2016	567,540	10.62
Granted	324,502	11.19
Forfeited	(16,669)	10.80
Vested	(244,411)	11.29
Unvested balance at December 31, 2017	630,962	10.66
Granted	349,091	10.19
Forfeited	(51,061)	10.44
Vested	(287,148)	11.02
Unvested balance at December 31, 2018	641,844	$ 10.25

The remaining share awards are expected to vest as follows: 310,117 during 2019, 215,368 during 2020, and 116,359 during 2021. As of December 31, 2018, the unrecognized compensation cost related to restricted stock awards was $4.0 million and the weighted-average period over which the unrecognized compensation expense will be recorded is approximately 21 months. For the years ended December 31, 2018, 2017, and 2016, we recorded $3.1 million, $3.1 million and $2.8 million, respectively, of compensation expense related to restricted stock awards.

Performance Stock Units

Performance stock units ("PSUs") are restricted stock units that vest three years from the date of grant. Each executive officer is granted a target number of PSUs (the "PSU Target Award"). For the PSUs issued in 2014 and 2015 and vested in 2017 and 2018, respectively, the actual number of shares of common stock issued to each executive officer was subject to the achievement of certain levels of total stockholder return relative to the total stockholder return of a peer group of publicly-traded lodging REITs over a three-year performance period. There is no payout of shares of our common stock if our total stockholder return falls below the 30th percentile of the total stockholder returns of the peer group. The maximum number of shares of common stock issued to an executive officer is equal to 150% of the PSU Target Award and is earned if our total stockholder return is equal to or greater than the 75th percentile of the total stockholder returns of the peer group.

For PSUs issued in 2016 and vesting in 2019, the calculation of total stockholder return relative to the total stockholder return of a peer group over a three-year performance period remained in effect for 75% of the number of PSUs to be earned in the performance period. The remaining 25% is determined based on achieving improvement in market share for each of our hotels over the three-year performance period.

For the PSUs issued in 2017 and 2018 and vesting in 2020 and 2021, respectively, the calculation of total stockholder return relative to the total stockholder return of a peer group over a three-year performance period applies to 50% of the number of PSUs to be earned in the performance period. The remaining 50% is determined based on achieving improvement in market share for each of our hotels over the three-year performance period.

We measure compensation expense for the PSUs based upon the fair market value of the award at the grant date. Compensation expense is recognized on a straight-line basis over the three-year performance period and is included in corporate expenses in the accompanying consolidated statements of operations. The grant date fair value of the portion of the PSUs based on our relative total stockholder return is determined using a Monte Carlo simulation performed by a third-party valuation firm. The grant date fair value of the portion of the PSUs based on improvement in market share for each of our hotels is the closing price of our common stock on the grant date. The determination of the grant-date fair values of outstanding awards based on our relative total stockholder return included the following assumptions:

Table of Contents

Award Grant Date	Volatility	Risk-Free Rate	Fair Value at Grant Date
February 26, 2016	24.3 %	0.93 %	$8.42
February 26, 2017	26.7 %	1.46 %	$10.89
March 2, 2018	26.9 %	2.40 %	$9.52
April 2, 2018	26.9 %	2.37 %	$9.00

A summary of our PSUs from January 1, 2016 to December 31, 2018 is as follows:

	Number of Units	Weighted-Average Grant Date Fair Value
Unvested balance at January 1, 2016	676,359	$ 11.41
Granted	310,398	8.54
Additional units from dividends	38,324	9.37
Vested (1)	(242,096)	9.85
Forfeited	(96,301)	10.74
Unvested balance at December 31, 2016	686,684	10.65
Granted	266,009	11.04
Additional units from dividends	33,478	11.17
Vested (2)	(200,374)	12.15
Unvested balance at December 31, 2017	785,797	10.42
Granted	293,111	9.82
Additional units from dividends	35,197	11.24
Vested (3)	(218,514)	11.98
Forfeited	(113,668)	9.86
Unvested balance at December 31, 2018	781,923	$ 11.19

---

(1) The number of shares of common stock earned for the PSUs vested in 2016 was equal to 89.5% of the PSU Target Award.

(2) There was no payout of shares of our common stock for PSUs that vested on February 27, 2017, as our total stockholder return fell below the 30th percentile of the total stockholder returns of the peer group over the three-year performance period.

(3) The number of shares of common stock earned for the PSUs vested in 2018 was equal to 51.75% of the PSU Target Award.

The remaining unvested target units are expected to vest as follows: 247,949 during 2019, 231,221 during 2020 and 302,753 during 2021. As of December 31, 2018, the unrecognized compensation cost related to the PSUs was $3.1 million and is expected to be recognized on a straight-line basis over a period of 22 months. For the years ended December 31, 2018, 2017, and 2016, we recorded approximately $1.9 million, $2.5 million, and $2.0 million, respectively, of compensation expense related to the PSUs.

The compensation expense recorded for the year ended December 31, 2016 includes the reversal of $0.4 million of previously recognized compensation expense resulting from the forfeiture of PSUs by our former Executive Vice President and Chief Operating Officer. The compensation expense for the year ended December 31, 2018 includes the reversal of $1.0 million of previously recognized compensation expense resulting from the forfeiture of PSUs by our former Executive Vice President and Chief Financial Officer.

7. Earnings Per Share

Basic earnings per share is calculated by dividing net income available to common stockholders by the weighted-average number of common shares outstanding. Diluted earnings per share is calculated by dividing net income available to common stockholders by the weighted-average number of common shares outstanding including dilutive securities.

The following is a reconciliation of the calculation of basic and diluted earnings per share (in thousands, except share and per-share data):

F-19

Table of Contents

	Years Ended December 31,		
	2018	2017	2016
Numerator:			
Net income attributable to common stockholders	$87,784	$ 91,877	$ 114,796
Denominator:			
Weighted-average number of common shares outstanding—basic	205,462,911	200,784,450	201,079,573
Effect of dilutive securities:			
Unvested restricted common stock	215,655	188,759	47,468
Shares related to unvested PSUs	452,584	548,259	549,217
Weighted-average number of common shares outstanding—diluted	206,131,150	201,521,468	201,676,258
Earnings per share:			
Net income per share available to common stockholders—basic	$0.43	$ 0.46	$ 0.57
Net income per share available to common stockholders—diluted	$0.43	$ 0.46	$ 0.57

The OP units held by the noncontrolling interest holders have been excluded from the denominator of the diluted earnings per share calculation as there would be no effect on the amounts since the OP units' share of income or loss would also be added or subtracted to derive net income (loss) available to common stockholders.

8. Debt

The following table sets forth information regarding the Company’s debt as of December 31, 2018 (dollars in thousands):

Table of Contents

Loan	Interest Rate	Maturity Date	Principal Balance as of December 31, 2018	2017
Salt Lake City Marriott Downtown mortgage loan	4.25 %	November 2020	$55,032	$56,717
Westin Washington D.C. City Center mortgage loan	3.99 %	January 2023	62,734	64,833
The Lodge at Sonoma, a Renaissance Resort & Spa mortgage loan	3.96 %	April 2023	27,633	28,277
Westin San Diego mortgage loan	3.94 %	April 2023	63,385	64,859
Courtyard Manhattan / Midtown East mortgage loan	4.40 %	August 2024	82,620	84,067
Renaissance Worthington mortgage loan	3.66 %	May 2025	82,540	84,116
JW Marriott Denver at Cherry Creek mortgage loan	4.33 %	July 2025	62,411	63,519
Boston Westin mortgage loan	4.36 %	November 2025	194,466	198,046
New Market Tax Credit loan (1)	5.17 %	December 2020	2,943	—
Unamortized debt issuance costs			(4,017)	(4,795)
Total mortgage and other debt, net of unamortized debt issuance costs			629,747	639,639
Unsecured term loan	LIBOR + 1.45% (2)	May 2021	100,000	100,000
Unsecured term loan	LIBOR + 1.45% (2)	April 2022	200,000	200,000
Unsecured term loan	LIBOR + 1.45% (3)	October 2023	50,000	—
Unamortized debt issuance costs			(1,781)	(1,847)
Unsecured term loans, net of unamortized debt issuance costs			348,219	298,153
Senior unsecured credit facility	LIBOR + 1.50%	May 2020 (4)	—	—
Total debt, net of unamortized debt issuance costs			$977,966	$937,792
Weighted-Average Interest Rate	4.01%			

(1) Assumed in connection with the acquisition of the Hotel Palomar Phoenix on March 1, 2018.
(2) The interest rate at December 31, 2018 was 3.80%.
(3) The interest rate at December 31, 2018 was 3.78%. We entered into an interest rate swap agreement in January 2019 to fix LIBOR at 2.41% through October 2023.
(4) The credit facility may be extended for an additional year upon the payment of applicable fees and the satisfaction of certain customary conditions.

The aggregate debt maturities as of December 31, 2018 are as follows (in thousands):

2019	14,195
2020	66,174
2021	116,461
2022	214,095

2023	194,649
Thereafter	378,190
	$983,764

Mortgage Debt

F-21

Table of Contents

We have incurred limited recourse, property specific mortgage debt secured by certain of our hotels. In the event of default, the lender may only foreclose on the pledged assets; however, in the event of fraud, misapplication of funds or other customary recourse provisions, the lender may seek payment from us. As of December 31, 2018, eight of our 31 hotel properties were secured by mortgage debt.

Our mortgage debt contains certain property specific covenants and restrictions, including minimum debt service coverage ratios that trigger "cash trap" provisions as well as restrictions on incurring additional debt without lender consent. As of December 31, 2018, we were in compliance with the financial covenants of our mortgage debt.

On March 1, 2018, in connection with our acquisition of the Hotel Palomar in Phoenix, Arizona, we assumed a $2.9 million loan originated under a qualified New Market Tax Credit program. The loan is interest-only and bears an annual fixed interest rate equal to 5.17%. The loan matures on December 6, 2020.

On April 26, 2017, we repaid the mortgage loan secured by the Lexington Hotel New York with proceeds from a new unsecured term loan, which is discussed further below. The mortgage loan had an outstanding balance of $170.4 million at repayment.

Senior Unsecured Credit Facility

We are party to a $300 million senior unsecured credit facility with a maturity date of May 2020. The maturity date of the facility may be extended for an additional year upon the payment of applicable fees and the satisfaction of certain other customary conditions. The facility also includes an accordion feature to expand up to $600 million, subject to lender consent. The interest rate on the facility is based upon LIBOR, plus an applicable margin based upon the Company's leverage ratio, as follows:

Leverage Ratio	Applicable Margin
Less than or equal to 35%	1.50%
Greater than 35% but less than or equal to 45%	1.65%
Greater than 45% but less than or equal to 50%	1.80%
Greater than 50% but less than or equal to 55%	2.00%
Greater than 55%	2.25%

In addition to the interest payable on amounts outstanding under the facility, we are required to pay an amount equal to 0.20% of the unused portion of the facility if the average usage of the facility was greater than 50% or 0.30% of the unused portion of the facility if the average usage of the facility was less than or equal to 50%.

The facility also contains various corporate financial covenants. A summary of the most restrictive covenants is as follows:

	Covenant	Actual at December 31, 2018
Maximum leverage ratio (1)	60%	27.5%
Minimum fixed charge coverage ratio (2)	1.50x	4.17x
Minimum tangible net worth (3)	$1.98 billion	$2.72 billion
Secured recourse indebtedness	Less than 45% of Total Asset Value	18.9%

(1) Leverage ratio is net indebtedness, as defined in the credit agreement, divided by total asset value, defined in the credit agreement as the value of our owned hotels based on hotel net operating income divided by a defined capitalization rate.

(2) Fixed charge coverage ratio is Adjusted EBITDA, generally defined in the credit agreement as EBITDA less FF&E reserves, for the most recently ending 12 months, to fixed charges, which is defined in the credit agreement as interest expense, all regularly scheduled principal payments and payments on capitalized lease obligations, for the same most recently ending 12-month period.

(3) Tangible net worth, as defined in the credit agreement, is (i) total gross book value of all assets, exclusive of depreciation and amortization, less intangible assets, total indebtedness, and all other liabilities, plus (ii) 75% of net proceeds from future equity issuances.

Table of Contents

As of December 31, 2018, we had no borrowings outstanding under the facility and the Company's leverage ratio was 27.5%. Accordingly, interest on our borrowings under the facility will be based on LIBOR plus 150 basis points for the following quarter. We incurred interest and unused credit facility fees on the facility of $1.2 million, $1.0 million and $1.3 million for the years ended December 31, 2018, 2017 and 2016, respectively. Subsequent to December 31, 2018, we borrowed $45 million under the facility.

Unsecured Term Loans

We are party to a five-year $100 million unsecured term loan, a five-year $200 million unsecured term loan, and a new five-year $50 million unsecured term loan, entered into on October 18, 2018. On December 5, 2018, in connection with the acquisition closing of Cavallo Point, we drew down the full balance of the new $50 million term loan. In January 2019, we entered into an interest rate swap agreement to economically hedge variability in LIBOR-indexed interest payments at 2.41% through October 2023 for the $50 million unsecured term loan.

The financial covenants of the three term loans are consistent with the covenants on our senior unsecured credit facility, which are described above. The interest rate on the term loans is based on a pricing grid ranging from 140 to 220 basis points over LIBOR, based on the Company’s leverage ratio, as follows:

Leverage Ratio	Applicable Margins $100 Million and $200 Million Term Loans	$50 Million Term Loan
Less than or equal to 25%	1.45%	1.40%
Greater than 25% but less than or equal to 35%	1.45%	1.45%
Greater than 35% but less than or equal to 45%	1.60%	1.55%
Greater than 45% but less than or equal to 50%	1.75%	1.75%
Greater than 50% but less than or equal to 55%	1.95%	1.95%
Greater than 55%	2.20%	2.20%

As of December 31, 2018, the Company's leverage ratio was 27.5%. We incurred interest on the term loans of $10.6 million, $6.2 million and $1.3 million for the years ended December 31, 2018, 2017 and 2016, respectively.

9. Dispositions

On June 8, 2016, we sold the 485-room Orlando Airport Marriott to an unaffiliated third party for a contractual sales price of $63 million. We received net proceeds of approximately $65.8 million from the transaction, which included credit for the hotel's capital replacement reserve. We recognized a pre-tax gain on sale of the hotel of approximately $3.7 million.

On June 30, 2016, we sold the 821-room Hilton Minneapolis to an unaffiliated third party for a contractual sales price of $140 million. The buyer assumed the $89.5 million mortgage loan secured by the hotel. We received net proceeds of approximately $54.8 million from the transaction, which included credit for the hotel's working capital. We recognized a pre-tax gain on sale of the hotel of approximately $4.9 million during the year ended December 31, 2016. We recognized an incremental pre-tax loss of $0.8 million during the year ended December 31, 2017 due to a post-closing adjustment for hotel expenses incurred under our ownership period.

On July 7, 2016, we sold the 169-room Hilton Garden Inn Chelsea/New York City to an unaffiliated third party for a contractual sales price of $65.0 million. We received net proceeds of approximately $63.3 million from the transaction. We recognized a pre-tax gain on sale of the hotel of approximately $2.0 million.

We had no dispositions during the years ended December 31, 2017 and 2018.

Our consolidated statements of operations include the following pre-tax income (loss), inclusive of the gains and losses on sale, from the hotel properties sold during 2016 (in thousands):

Table of Contents

	2018	2017	2016
Orlando Airport Marriott	$ —	$ —	$ 8,225
Hilton Minneapolis	—	(764)	4,872
Hilton Garden Inn Chelsea/New York City	—	—	3,107
Total pre-tax (loss) income	$ —	$ (764)	$ 16,204

10. Acquisitions

2018 Acquisitions (Accounted for as Asset Acquisitions)

On March 1, 2018, we acquired the 77-room Landing Resort & Spa in South Lake Tahoe, California, for a total contractual purchase price of $42 million. The acquisition was funded with corporate cash. The acquisition is accounted for as an acquisition of assets; accordingly, direct acquisition costs were capitalized.

On March 1, 2018, we acquired the 242-room Hotel Palomar in Phoenix, Arizona, for a total contractual purchase price of $80 million. The acquisition was funded with corporate cash. In connection with the acquisition, we assumed a $2.9 million loan under a qualified New Market Tax Credit program. Refer to Note 8 for additional information about the loan. The acquisition is accounted for as an acquisition of assets; accordingly, our direct acquisition costs were capitalized.

We lease the surface and air rights of the hotel property pursuant to a ground lease with the City of Phoenix. We own the building improvements fee simple. The ground lease expires in 2085, including all extension options. Refer to Note 13 for additional information about this lease. As lessee of government property, we are subject to a Government Property Lease Excise Tax ("GPLET") under Arizona state statute in lieu of ad valorem real estate taxes through the end of the term of the ground lease. We reviewed the terms of the ground lease and GPLET agreement and concluded that the terms of the ground lease are favorable to us compared with a comparable market ground lease. Accordingly, we allocated $20.0 million of the total acquisition cost to a favorable ground lease asset that will be amortized over the remaining term of the ground lease, including all extension options.

We assumed an agreement previously made with the lessee of the subsurface parking facility under the hotel, which requires us to pay 50% of the lessee's lease payments to the landlord—the City of Phoenix. The agreement is coterminous with the underlying subsurface ground lease, which expires in 2085, including all extension options. We reviewed the terms of the parking agreement and concluded that the terms are unfavorable to us compared with a typical market parking agreement. Accordingly, we allocated $4.6 million of the total acquisition cost to an unfavorable agreement liability that will be amortized over the remaining term of the parking agreement, including all extension options.

On December 12, 2018, we acquired the 142-room Cavallo Point for a total contractual purchase price of $152 million. The acquisition was funded through a combination of corporate cash, proceeds from the new $50 million unsecured term loan and the issuance of OP units. The acquisition is accounted for as an acquisition of assets; accordingly, our direct acquisition costs were capitalized.

Cavallo Point is subject to a long-term ground lease agreement with the United States National Park Service that expires in 2066. Refer to Note 13 for additional information about this lease. We reviewed the terms of the ground lease and concluded that the terms of the ground lease are favorable to us compared with a comparable market ground lease. Accordingly, we allocated $17.9 million of the total acquisition cost to a favorable ground lease asset that will be amortized over the remaining term of the ground lease.

2017 Acquisitions (Accounted for as Business Combinations)

On February 28, 2017, we acquired the 88-room L'Auberge de Sedona and the 70-room Orchards Inn Sedona, each located in Sedona, Arizona, for a total contractual purchase price of $97 million. The acquisition was funded with corporate cash.

We lease the buildings and sublease the underlying land containing 28 of the 70 rooms at the Orchards Inn Sedona, which expires in 2070, including all extension options. We reviewed the terms of the annex sublease in conjunction with the hotel acquisition accounting and concluded that the terms are favorable to us compared with a comparable market lease. As a result, we recorded a $9.1 million favorable lease asset that will be amortized through 2070.

Acquired properties are included in our results of operations from the date of acquisition. The following pro forma financial information for the years ended December 31, 2017, and 2016, present our results of operations (in thousands, except per share

Table of Contents

data) as if the hotels acquired in 2017 and accounted for a business combinations were acquired on January 1, 2016. The hotels acquired in 2018 are accounted for as asset acquisitions and are not included in the information presented below. The pro forma information is not necessarily indicative of the results that actually would have occurred nor does it indicate future operating results.

	Year Ended December 31,	
	2017 (unaudited)	2016 (unaudited)
Revenues	$ 873,427	$ 924,806
Net income	$ 91,602	$ 118,232
Earnings per share:		
Net income per share available to common stockholders—basic	$ 0.46	$ 0.59
Net income per share available to common stockholders—diluted	$ 0.45	$ 0.59

For the years ended December 31, 2018 and 2017, our consolidated statements of operations includes $34.7 million and $29.3 million of revenues, respectively, and $6.9 million and $5.9 million of net income, respectively, related to the operations of the hotels acquired in 2017 under business combination accounting.

The following table summarizes the assets acquired and liabilities assumed in our 2017 and 2018 acquisitions (in thousands):

	Cavallo Point	Landing Resort & Spa	Hotel Palomar Phoenix	L'Auberge de Sedona	Orchards Inn Sedona
Land	$—	$ 14,816	$—	$ 39,384	$ 9,726
Building and improvements	123,100	24,351	59,703	22,204	10,180
Furniture, fixtures and equipment	10,470	3,346	5,207	4,376	1,982
Construction in progress	1,734	—	—	—	—
Total fixed assets	135,304	42,513	64,910	65,964	21,888
Favorable lease asset	17,907	—	20,012	—	9,065
Unfavorable lease liability	—	—	(4,644)	—	—
New Market Tax Credit loan assumption	—	—	(2,943)	—	—
Other assets and liabilities, net	(5,083)	(658)	497	(2,710)	(412)
Total	$ 148,128	$ 41,855	$ 77,832	$ 63,254	$ 30,541

11. Income Taxes

We have elected to be treated as a REIT under the provisions of the Internal Revenue Code, which requires that we distribute at least 90% of our taxable income annually to our stockholders and comply with certain other requirements. In addition to paying federal and state taxes on any retained income, we may be subject to taxes on “built in gains” on sales of certain assets. Our taxable REIT subsidiaries are subject to federal, state, local and/or foreign income taxes.

Our provision for income taxes consists of the following (in thousands):

Table of Contents

	Year Ended December 31,		
	2018	2017	2016
Current - Federal	$66	$622	$—
State	984	1,221	1,297
Foreign	460	662	697
	1,510	2,505	1,994
Deferred - Federal	1,857	6,432	9,779
State	178	425	1,324
Foreign	(444)	845	(698)
	1,591	7,702	10,405
Income tax provision	$3,101	$10,207	$12,399

A reconciliation of the statutory federal tax provision to our income tax provision is as follows (in thousands):

	Year Ended December 31,		
	2018	2017	2016
Statutory federal tax provision (1)	$19,089	$35,729	$44,518
Tax impact of REIT election	(14,439)	(22,277)	(31,101)
State income tax provision, net of federal tax benefit	705	1,652	1,703
Foreign income tax benefit	(2,927)	(430)	(3,080)
Tax reform impact on U.S. taxes	—	(2,143)	—
Tax reform impact on foreign taxes	—	(2,076)	—
Other	673	(248)	359
Income tax provision	$3,101	$10,207	$12,399

(1) Beginning January 1, 2018, the U.S. federal income tax rate decreased from 35% to 21%.

On December 22, 2017, the U.S. government enacted comprehensive tax legislation, H.R. 1, originally known as the Tax Cuts and Jobs Act (the "Tax Act"). Among other changes to the U.S. tax code, the Tax Act reduces the U.S. federal corporate income tax rate to 21%, and requires companies to pay a one-time transition tax on certain unrepatriated earnings (where applicable) of foreign subsidiaries with an election option to defer the transition tax over eight years. Accordingly, our federal net deferred tax liabilities as of December 31, 2017 have been remeasured using a U.S. federal income tax rate of 21% that is effective beginning on January 1, 2018, to reflect the effects of the enacted changes in tax rates at the date of enactment based on the applicable enacted tax rate when the temporary differences and carryforwards are expected to reverse. The impact of this remeasurement is a decrease to net deferred tax liabilities and a decrease to the deferred income tax provision in 2017 of approximately $4.2 million. Additionally, we elected to defer the transition tax inclusion of approximately $17.8 million into REIT taxable income related to the deemed mandatory repatriation of foreign earnings and profits of the Frenchman's Reef & Morning Star Beach Resort (located in the U.S. Virgin Islands) over the eight-year period allowed under the Tax Act. The transition tax increased our 2017 REIT taxable income in 2017 by approximately $1.5 million. The remaining deferred transition tax inclusion was included in our 2018 REIT taxable income.

We are required to pay franchise taxes in certain jurisdictions. We recorded approximately $0.4 million of franchise taxes during each of the years ended December 31, 2018, 2017 and 2016, which are classified as corporate expenses in the accompanying consolidated statements of operations.

Deferred income taxes are recognized for temporary differences between the financial reporting bases of assets and liabilities and their respective tax bases and for operating loss and tax credit carryforwards based on enacted tax rates

expected to be in effect when such amounts are paid. However, deferred tax assets are recognized only to the extent that it is more likely than not that they will be realizable based on consideration of available evidence, including future reversals of existing taxable temporary differences, projected future taxable income and tax planning strategies. Deferred tax assets are included in prepaid and other assets and deferred tax liabilities are included in accounts payable and accrued expenses on the accompanying consolidated balance sheets. The total deferred tax assets and liabilities are as follows (in thousands):

Table of Contents

	2018	2017
Federal		
Net operating loss carryforwards	$1,983	$3,099
Deferred income related to key money	2,465	2,549
Alternative minimum tax credit carryforwards	103	169
Other	326	355
Depreciation and amortization	(9,188)	(8,889)
Federal - Deferred tax (liabilities) assets, net	$(4,311)	$(2,717)
State		
Net operating loss carryforwards	$2,975	$3,126
Deferred income related to key money	780	801
Alternative minimum tax credit carryforwards	80	81
Other	103	111
Depreciation and amortization	(2,906)	(2,803)
Less: Valuation allowance	(700)	(400)
State - Deferred tax assets, net	$332	$916
Foreign (USVI)		
Deferred income related to key money	$—	$95
Depreciation and amortization	(255)	(796)
Other	—	1
Land basis recorded in purchase accounting	(2,617)	(2,617)
Foreign - Deferred tax liabilities, net	$(2,872)	$(3,317)

As of December 31, 2018, we had deferred tax assets of $5.0 million consisting of federal and state net operating loss carryforwards. The federal loss carryforwards of $2.0 million generally expire in 2029 through 2034 if not utilized by then. We believe that it is more likely than not that the results of future operations will generate sufficient taxable income to realize the deferred tax asset related to federal loss carryforwards prior to their expiration and have determined that no valuation allowance is required. The state loss carryforwards of $3.0 million generally expire in 2020 through 2034 if not utilized by then. The Company analyzes state loss carryforwards on a state by state basis and records a valuation allowance when we deem it more likely than not that future results will not generate sufficient taxable income in the respective state to realize the deferred tax asset prior to the expiration of the loss carryforwards. As of December 31, 2018, we have a $0.7 million valuation allowance on the deferred tax asset related to the Illinois state loss carryforward. The remaining deferred tax assets of $3.9 million are expected to be recovered against reversing existing taxable temporary differences.

The Frenchman's Reef & Morning Star Beach Resort is owned by a subsidiary that has elected to be treated as a TRS, and is subject to U.S. Virgin Islands ("USVI") income taxes. We are party to a tax agreement with the USVI that reduces the income tax rate to approximately 7%. This agreement expires in February 2030.

12. Relationships with Managers and Franchisors

We are party to hotel management agreements for each of our hotels owned. Under our hotel management agreements, the hotel manager receives a base management fee and, if certain financial thresholds are met or exceeded, an incentive management fee. The base management fee is generally payable as a percentage of gross hotel revenues for each fiscal year. The incentive management fee is generally based on hotel operating profits, but the fee

only applies to that portion of hotel operating profits above a negotiated return on our invested capital, which we refer to as the owner's priority. We refer to this excess of operating profits over the owner's priority as “available cash flow.”

The following is a summary of management fees for the years ended December 31, 2018, 2017 and 2016 (in thousands):

F-27

Table of Contents

	Year Ended December 31,		
	2018	2017	2016
Base management fees	$20,467	$22,265	$24,480
Incentive management fees	5,805	6,259	7,810
Amortization of deferred income related to key money	(2,398)	(4,840)	(432)
Amortization of unfavorable contract liabilities	(1,715)	(1,715)	(1,715)
Total management fees, net	$22,159	$21,969	$30,143

Nine of our hotels earned incentive management fees for the year ended December 31, 2018. Ten of our hotels earned incentive management fees for the year ended December 31, 2017. Nine of our hotels earned incentive management fees for the year ended December 31, 2016.

Performance Termination Provisions

Our management agreements provide us with termination rights upon a manager's failure to meet certain financial performance criteria and manager's decision not to cure the failure by making a cure payment.

Key Money

Our managers and franchisors have contributed to us certain amounts in exchange for the right to manage or franchise hotels we have acquired and in connection with the completion of certain brand enhancing capital projects. We refer to these amounts as “key money.” Key money is classified as deferred income in the accompanying consolidated balance sheets and amortized against management fees or franchise fees on the accompanying consolidated statements of operations. We amortized $2.6 million of key money during the year ended December 31, 2018, $5.8 million during the year ended December 31, 2017, and $2.9 million during the year ended December 31, 2016.

In connection with a change in hotel manager of the Courtyard Manhattan/Midtown East, we recognized $1.9 million of accelerated amortization in 2017 of key money provided to us by the previous hotel manager. In connection with the termination of the management agreement for Frenchman's Reef, we accelerated the amortization of key money received from the hotel manager from the date of our notice of termination in 2017 through the effective termination date of February 20, 2018. We recognized an additional $2.6 million of amortization of key money during the year ended December 31, 2017 in connection with this acceleration. The remaining $2.2 million was amortized during the first quarter of 2018.

During 2015, Starwood provided us with $3.0 million of key money in connection with our renovation associated with the brand conversion of the hotel formerly known as the Conrad Chicago to The Gwen, a Luxury Collection Hotel. The key money was amortized against franchise fees over the period of the renovation—January 2016 through April 2017.

Franchise Agreements

We have franchise agreements for 13 of our hotels. Pursuant to these franchise agreements, we pay franchise fees based on a percentage of gross room sales, and, under certain agreements, a percentage based on gross food and beverage sales. Further, we pay certain other fees for marketing and reservation services.

The following is a summary of franchise fees for the years ended December 31, 2018, 2017 and 2016 (in thousands):

Year Ended December 31,

	2018	2017	2016
Franchise fees	$26,348	$24,890	$24,237
Amortization of deferred income related to key money	(170)	(920)	(2,420)
Total franchise fees, net	$26,178	$23,970	$21,817

Total franchise fees are included in other hotel expenses on the accompanying consolidated statements of operations.

13. Commitments and Contingencies

Table of Contents

Litigation

We are subject to various claims, lawsuits and legal proceedings, including routine litigation arising in the ordinary course of business, regarding the operation of our hotels and Company matters. While it is not possible to ascertain the ultimate outcome of such matters, management believes that the aggregate amount of such liabilities, if any, in excess of amounts covered by insurance will not have a material adverse impact on our financial condition or results of operations. The outcome of claims, lawsuits and legal proceedings brought against the Company, however, is subject to significant uncertainties.

On August 13, 2018, the Company brought suit against certain of its property insurers in St. Thomas, U.S. Virgin Islands, over the amount of the coverage the insurers owe as a result of the damage caused to Frenchman's Reef by Hurricanes Irma and Maria. On September 28, 2018, certain of the Company's property insurers brought a similar suit against the Company in New York seeking a declaration that the insurers do not owe the full amount of the Company's claim. Notwithstanding the litigation, the Company and its insurers continue to engage in discussions and negotiation regarding the Company's claim.

Other Matters

In February 2016, the Company was notified by the franchisor of one of its hotels that as a result of low guest satisfaction scores, the Company was in default under the franchise agreement for that hotel. The Company continues to proactively work with the franchisor and the manager of the hotel and has developed and executed a plan aimed to improve guest satisfaction scores. Though the guest satisfaction scores have improved, the Company remains in default under the franchise agreement. While the franchisor has reserved all of its rights under the franchise agreement, no action to terminate the franchise agreement has been taken by the franchisor and no accrual was recorded as of December 31, 2018 or 2017.
If the Company is not successful in resolving the matter, the franchisor may seek to terminate the franchise agreement and assert a claim it is owed a termination fee, including a payment for liquidated damages, which could result in a material adverse effect on the Company's business, financial condition or results of operation.
Restricted Cash

As of December 31, 2018 and 2017, we had $47.7 million and $40.2 million, respectively, of restricted cash, which consists of reserves for replacement of furniture and fixtures generally held by our hotel managers and cash held in escrow pursuant to lender requirements.
Ground Leases

Seven of our hotels are subject to ground lease agreements that cover all of the land underlying the respective hotel:

- The Bethesda Marriott Suites hotel is subject to a ground lease that runs until 2087. There are no renewal options.

- The Courtyard Manhattan/Fifth Avenue is subject to a ground lease that runs until 2085, inclusive of one 49-year renewal option.

- The Salt Lake City Marriott Downtown is subject to two ground leases: one ground lease covers the land under the hotel and the other ground lease covers the portion of the hotel that extends into the adjacent City Creek Project. We own a 21% interest in the land under the hotel. The term of the ground lease covering the land under the hotel runs through 2056, inclusive of renewal options. The term of the ground lease covering the extension into the City Creek Project was amended during 2017 to run coterminously with the term of the ground lease covering the land under the

hotel. As such, the term now runs through 2056, inclusive of renewal options.

- The Westin Boston Waterfront is subject to a ground lease that runs until 2099. There are no renewal options.
- The Shorebreak Hotel is subject to a ground lease that runs until 2100, inclusive of two renewal options of 25 years each and one 24-year renewal option. We own a 95.5% undivided interest in the land underlying the hotel and lease the remaining 4.5% under the ground lease.
- The Hotel Palomar Phoenix is subject to a ground lease that runs until 2085, inclusive of three renewal options of five years each.

Table of Contents

- Cavallo Point is subject to a ground lease with the United States National Park Service that runs until 2066. There are no renewal options.

A portion of the parking garage relating to the Renaissance Worthington is subject to three ground leases that cover, contiguously with each other, approximately one-fourth of the land on which the parking garage is constructed. Each of the ground leases has a term that runs through July 2067, inclusive of three 15-year renewal options. The remainder of the land on which the parking garage is constructed is owned by us in fee simple.

A portion of the JW Marriott Denver at Cherry Creek is subject to a ground lease that covers approximately 5,500 square feet. The term of the ground lease runs through December 2030, inclusive of two 5-year renewal options. The lease may be indefinitely extended thereafter in one-year increments. The remainder of the land on which the hotel is constructed is owned by us in fee simple.

We lease the buildings and sublease the underlying land containing 28 of the 70 rooms at the Orchards Inn Sedona, which expires in 2070, including all extension options. The remainder of the land underlying the hotel is owned by us in fee simple.

These ground leases generally require us to make rental payments (including a percentage of gross receipts as percentage rent with respect to the Courtyard Manhattan/Fifth Avenue, Westin Boston Waterfront Hotel, Salt Lake City Marriott Downtown, and Cavallo Point ground leases). Most of our ground leases require us to make payments for all charges, costs, expenses, assessments and liabilities, including real property taxes and utilities. Furthermore, these ground leases generally require us to obtain and maintain insurance covering the subject property.

Ground rent expense was $11.6 million, $10.2 million and $12.7 million for the years ended December 31, 2018, 2017 and 2016, respectively. Cash paid for ground rent was $4.7 million, $4.1 million and $7.0 million for the years ended December 31, 2018, 2017 and 2016, respectively.

The following table reflects the current and future annual rents under our ground leases:

Table of Contents

Property	Term (1)	Annual Rent
Bethesda Marriott Suites	Through 4/2087	$781,366 (2)
Courtyard Manhattan/Fifth Avenue (3)	10/2007 - 9/2017	$906,000
	10/2017 - 9/2027	$1,132,812
	10/2027 - 9/2037	$1,416,015
	10/2037 - 9/2047	$1,770,019
	10/2047 - 9/2057	$2,212,524
	10/2057 - 9/2067	$2,765,655
	10/2067 - 9/2077	$3,457,069
	10/2077 - 9/2085	$4,321,336
Salt Lake City Marriott Downtown (Ground lease for hotel) (4)	Through 12/2056	Greater of $132,000 or 2.6% of annual gross room sales
Salt Lake City Marriott Downtown (Ground lease for extension)	1/2013 - 12/2016	$11,305
	1/2017 - 12/2017	$13,000
	1/2018 - 12/2056 (5)	$13,500
Westin Boston Waterfront Hotel (6) (Base rent)	1/2016 - 12/2020	$750,000
	1/2021 - 12/2025	$1,000,000
	1/2026 - 12/2030	$1,500,000
	1/2031 - 12/2035	$1,750,000
	1/2036 - 5/2099	No base rent
Westin Boston Waterfront Hotel (Percentage rent)	Through 5/2015	0% of annual gross revenue
	6/2016 - 5/2026	1.0% of annual gross revenue
	6/2026 - 5/2036	1.5% of annual gross revenue
	6/2036 - 5/2046	2.75% of annual gross revenue
	6/2046 - 5/2056	3.0% of annual gross revenue
	6/2056 - 5/2066	3.25% of annual gross revenue
	6/2066 - 5/2099	3.5% of annual gross revenue
JW Marriott Denver at Cherry Creek	1/2015 - 12/2020	$50,000
	1/2021 - 12/2025	$55,000
	1/2026 - 12/2030 (7)	$60,000
Shorebreak Hotel	Through 4/2016	$115,542
	5/2016 - 4/2021 (8)	$126,649
Orchards Inn Sedona	Through 6/2018	$117,780
	7/2018 - 12/2070	$121,078 (9)
Hotel Palomar Phoenix (Base Rent)	Through 3/2020	$16,875
	4/2020 - 3/2021	$33,750
	4/2021 - 3/2085	$34,594 (10)
Hotel Palomar Phoenix (Government Property Lease Excise Tax) (11)	1/2022 - 12/2023	$390,000
	1/2024 - 12/2033	$312,000
	1/2034 - 12/2043	$234,000
	1/2044 - 12/2053	$156,000
	1/2054 - 12/2063	$78,000

	1/2064 - 3/2085	$—
Cavallo Point (Base Rent)	Through 12/2018	$1
	1/2019 - 12/2066	$67,034 (12)
Cavallo Point (13) (Percentage Rent)	Through 12/2018	1.0% of adjusted gross revenue over threshold
	1/2019 - 12/2023	2.0% of adjusted gross revenue over threshold
	1/2024 - 12/2028	3.0% of adjusted gross revenue over threshold
	1/2029 - 12/2033	4.0% of adjusted gross revenue over threshold
	1/2034 - 12/2066	5.0% of adjusted gross revenue over threshold
Cavallo Point (14) (Participation Rent)	Through 12/2066	10.0% of adjusted gross revenue over threshold

Table of Contents

Property	Term (1)	Annual Rent
Renaissance Worthington garage ground lease	8/2013 - 7/2022	$40,400
	8/2022 - 7/2037	$46,081
	8/2037 - 7/2052	$51,763
	8/2052 - 7/2067	$57,444

---

(1) These terms assume our exercise of all renewal options.

(2) Represents rent for the year ended December 31, 2018. Rent increases annually by 5.5%.

(3) The total annual rent includes the fixed rent noted in the table plus a percentage rent equal to 5% of gross receipts for each lease year, but only to the extent that 5% of gross receipts exceeds the minimum fixed rent in such lease year. There was no such percentage rent earned during the year ended December 31, 2018.

(4) We own a 21% interest in the land underlying the hotel and, as a result, 21% of the annual rent under the ground lease is paid to us by the hotel.

(5) Rent will increase from the prior year's rent based on a Consumer Price Index calculation on each January 1, beginning January 1, 2019 and through the end of the lease.

(6) Total annual rent under the ground lease is capped at 2.5% of hotel gross revenues during the initial 30 years of the ground lease.

(7) Beginning January 2031, we have the right to renew the ground lease in one-year increments at the prior year's annual rent plus 3%.

(8) Rent will increase on May 1, 2021 and every five years thereafter based on a Consumer Price Index calculation.

(9) Represents rent from July 2018 through June 2019. On July 1, 2018, rent increased based on a Consumer Price Index calculation, and will continue to do so annually through the end of the lease.

(10) Represents rent from April 2021 through March 2022. Rent increases annually each April by 2.5%.

(11) As lessee of government property, the hotel is subject to a Government Property Lease Excise Tax ("GPLET") under Arizona state statute with payments beginning in 2022.

(12) Base rent increases in January 2019 and resets every five years based on the average of the previous three years of adjusted gross revenues, as defined in the ground lease, multiplied by 75%.

(13) Percentage rent is applied to annual adjusted gross revenues, as defined in the ground lease, between $30 million and the participation rent threshold. Base rent is deducted from the percentage rent.

(14) Participation rent is applied to annual adjusted gross revenues, as defined in the ground lease, over $40 million in 2018, $42 million in 2019, and $42 million plus an annual increase based on a Consumer Price Index calculation for 2020 and every year thereafter through the end of the lease term.

Future minimum annual rental commitments under all non-cancelable operating leases as of December 31, 2018 are as follows (in thousands):

2019	$5,232
2020	4,866
2021	6,132
2022	5,122
2023	5,096
Thereafter	636,770
	$663,218

14. Fair Value of Financial Instruments

The fair value of certain financial assets and liabilities and other financial instruments as of December 31, 2018 and 2017, in thousands, are as follows:

	December 31, 2018		December 31, 2017	
	Carrying Amount (1)	Fair Value	Carrying Amount (1)	Fair Value
Debt	$977,966	$960,447	$937,792	$942,529

(1) The carrying amount of debt is net of unamortized debt issuance costs.

F-32

Table of Contents

The fair value of our mortgage debt is a Level 2 measurement under the fair value hierarchy (see Note 2). We estimate the fair value of our mortgage debt by discounting the future cash flows of each instrument at estimated market rates. The carrying value of our other financial instruments approximate fair value due to the short-term nature of these financial instruments.

15. Quarterly Operating Results (Unaudited)

	2018 Quarter Ended			
	March 31	June 30	September 30	December 31
	(In thousands, except per share data)			
Total revenue	$181,530	$237,949	$220,818	$223,407
Total operating expenses	168,011	200,012	176,589	189,031
Operating income	$13,519	$37,937	$44,229	$34,376
Net income	$4,338	$28,009	$31,443	$24,006
Net income attributable to common stockholders	$4,338	$28,009	$31,443	$23,994
Net income per share available to common stockholders—basic	$0.02	$0.14	$0.15	$0.12
Net income per share available to common stockholders—diluted	$0.02	$0.14	$0.15	$0.12

	2017 Quarter Ended			
	March 31	June 30	September 30	December 31
	(In thousands, except per share data)			
Total revenue	$196,210	$243,272	$223,486	$207,037
Total operating expenses	176,914	192,621	189,168	171,519
Operating income	$19,296	$50,651	$34,318	$35,518
Net income	$8,887	$36,595	$21,623	$24,772
Net income attributable to common stockholders	$8,887	$36,595	$21,623	$24,772
Net income per share available to common stockholders—basic	$0.04	$0.18	$0.11	$0.12
Net income per share available to common stockholders—diluted	$0.04	$0.18	$0.11	$0.12

Table of Contents

DiamondRock Hospitality Company
Schedule III - Real Estate and Accumulated Depreciation
As of December 31, 2018 (in thousands)

		Initial Cost		Costs Capitalized Subsequent to	Gross Amount at End of Year				
Description	Encumbrances	Land	Building and Improvements	Acquisition	Land	Building and Improvements	Total	Accumulated Depreciation	Net Book Value
Atlanta Alpharetta Marriott	$—	$3,623	$33,503	$2,534	$3,623	$36,037	$39,660	$(11,696)	$27,964
Bethesda Marriott Suites	—	—	45,656	5,345	—	51,001	51,001	(16,740)	34,261
Boston Westin Waterfront	(194,466)	—	273,696	26,091	—	299,787	299,787	(88,210)	211,577
Cavallo Point	—	—	123,100	—	—	123,100	123,100	(308)	122,792
Chicago Marriott Downtown	—	36,900	347,921	93,281	36,900	441,202	478,102	(121,187)	356,915
The Gwen Chicago	—	31,650	76,961	22,243	31,650	99,204	130,854	(25,029)	105,825
Courtyard Denver	—	9,400	36,180	2,978	9,400	39,158	48,558	(7,003)	41,555
Courtyard Manhattan/Fifth Avenue	—	—	34,685	4,485	—	39,170	39,170	(13,359)	25,811
Courtyard Manhattan/Midtown East	(82,620)	16,500	54,812	5,199	16,500	60,011	76,511	(20,284)	56,227
Frenchman's Reef & Morning Star Beach Resort	—	17,713	50,697	17,949	17,713	68,646	86,359	(15,230)	71,129
Havana Cabana Key West	—	32,888	13,371	5,513	32,888	18,884	51,772	(1,491)	50,281
Hilton Boston Downtown	—	23,262	128,628	12,877	23,262	141,505	164,767	(22,112)	142,655
Hilton Burlington	—	9,197	40,644	2,006	9,197	42,650	51,847	(6,954)	44,893
Hilton Garden Inn/New York Times Square Central	—	60,300	88,896	472	60,300	89,368	149,668	(9,702)	139,966
Hotel Emblem	—	7,856	21,085	(36)	7,856	21,049	28,905	(3,231)	25,674
Hotel Palomar Phoenix	(2,943)	—	59,703	(171)	—	59,532	59,532	(1,281)	58,251
JW Marriott Denver	(62,411)	9,200	63,183	1,488	9,200	64,671	73,871	(12,250)	61,621
The Landing at Lake Tahoe	—	14,816	24,351	(241)	14,816	24,110	38,926	(531)	38,395
L'Auberge de Sedona	—	39,384	22,204	293	39,384	22,497	61,881	(1,592)	60,289
Lexington Hotel New York	—	92,000	229,368	22,796	92,000	252,164	344,164	(45,686)	298,478
Orchards Inn Sedona	—	9,726	10,180	102	9,726	10,282	20,008	(511)	19,497

Renaissance Charleston	—	5,900	32,511	5,208	5,900	37,719	43,619	(7,135)	36,484
Renaissance Worthington	(82,540)	15,500	63,428	18,037	15,500	81,465	96,965	(23,086)	73,879
Salt Lake City Marriott Downtown	(55,032)	—	45,815	5,701	855	50,661	51,516	(16,944)	34,572
Sheraton Suites Key West	—	49,592	42,958	742	49,592	43,700	93,292	(3,996)	89,296
Shorebreak Hotel	—	19,908	37,525	3,332	19,908	40,857	60,765	(3,847)	56,918
The Lodge at Sonoma, a Renaissance Resort and Spa	(27,633)	3,951	22,720	8,601	3,951	31,321	35,272	(12,233)	23,039
Vail Marriott Mountain Resort & Spa	—	5,800	52,463	17,335	5,800	69,798	75,598	(18,695)	56,903
Westin Fort Lauderdale Beach Resort	—	54,293	83,227	8,767	54,293	91,994	146,287	(8,929)	137,358
Westin San Diego	(63,385)	22,902	95,617	9,123	22,902	104,740	127,642	(16,454)	111,188
Westin Washington, D.C City Center	(62,734)	24,579	122,229	11,802	24,579	134,031	158,610	(21,162)	137,448
Total	$(633,764)	$616,840	$2,377,317	$313,852	$617,695	$2,690,314	$3,308,009	$(556,868)	$2,751,1

F-34

Table of Contents

Notes:

A) The change in total cost of properties for the fiscal years ended December 31, 2018, 2017 and 2016 is as follows (in thousands):

Balance at December 31, 2015	$3,125,051
Additions:	
Acquisitions	—
Capital expenditures	61,823
Deductions:	
Dispositions and other	(269,240)
Balance at December 31, 2016	2,917,634
Additions:	
Acquisitions	81,494
Capital expenditures	$68,573
Deductions:	
Dispositions and other	(42,612)
Balance at December 31, 2017	3,025,089
Additions:	
Acquisitions	221,970
Capital expenditures	60,950
Deductions:	
Dispositions and other	—
Balance at December 31, 2018	$3,308,009

B) The change in accumulated depreciation of real estate assets for the fiscal years ended December 31, 2018, 2017 and 2016 is as follows (in thousands):

Balance at December 31, 2015	$419,309
Depreciation and amortization	65,490
Dispositions and other	(42,847)
Balance at December 31, 2016	441,952
Depreciation and amortization	60,023
Dispositions and other	(9,104)
Balance at December 31, 2017	492,871
Depreciation and amortization	63,997
Dispositions and other	—
Balance at December 31, 2018	$556,868

C) The aggregate cost of properties for Federal income tax purposes (in thousands) is approximately $3,151,650 as of December 31, 2018.