NEW MEXICO SOFTWARE, INC
Form 10KSB/A
April 19, 2007

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-KSB

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES

EXCHANGE ACT OF 1934

FOR THE FISCAL YEAR ENDED DECEMBER 31, 2006

COMMISSION FILE #333-30176

NEW MEXICO SOFTWARE, INC.

(Name of small business issuer in its charter)

NEVADA

(State or other jurisdiction of incorporation or organization)

91-1287406

(I.R.S. Employer Identification No.)

5021 INDIAN SCHOOL RD., SUITE 100

ALBUQUERQUE, NEW MEXICO 87110

(Address of principal executive offices)(Zip code)

(505) 255-1999

(Issuer s telephone number)

SECURITIES REGISTERED PURSUANT TO SECTION 12(B) OF THE ACT: NONE

SECURITIES REGISTERED PURSUANT TO SECTION 12(G) OF THE ACT: NONE

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES [X] NO [ ]

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B contained in this form, and no disclosure will be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of the Form 10-KSB or any amendment to this Form 10-KSB. [X]

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES [ ] NO [X]

REVENUES FOR YEAR ENDED DECEMBER 31, 2006: $913,000

AGGREGATE MARKET VALUE OF THE VOTING COMMON STOCK HELD BY NON-AFFILIATES OF THE REGISTRANT AS OF APRIL 9, 2007, WAS: $ 2,986,257

NUMBER OF SHARES OF THE REGISTRANT'S COMMON STOCK OUTSTANDING AS OF APRIL 9, 2007: 93,320,544

DOCUMENTS INCORPORATED BY REFERENCE

None

Transitional Small Business Disclosure Format YES [ ] NO [X]

PART I

ITEM 1. DESCRIPTION OF BUSINESS

Our History and Background

New Mexico Software, Inc., was originally incorporated under the laws of the state of New Mexico in April 1996. The privately held company was involved in a reverse merger with Raddatz Exploration, Inc. on August 3, 1999, and the corporate name was changed to NMXS.com, Inc., with New Mexico Software, Inc. becoming a wholly-owned subsidiary. NMXS.com, Inc. went public at that time. NMXS was quoted on the OTC Bulletin Board under the symbol NMXS and on the Berlin Stock Exchange with the symbol NM9. In 2004 we filed an alternate name registration in the state of Delaware to use the name New Mexico Software. On January 1, 2006, NMXS.com, Inc merged into its newly incorporated, wholly-owned subsidiary, New Mexico Software, Inc., a Nevada corporation, for the purpose of changing its state of incorporation and its name. The new stock symbol on the OTC Bulletin Board is NMXC .

In April 2000, we acquired Working Knowledge, Inc., a Kansas corporation. Working Knowledge became our wholly-owned subsidiary which provided services necessary to prepare, enter, and maintain the customer s data in our software.

Our Business

New Mexico Software, Inc. develops and markets a range of proprietary Internet-based software products for digital asset management. Our software can assist the customer in the conversion of documents or images into digital media, and the storage, organization, retrieval and search of documents, high-resolution graphic images, video clips and audio recordings. In addition, we provide related services such as software hosting and maintenance, database management and consulting. Our address on the World Wide Web is www.nmxs.com. The information at that web site is not part of our annual report, and we specifically disclaim any liability under federal securities law related there.

Our Products

New Mexico Software develops and markets sophisticated Internet-based document and image management systems for a wide variety of applications. Every industry shares the need to track, organize and distribute information efficiently and accurately. Our products bridge the gap between the paper and digital worlds and reduce dependence on paper files. In addition to organizing and archiving, our products allow a company to control access to and dissemination of its digital files, providing protection of the digital assets.

Our core technology is called the Roswell. Roswell optimizes the movement of information throughout an enterprise, its clients, its suppliers and its partners. As a core product, it can be integrated into a highly customized enterprise-level system on its own, and it is the central technology in all of our other products. Roswell offers extensive file management capabilities which allow information to be intelligently organized so that any particular item can be instantly located. In addition, it allows the customer to track and control the entire flow of information and to create a hierarchy of groups and users with varying levels of access to that information.

Our first product is called XR-EXpress. It is a secure, web-based software that allows medical providers to store, organize and access patient medical images such as x-rays, EKG s, MRI s, CT s, and ultrasounds. It instantly delivers images to radiologists over the Internet; the independent radiologist then diagnoses the case and returns the results, cutting the time it takes for a patient to receive a diagnosis. XR-EXpress is structured and delivered as a hosted model, reducing the customer s need for technology and capital investment.

DFC3 (Digital Filing Cabinet 3) is our second product. DFC3 allows the customer to find the right document at the right time, whether it s an invoice, contract, legal brief, logo or other image. It easily converts paper documents to digital format, and every word of every document is searchable with Optical Character Recognition and DFC3 s advanced search engine. The hierarchical security structure allows the customer to determine who has access to what information. We have diversified the DFC3 product; it now consists of four models of varying price and complexity, ranging from a hosted application to enterprise servers, in order to accommodate a wider variety of customers. It can be used on Windows, Macintosh or Linux operating systems.

Our third product is the TORC backup server. This product allows customers to schedule routine backups, and TORC performs these backups automatically, with no further input from the user. The first backup creates an image of the computer s entire hard disk, including the operating system, and subsequent backups are incremental. The backup files are stored on our servers. Our software is able to locate and restore any or all files to a damaged computer and have it back up and running in minutes. TORC will be widely marketed, because every office or home with one or more computers can benefit from automated backups to protect data.

Our latest product is DDS-Express. DDS-Express is an online dental solution including practice management software, clinical charting, online insurance claim filing, referrals and consultations, and secure off-site data backup. These features are integrated into an online hosted package. DDS-Express will be marketed to dental offices.

Our Technology

Our technology is one of the keys to our product differentiation. We engineer our products around a central core of unique Internet technology that makes it possible to rapidly view, distribute and manage a variety of media files such as documents, graphic images, animation sequences, film clips, audio files, x-rays and high-definition media streams. The value of our core technology, which is found in the Roswell ICMS, is that it provides maximum flexibility in the presentation of digital images to the customer, and integrates general browsing capabilities with specific search capabilities in one product.

Our technology is based on Open Source. Open Source is source code from independent programmers who build applications and release their source code in the public interest. By integrating Open Source programs into our technology, we are able to reduce development time and costs, thereby providing well-built, low-cost products for the digital management market. In addition, the code that we deliver to customers is compiled. When software code is compiled it is difficult to use the code to create a similar program, even though the code we create originates from Open Source. This provides better protection and security of our products.

Most of our products are accessed via the Internet. This means that the customer needs only a PC with browser capability to be able to use our products. No additional expensive equipment is required, and training is accomplished smoothly and quickly. The customer s data is available 24 hours per day, so that customers can work according to schedules that are convenient to them and be productive at any time. Additionally, documents and images can be distributed anywhere in the world at any time. We also create two desktop applications, DFC Client and JAL Client, for direct uploading to DFC and XR-EXpress from the desktop.

Another technological advantage our company has is the ability to provide totally integrated services that a customer would normally need to outsource to several different suppliers. For example, with our business model and technology, we are able to provide the software itself, plus custom programming, hosting, and database administration as a total solution.

These unique features make our core technology adaptable to and highly desirable in a wide variety of commercial applications. Basically, any company in any industry that manages digital assets and makes use of browser and search engine technology can benefit from our products.

In general, our programmers and engineers are tasked with adding new features to our products and fixing any problems users might encounter on an ongoing basis. There are risks inherent in software development including unanticipated delays, technical problems that could mean significant deviation from original product specifications, and hardware problems. In addition, once improvements and bug fixes are deployed there is no assurance that they will work as anticipated or that they will be durable in actual use by customers.

We are continuing to develop our core products using a mix of readily available Open Source software development tools. Knowledgeable competitors may be able to deduce how we have assembled our code base and be able to develop competing products. The principal advantage in utilizing Open Source tools is the extremely high degree of portability they ensure. Migrating our products from one operating system or hardware base to another is more easily accomplished by avoiding proprietary development tools. The risk factor inherent in the use of such freely available tools is the fact that a sophisticated competitor might be able to imitate our work and produce similar functionality. Any such imitation, should it occur, could have material adverse effects on our business, operations, and financial condition.

Business Strategy

According to an IDC study entitled *Worldwide Digital Asset Management Software 2006 2010 Forecast*, the digital asset management software market posted double-digit growth in 2005 , and expectations are that there will be continued strong growth in this market over the forecast period as organizations seek to manage, share, and monetize their rich media assets . And, according to a Frost & Sullivan study entitled *U.S. Digital Asset Management Systems Markets*, what was once a niche product aimed at specialty markets such as broadcasting, entertainment, and advertising is rapidly moving into the mainstream as businesses realize the need to efficiently manage their growing portfolio of digital assets. New Mexico Software believes that the rapid growth in the digital asset management industry is causing intense competition and rapid changes in the market, but also a number of opportunities as well.

Currently, our competition consists of many large and small vendors offering systems that have some features that are comparable to some of our current products. However, to our knowledge, few if any competitors have all of the features our products offer for the complete management and distribution of both documents and images at a price that is competitive to ours.

One of the challenges of operating in an industry characterized by rapid growth and changes is being able to create a balance between sustaining a consistent vision and business strategy and yet maintaining the flexibility required to adapt to the rapidly changing market conditions. We believe that our product structure allows us to do that. Since our core technology is useful to literally any company that manages digital assets and has access to Internet browser functions, it is the backbone of our product framework. As such, it provides the consistency and stability aspect of the business strategy. The next generation of our products primarily consists of derivative products, new technological combinations, and enhancements to the core product. These have the advantage of taking an extraordinarily short time to develop into a marketable product (sometimes in as little as a few months). This aspect of our product structure provides the flexibility necessary to be able to respond quickly to new market opportunities.

Our main business strategy for the coming year is to take advantage of the current accelerated growth of the digital asset management market. In order to accomplish this strategy, we will concentrate on expanding our reseller and partner programs in the coming year. Management believes that taking advantage of the sales capacity of resellers and partners, particularly for the lower-cost range of products and hosting, is the quickest way to effect market penetration, as well as providing a more profitable business model. At the same time, this model allows us to focus our attention on attracting larger custom projects and facilitating consulting services for more complex systems, making the most effective use of our time and personnel.

One competitive strategy we are using is offering our enterprise-level products as hosted applications. By hosting our applications, we are able to provide the customer with a customized product that is maintained by us, which eliminates the customer s need for an information technology staff. We provide the hardware, connectivity, maintenance, technical support, and automatic backups of the customer s data. Now that our core product has been completed, our cycle time (the time required to get a new customer up and running) is greatly reduced. We are often able to accommodate new customers within days, including training, and even those with complex databases, in a matter of weeks.

In addition, in response to market demand, we have diversified our DFC3 product into four models of varying complexity and price. We anticipate that the variety of options available with this product will allow us to be responsive to the needs of a broader range of customers with less time and effort on our part. In general, we believe that our strategy to provide hosted applications coupled with our custom system design capabilities provide us with a diversity of competitive market penetration opportunities.

We believe that establishing and maintaining brand identity of our products and services is critical to attracting new customers and retaining our customer base of large corporations. The importance of brand recognition will continue to increase as new competitors enter the digital lifecycle management marketplace. In the coming year, we will be emphasizing our product brands in our marketing efforts, rather than our company name, in order to boost the brand recognition of our products. Promotion and enhancement of our brands will depend largely on our success in continuing to provide high quality service and developing leading-edge products, and this cannot be assured. If we are unable to provide high quality services, or otherwise fail to promote and maintain our products, or if we incur excessive expenses in an attempt to improve our services, or promote and maintain our products, our business, results of operations, and financial condition could be adversely affected.

Other, better-financed companies may be developing similar products that could compete with our products. Such competition could materially adversely affect our financial condition. There may exist better-capitalized companies on a parallel development path with similar products addressing our target markets. While the Internet technology marketplace is extremely competitive, we have anticipated a first-to-market advantage with our products. However, other highly capitalized companies that have recognized the absence of digital image management products could overwhelm our first-to-market advantage with expensive and expansive media blitzes that create the perception of a dominant market presence and/or superior products. If we are unsuccessful in addressing these risks and uncertainties, our business, results of operations, and financial condition will be materially and adversely affected.

Marketing and Customers

During the last two years we have concentrated on expanding our customer base for recurring revenues. Although our XR-Express and DDS-Express products have particular target markets, our other products are useful for any customers that deal with paper or images and have access to the Internet. As discussed in the Business Strategy section above, Management believes that the most effective way to achieve broad market penetration for our DFC3 and TORC backup systems is to expand our reseller and partner programs. This approach, coupled with targeted trade shows and direct marketing to XR-Express and DDS-Express customers, as well as to larger customers requiring more complex systems, will be our marketing focus for the coming year. Overall, we anticipate that our customer base will continue to broaden in the next year, giving more stability, steady growth, and predictability to our revenues.

Our Intellectual Properties

We have several proprietary aspects to our software that we believe make our products unique and desirable in the marketplace. Consequently, we regard protection of the proprietary elements of our products to be of paramount importance and we attempt to protect them by relying on trademark, service mark, trade dress, copyright and trade secret laws, and restrictions on disclosure and transferring of title. In addition, as stated above in the technology section, the compiled software code that we offer makes it difficult to use the source code to create other similar programs, even though the code used originates from Open Source. Because we maintain our enterprise software code on dedicated servers in our Albuquerque data center, it provides better protection and security of our products.

We have entered into confidentiality and non-disclosure agreements with our employees and contractors in order to limit access to, and disclosure of, our proprietary information. There can be no assurance that these contractual arrangements or the other steps taken by us to protect our intellectual property will prove sufficient to prevent misappropriation of our technology or to deter independent third-party development of similar technologies.

Although we do not believe that we infringe the proprietary rights of third parties, there can be no assurance that third parties will not claim infringement by us with respect to past, current, or future technologies. We expect that participants in our markets will be increasingly subject to infringement claims as the number of services and competitors in our industry grows. Any such claim, whether meritorious or not, could be time-consuming, result in costly litigation, cause service upgrade delays, or require us to enter into royalty or licensing agreements. Such royalty or licensing agreements may not be available on terms acceptable to us or at all. As a result, any such claim could have a material adverse effect upon our business, results of operations, and financial condition.

While we have commenced the process to protect our trade names, we have not completed the process. Thus, others could attempt to use trade names that we have selected. Such misappropriation of our brand identity could cause significant confusion in the highly competitive Internet technology marketplace and legal defense against such misappropriation could prove costly and time-consuming. As part of the brand identity creation process that defines our products to be unique in the Internet technology marketplace and proprietary in nature, we have begun the process to protect certain product names and slogans as registered trademarks to designate exclusivity and ownership.

Although trademarked in the U.S., effective trademark, copyright or trade secret protection may not be available in every country in which our products may eventually be distributed. There can also be no assurance that the steps taken by us to protect our rights to use these trademarked names and slogans and any future trademarked names or slogans will be adequate, or that third parties will not infringe or misappropriate our copyrights, trademarks, service marks, and similar proprietary rights.

Government Regulation

Our operations, products, and services are all subject to regulations set forth by various federal, state and local regulatory agencies. We take measures to ensure our compliance with all such regulations as promulgated by these agencies from time to time. The Federal Communications Commission sets certain standards and regulations regarding communications and related equipment.

There are currently few laws and regulations directly applicable to the Internet. It is possible that a number of laws and regulations may be adopted with respect to the Internet covering issues such as user privacy, pricing, content, copyrights, distribution, antitrust and characteristics and quality of products and services. The growth of the market for online commerce may prompt calls for more stringent consumer protection laws that may impose additional burdens on companies conducting business online. Tax authorities in a number of states are currently reviewing the appropriate tax treatment of companies engaged in online commerce, and new state tax regulations may subject us to additional state sales and income taxes.

Because our services are accessible worldwide, other jurisdictions may claim that we are required to qualify to do business as a foreign corporation in a particular state or foreign country. Our failure to qualify as a foreign corporation in a jurisdiction where we are required to do so could subject us to taxes and penalties for the failure to qualify and could result in our inability to enforce contracts in such jurisdictions. Any such new legislation or regulation, or the application of laws or regulations from jurisdictions whose laws do not currently apply to our business, could have a material adverse effect on our business, results of operations, and financial condition.

Employees

As of April 9, 2007, we had 14 full-time and one part-time staff, including 6 in systems engineering and quality assurance; 4 in sales and customer support; and 5 in administration.

ITEM 2. DESCRIPTION OF PROPERTY

We currently lease a 3,000 square foot facility in Albuquerque, New Mexico, at a cost of approximately $4,000 per month. The lease expires on April 30, 2009. The facility houses our administrative, marketing and engineering offices, and provides adequate room for expansion. It also contains an advanced telephone system which will provide the capability needed to provide adequate customer telephone support. Our servers are located in a separate facility downstairs from ours, and the two locations are networked together by fiber optics. In this facility we have access to a large power generator, which enables our servers to continue operating during power outages.

In March 2005, we leased approximately 400 square feet of office space in Santa Monica, California, to house the scanning and site development operations. Monthly lease payments were $1,400. The lease expired on February 28, 2006, and at that time we discontinued the California site and absorbed those activities into the Albuquerque site.

ITEM 3. LEGAL PROCEEDINGS

We are not engaged in any legal proceedings, and do not know of any threatened litigation or claims.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of the security holders during the fourth quarter ended December 31, 2006.

PART II

ITEM 5. MARKET FOR COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

Market Information

Our stock has historically been quoted on the OTC Bulletin Board under the symbol "NMXS." When we merged NMXS.com, Inc. with New Mexico Software on January 1, 2006 our new symbol became NMXC. The table below sets forth, for the periods indicated below, our high and low sales prices. These quotations reflect inter-dealer prices, without retail mark-up, mark-down or commission, and may not necessarily represent actual transactions. The source of this information is Big Charts.

	Quarter	High	Low
FISCAL YEAR ENDED DECEMBER 31, 2005	First	$0.505	$0.135
	Second	$0.25	$0.134
	Third	$0.16	$0.098
	Fourth	$0.13	$0.098
FISCAL YEAR ENDED DECEMBER 31, 2006	First	$0.24	$0.101
	Second	$0.155	$0.09
	Third	$0.109	$0.055
	Fourth	$0.095	$0.031
FISCAL YEAR ENDED DECEMBER 31, 2007	First	$0.061	$0.036

Recent Sales of Unregistered Securities

On October 9, 2006, we issued 1,000,000 shares of our common stock to Anthony Jeffries, our legal counsel. We did not pay and no one acting on his behalf or to our knowledge paid any commissions of other compensation with respect to the sale of any of these shares to Mr. Jeffries. We made the sale directly to Mr. Jeffries. We issued the shares to him in payment of legal services during the year ended December 31, 2006. Mr. Jeffries acknowledged the investment nature of the securities issued, and we believe Mr. Jeffries has such knowledge and experience in business and financial transactions that he was able to understand and evaluate the risks and merits of investment in a high-risk enterprise. A legend was placed on each certificate, prohibiting public resale of the shares, except in compliance with Rule 144. We claim exemption from the registration requirement of the Securities Act of 1933, as amended (the Act) by reason of Section 4(2) of the Act and the rules and regulations thereunder, on grounds that this sale did not involve a public offering within the meaning of the Act.

On December 27, 2006, we issued 11,060,000 shares of our common stock to Mr. Govatski, one of our directors and our chief executive officer. We did not pay and no one acting on his behalf or to our knowledge paid any commissions or other compensation with respect to the sale of any of these shares to Mr. Govatski. We made the sale directly to Mr. Govatski. We issued the shares to him in replacement of shares that he surrendered in March 2005 in satisfaction of a guaranty of a loan on our behalf. From his preexisting relationship with us, it is clear he has access to material investment information and financial statements needed by a purchaser to make an informed investment decision. We believe Mr. Govatski has such knowledge and experience in business and financial transactions that he was able to understand and evaluate the risks and merits of investment in a high-risk enterprise. A legend was placed on each certificate, prohibiting public resale of the shares, except in compliance with Rule 144. We claim exemption from the registration requirement of the Securities Act of 1933, as amended (the Act) by reason of Section 4(2) of the Act and the rules and regulations thereunder, on grounds that this sale did not involve a public offering within the meaning of the Act.

Beginning in 2001, we issued shares in compensation to employees and consultants pursuant to stock issuance plans and related registration statements on Form S-8. It has been brought to our attention in connection with out 2006 audit that the number of shares issued under these plans has exceeded the plan amounts and registered amounts, as follows:

Plan Designation	Shares Authorized and Registered	Shares issued
2001 Stock Issuance Plan	4,900,000	5,947,196
2004 Stock Issuance Plan	3,000,000	3,074,143
2005 Stock Issuance Plan	5,000,000	9,603,733
2006 Stock Issuance Plan	15,000,000	17,361,419

An aggregate of 8,086,491 were issued in excess of the number of shares authorized and registered. We believed we were issuing these shares in reliance upon the related S-8 registration statement and did not require a restrictive legend. Notwithstanding the fact that we may have been able to rely in all cases on an exemption from registration had a restrictive legend been applied to the share certificates, including but not limited to Rule 701, we believe that most of the recipients of the shares have resold the shares into the public market before one year after the issue date and, not knowing the shares were in fact restricted securities, they did so without compliance with the Form 144 filing requirement and the other applicable requirements of Rule 144. We are notifying those persons who received the shares in excess of the plan and registered amounts that the shares are restricted securities and that compliance with Rule 144 is required with respect to any shares that remain unsold. We did not pay any commissions or other compensation in connection with the issuances of these shares, which may be deemed to have been made by our officers on our behalf to persons with whom we had a previously existing relationship, all of whom were acquainted with us, our business, our financial condition and our prospects. While we believed our compliance with the number of shares authorized under each of the respective plans was being monitored by our transfer agent, we have learned that this was not the case. We have instituted procedures to assure that over issuances do not occur in the future.

Shareholders

As of April 9, 2007, there were 342 holders of record of our common shares.

Dividends

We did not declare any cash dividends on our common stock during the year ended December 31, 2006. We have no plans to pay any dividends to the holders of our common stock in 2007.

ITEM 6. MANAGEMENT S DISCUSSION AND ANALYSIS

The following discussion and analysis of financial condition and results of operations should be read in conjunction with the Consolidated Financial Statements and Notes thereto included elsewhere in this Form 10-KSB.

OVERVIEW

We presently realize revenues from four primary sources: (i) software sales and license fees; (ii) software hosting and maintenance services; (iii) custom programming; and (iv) XR-Express usage fees. We also occasionally realize revenues from scanning services, hardware sales when the hardware is sold together with the software, and occasionally from other services. With each sale of our enterprise-level products, the end user enters into a license agreement for which an initial license fee is paid. The license agreement also provides that in order to continue the license, the licensee must pay an annual software maintenance fee for which the party receives access to product upgrades and bug fixes or product patches. Software maintenance consists primarily of hosting and managing our customers data on our servers, as well as technical support programs for our products.

Cost of services consists primarily of engineering salaries and compensation-related expenses, engineering supplies, hardware purchases and connectivity costs. General and administrative expenses consist primarily of salaries and benefits of personnel responsible for business development and operating activities, and include corporate overhead expenses. Corporate overhead expenses relate to salaries and benefits of personnel responsible for corporate activities, including acquisitions, sales and marketing, administrative, and reporting responsibilities. We record these expenses when incurred.

In general, our key indicator of operating progress is gross revenue. For the years ending December 2006 and 2005, personnel-related expenses have accounted for approximately 60% of our total operating expenses, with fixed costs such as building and equipment rent, utilities, insurance, communications and depreciation accounting for an additional 10%. The only personnel-related costs that are directly variable with sales are those associated with custom programming, because they are directly billable. This means that over 70% of our expenses are relatively fixed. All of the remaining expenses vary, but less than 5% varies directly with sales. Until we have been marketing our products consistently for a certain period of time, gross revenue will remain the best gauge of our progress.

During the year ended 2006, our focus was on increasing our monthly recurring revenues, rather than relying on large one-time software sales. This means that our revenues have temporarily decreased since we had no large software sales this year. However, our monthly recurring revenues increased from approximately $28,000 per month at December 2005 to approximately $61,000 per month at December 2006. We expect this growth to continue during 2007, although there is no guarantee that it will continue at the same rate. During 2007, we will also be focusing our attention on reducing our general and administrative expenses by concentrating on allocating our resources where they provide the most value. We anticipate that the combination of efforts in growing our recurring revenues and reducing our administrative expenses will help us meet our goal of becoming profitable by the end of 2007.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The preparation of our financial statements in conformity with accounting principles generally accepted in the United States of America requires our management to make certain 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. As such, in accordance with the use of accounting principles generally accepted in the United States of America, our actual realized results may differ from management s initial estimates as reported. A summary of our significant accounting policies is detailed in the notes to the financial statements, which are an integral component of this filing.

Revenue Recognition

Our software recognition policies are in accordance with the American Institute of Certified Public Accountants Statement of Position (SOP) 97-2, *Software Revenue Recognition* as amended. Revenue is recognized when (a) persuasive evidence of an arrangement exists, (b) delivery has occurred, (c) the fee is fixed or determinable, and (d) collectibility is probable. We follow the guidance in SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts* for custom software development arrangements that require us to provide significant production, customization or modification to our core software. Revenue is generally recognized for such arrangements under the percentage of completion method. Amounts collected prior to satisfying the above revenue recognition criteria are included in deferred revenue.

We follow the guidance provided by SEC Staff Accounting Bulletin (SAB) No. 101, *Revenue Recognition in Financial Statements* and SAB No. 104 *Revenue Recognition* which provide guidance on the recognition, presentation and disclosure of revenue in financial statements filed with the SEC.

Income Taxes

Management evaluates the probability of the utilization of the deferred income tax assets. We have estimated a $5,228,000 deferred income tax asset at December 31, 2006, related primarily to net operating loss carryforwards at December 31, 2006. Management determined that because we have not yet generated taxable income it was not appropriate to recognize a deferred income tax asset related to the net operating loss carryforward. Therefore, the fully deferred income tax asset is offset by an equal valuation allowance. If we begin to generate taxable income, we may determine that some, if not all of the deferred income tax asset may be recognized. Recognition of the asset could increase after tax income in the future. Management is required to make judgments and estimates related to the timing and utilization of net operating loss carryforwards, utilization of other deferred income tax assets, applicable tax rates and feasible tax planning strategies.

Stock Based Compensation

We grant stock awards and stock options to employees and non-employees as consideration for services. Management believes that the best indicator of value for stock awards is the trading value of the shares of stock on the date the Company enters into the agreements. For non-employees, that date is generally the date on which the company is committed to such an agreement. At times the Company may grant stock as payment for accrued but unpaid payroll. In these cases, the Company values the shares at the trading price on the date they are granted and reduces the payroll accrual by the same amount. We have elected to apply the intrinsic value method prescribed in SFAS 123(R) for stock options granted to employees. For options granted to non-employees, we estimate the value of those awards using the Black-Scholes option pricing model.

Contingencies

We are subject to the possibility of various law contingencies arising in the ordinary course of business. We consider the likelihood of loss or impairment of an assets or the incurrence of a liability, as well as our ability to reasonably estimate the amount of the loss contingencies.

Software Development Costs

We account for software development costs in accordance with SFAS No. 86 *Accounting for Costs of Computer Software to be Sold, Leased, or Otherwise Marketed*. Product research and development expenses consist primarily of personnel, outside consulting and related expenses for development, and systems personnel and consultants and are charged to operations as incurred until technological feasibility is established. The Company considers technological feasibility to be established when all planning, designing, coding and testing have been completed to design specifications. After technological feasibility is established, costs are capitalized. Historically, product development has been substantially completed with the establishment of technological feasibility and, accordingly, no costs have been capitalized.

See Note B to the Company s Consolidated Financial Statements for a full discussion of the Company s critical accounting policies and estimates.

RESULTS OF OPERATIONS

A summary of operating results for the twelve months ended December 31, 2006 and 2005 is as follows:

	2006		2005	
		% of		% of
	Amount	Revenue	Amount	Revenue
Revenues	$913,000	100.0%	$1,399,000	100.0%
Cost of service	467,000	51.0%	583,000	41.7%
Gross profit	446,000	49.0%	816,000	58.3%
General & administrative	2,906,000	318.5%	1,348,000	96.4%
Research & development	195,000	21.4%	215,000	15.4%
Bad Debt Expense	23,000	2.5%	61,000	4.3%

Net operating (loss)	(2,678,000)	(293.4)%	(808,000)	(63.6)%
Other income (expense)	(45,000)	(4.8)%	(240,000)	(11.3)%
Net income (loss)	(2,723,000)	(298.2)%	(1,048,000)	(74.9)%
Earnings (loss) per share	$ (0.04)		$ (0.03)	

Revenues: Total revenues decreased 34.7%, or $486,000, for the year ended December 31, 2006, as compared to the same period in the prior year (the comparable prior year period). These revenues were primarily generated from the following four revenue streams:

1. Revenues generated by software sales and licenses decreased 79%, or $426,000 for the year ended December 31, 2006, as compared to the comparable prior year period. This decrease was mostly attributable to several large software sales during 2005 as compared with none in 2006. Since software based on our Roswell ICMS technology is a highly customized enterprise-level system, its sales are characterized by a small number of contracts with much higher revenues than our other products. As a result, its sales growth will most likely be inconsistent from one year to the next. We anticipate that sales of our DFC3 Model 100 appliances will begin to provide more consistent revenue in this category during 2007.

2. Revenues from software hosting and maintenance increased 12% or $49,000 for the year 2006 as compared to the comparable prior year period. Revenue from hosting and maintenance for our products marketed prior to DFC3 and XR-Express decreased approximately $57,000 during 2006 as compared to 2005, while revenue from hosting our DFC3 and XR-Express products increased $106,000 during 2006 as compared to 2005. These changes reflect a gradual shift in our customer base from our older products to our newer ones. Overall, we have doubled our customer base for recurring monthly revenues during 2006. Software maintenance consists mainly of hosting and managing our customers data on our systems, and to a lesser extent includes technical support programs associated with our products. Based on the market response to our DFC3 and XR-Express products during 2006, and with the addition of the TORC backup system and the DDS-Express dental management system in 2007, management anticipates that revenues from software hosting and maintenance will continue to increase in the coming year, although it is not possible to predict the rate of increase until we have been actively marketing the products for some time.

3. Custom programming revenue decreased 82%, or $227,000 for the year ended December 31, 2006, as compared to the comparable prior year period. This increase was primarily due to the fact that we recognized revenue on two custom programming contracts during 2005, and we had no major custom programming contracts during 2006. Our Roswell ICMS technology is only available as a highly customized enterprise-level product, and our DFC3 Models 300 and 400 are customizable products. In addition, approximately 10% of the customers that purchase our other products will require customization, and we continue to offer this service. As discussed in the Business Strategy and Marketing sections above, we will be concentrating on attracting customers seeking more complex systems that require custom programming and other services in the coming year. Based on this strategy, coupled with the history of this revenue category, we anticipate that custom programming projects associated with new product purchases will continue to provide revenues in this category, although there is no assurance they will remain at this level. We also continue to offer programming services for customer database integration, and for other projects for our existing customers.

4. XR-Express report fees increased $188,000 (over 2,000%) for the year ended December 31, 2006, as compared to the comparable prior year period. This increase is due to the addition of new XR-Express customers during 2006. Although we began marketing XR-EXpress during the first quarter of 2005, there were almost no revenues from

report fees until the fourth quarter of 2005. We expect further increases in this revenue category for 2007, but it is not possible to predict the rate of increase until we have been actively marketing the products for some time.

We also generated revenue from scanning services, hardware sales, and other services. Our long-term scanning project with a major movie studio was completed near the end of 2005; we had one major scanning project in the second half of 2006 that has been extended into 2007. Although we still offer scanning, we are not emphasizing this service, so we do not anticipate any major projects in the future. All hardware sales were associated with sales of our XR-EXpress and DFC3 software. Although we have not emphasized hardware sales in the past, we expect that the diversification of our DFC3 product into various appliance models will result in increased hardware revenues during 2007. It will not be possible to predict the impact of these sales on hardware revenues until we have been actively marketing the products for some time.

Cost of Services. Cost of services decreased 19.9%, or $116,000 for the year ended December 31, 2006, as compared to the comparable prior year period. This decrease is a combination of a decrease in personnel costs relative to 2005 (approximately $125,000) and a net increase in costs for hardware and shipping related to our DFC3 and XR-Express products (approximately $17,000). During 2006, approximately 80% of our cost of sales consisted of salaries, contract services and other personnel-related expenses for our engineering staff. We consider these expenses to be directly associated with our ability to generate revenues, however, they do not vary with revenues in that much of those costs are fixed. As a result, the gross margin percent will vary as sales vary.

For the year ended December 31, 2006, cost of services as a percentage of revenues was 51.0%, as compared with 41.7% for the comparable prior year period. Although we experienced several large software sales in 2005 that were not repeated in 2006, our customer base actually increased during 2006. This means that the personnel necessary to provide high-quality customer service remained constant; as a result, our cost of service did not decrease at the same rate as revenues. Management anticipates that as revenues increase in the coming year, the cost of goods and services required to support those revenues will continue to increase, and engineering salaries will also increase as we hire additional staff to support a greater number of products and customers. However, we expect that revenues will increase at a greater rate than cost of services, since most of our costs are relatively fixed.

General and Administrative. General and administrative expenses increased 115.6%, or $1,558,000 for the year ended December 31, 2006, as compared to the comparable prior year period. Although we have streamlined the majority of our administrative expenses during the last several years, our marketing and consulting expenses increased considerably during 2006. We terminated three consulting agreements at the end of 2006 and wrote off the remaining balances of those contracts, resulting in a charge to expense of $269,000 in December. Overall, general and administrative expenses increased approximately $565,000 during 2006 as a result of these consulting contracts. We expect consulting expenses to be nominal in 2007. Management also used approximately $215,000 in prepaid advertising credits during 2006, and at the end of the year concluded that we were not seeing value from the ads in terms of increased sales leads. We therefore wrote off the remainder of the ads in December, resulting in a $385,000 charge to expense. Advertising expenses overall increased approximately $556,000 during 2006. We also expect advertising expenses to be nominal during 2007.

For the year ended December 31, 2006, general and administrative expenses as a percentage of revenues was 318.5%, as compared with 96.4% for the comparable prior year period. This change is a result of the combination of reduced revenues and increased general and administrative expenses during 2006. We anticipate that the ratio of general and administrative costs to revenues will decrease in the future because revenues will increase at a greater rate than general and administrative costs, but until we have been in the active marketing phase for a longer period, management is unable to yet determine to what extent this percentage may change in the future.

Research and Development. Research and development expenses decreased 9.3%, or $20,000 for the year ended December 31, 2006, as compared to the comparable prior year period. This decrease is entirely due to reduction in staffing costs as we continue to shift our focus toward marketing and supporting our completed products.

During 2006, over 90% of our research and development costs are directly associated with staffing. In the software industry it is common for research and development costs to be ongoing, since development of the next version of the software begins as soon as the current version is completed. In addition, we are constantly developing new applications for our existing software that require modification. Management anticipates that research and development costs in the future will focus both on the upgrading of our existing products and the continued development of new products using our core technology; therefore they will remain relatively steady during the coming year.

Bad Debt. Bad debt expense decreased 62.3%, or $38,000 for the year ended December 31, 2006, as compared to the comparable prior year period. This decrease is due to improved communications with our customers and more targeted collections efforts.

Other Income. Interest expense decreased 81.3%, or $195,000 for the year ended December 31, 2006, as compared to the comparable prior year period. This decrease was due to the payment during 2006 of a substantial portion both of our IRS obligation and our long-term debt, resulting in significantly reduced interest charges.

LIQUIDITY AND CAPITAL RESOURCES

As of December 31, 2006, cash and cash equivalents totaled $21,000, representing a $136,000 decrease from the beginning of the period. The decrease in available cash was due to a combination of several factors during the year:

Operating activities used $342,000 of cash for the year ended December 31, 2006, as compared to $343,000 for the comparable prior year period, a decrease of $1,000. Although the total cash used for operating activities was similar for the two years, the uses of cash differed in several areas. Stock and options issued for salaries and services was approximately $884,000 in 2005 as compared with $2,246,000 in 2006. The primary reasons for this increase are the issuance of stock for several consulting contracts during 2006 and options issued to the Directors at the end of 2005.

Prepaid expenses represented a use of $448,000 during 2005 and a source of $587,000 during 2006. In 2005 we sold software in return for advertising credits rather than cash, resulting in a net use of cash. In 2006 we used the advertising credits; since this was a cashless expense it resulted in a net source of cash. Finally, in 2006 our accrued expenses represented a use of $315,000. This use of cash primarily corresponded to the payment of our past-due tax obligation during 2006.

Investing activities used $67,000 for the year ended December 31, 2006, as compared to $26,000 for the comparable prior year period. The increase in the cash used for investing activities for the current period was due to the purchase of equipment to provide additional data facilities and security for our customers.

Financing activities provided $273,000 in cash for the year ended December 31, 2006, as compared to $526,000 for the comparable prior year period. This decrease was entirely due to a decrease in the issuance of common stock for cash during the year ended 2006. During the year we issued approximately 3,326,591 shares of common stock for gross proceeds of approximately $323,000.

During the year ended December 31, 2006, we had two barter transactions totaling $600,000 for the sale of software to Forbes.com in return for advertising credits. These transactions are in addition to $135,000 of advertising remaining from a prior barter transaction, which was used during the fourth quarter of 2006. We used approximately $215,000 of advertising credits during 2006. After evaluation, Management determined that the ads were not providing the value we anticipated in terms of sales leads, and the remaining $385,000 of advertising credits was charged to expense in December 2006.

During January 2001, we borrowed $300,000 from Los Alamos National Bank (LANB) which was originally due on July 24, 2002. The outstanding principal amount due at that date was $300,000, plus interest of $10,545. We negotiated a three month extension on the repayment of the outstanding balance of the line of credit by reducing the principal amount of the debt with the payment of $50,000 and the payment of the interest due on July 24, 2002. Management has continued to negotiate extensions by paying a portion of the principal and all accumulated interest owed at the due dates. The outstanding principal balance was approximately $39,000 at December 31, 2006. Our inability to retire this debt, negotiate an extension of the payment amount and/or date, or obtain an alternative loan would likely have a material negative impact on our business, and could impair our ability to continue operations if the bank foreclosed on the note. However, the bank has continued to extend the note six months at a time, providing we pay an agreed-upon amount of principal and interest at the time of the extension. We believe that LANB will continue to work with us in this manner. We expect to pay the remainder of this balance during 2007.

We do not currently have material commitments for capital expenditures and do not anticipate entering into any such commitments during the next twelve months. Our current commitments consist primarily of lease obligations for office space.

At December 31, 2006 we had a working capital deficit of $130,000 as opposed to a working capital deficit of $57,000 at the end of 2005. This reduction is primarily due to the write-off of the remaining advertising credits during 2006. We have incurred operating losses and negative cash flows for the past two fiscal years that have been funded through the issuance of additional equity securities. Approximately 27% of our cash flow for 2006 was funded by the sale of equity securities during the year, as compared to 43% for the prior year. Our monthly recurring revenues increased from $28,000 per month to $61,000 per month during 2006, and we expect our marketing programs and new products will continue to positively impact revenues during 2007. We may also continue to sell equity securities and incur debt as needed to meet our operating needs during 2007. In addition, we may continue to issue equity compensation to employees and outside consultants to meet payroll and pay for needed legal and other services.

We anticipate that our primary uses of cash in the next year will be allocated to finish satisfying delinquent obligations and for general operating purposes. Based on cash flow projections, our cash requirements for the next twelve months will continue to be approximately $1,200,000 - $1,500,000. Our goal during 2006 was to be funding our operating requirements entirely from revenues by the end of the year, and although we did not achieve that goal, we made substantial progress toward it. We are currently generating cash flow from recurring revenues of approximately $70,000 per month, and this amount has increased steadily since the beginning of 2006. This level of cash flow will allow us to meet current obligations and maintain our current level of operations as long as we continue to issue equity compensation to employees and consultants. Our goal for 2007 is to generate the cash flow necessary to fund all operating expenses as well as expected growth in the near future and to become profitable by the end of the year. We expect the upward trend in recurring revenues to continue in 2007, although it is not possible to predict the rate of increase until our new products have been established in the market for a reasonable period of time.

As noted under Item 5, "Recent Sales of Unregistered Securities", we issued an aggregate of 8,086,491, beginning in 2001 and ending in 2006, in excess of the number of shares we had registered on Form S-8 to issue as compensation to employees and consultants. Notwithstanding the fact that these shares were not registered, they were issued as if they were registered without a restrictive legend and other precautions typically applied in unregistered offerings exempt from registration and have in most cases probably been resold into the public market. Accordingly, most of the shares have probably been issued and resold in violation of the registration requirements of the Securities Act of 1933. We have notified the U.S. Securities and Exchange Commission regarding these probable violations; but we are not able to predict what action, if any, the Commission may take. Such action could include among other things, administrative proceedings or civil court proceedings and, if taken, could result in consent order, fines and penalties which impact our future financial condition and restrict our ability to rely on exemptions from registration in the future sale of securities which have been essential in supporting our operations in the past.

ITEM 7. FINANCIAL STATEMENTS

AUDITOR S REPORT AND FINANCIAL STATEMENTS AND FOOTNOTES BEGIN ON THE NEXT PAGE

Report of Independent Registered Public Accounting Firm

To The Board of Directors and Stockholders of

New Mexico Software, Inc.

Albuquerque, New Mexico

We have audited the accompanying consolidated balance sheet of New Mexico Software, Inc. as of December 31, 2006, and the related consolidated statements of operations, stockholders' deficit, and cash flows for the year then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We did not audit the consolidated financial statements of New Mexico Software, Inc. for the year ended December 31, 2005. Those statements were audited by other auditors whose report has been furnished to us.

We conducted our audit in accordance with standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of New Mexico Software, Inc. as of December 31, 2006, and the consolidated results of their operations and cash flows for the years ended December 31, 2006 and 2005 in conformity with accounting principles generally accepted in the United States of America.

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note A, the Company has incurred an accumulated deficit of $13,422,000 as of December 31, 2006. These conditions raise substantial doubt about the Company's ability to continue as a going concern. Management's plans in regard to these matters are also described in Note A. The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

/s/ De Joya Griffith & Company, LLC

Certified Public Accountants & Consultants

Henderson, Nevada

April 17, 2007

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Stockholders and Board

of New Mexico Software, Inc.:

We have audited the accompanying consolidated balance sheet of New Mexico Software, Inc. and subsidiaries as of December 31, 2005 and the related statements of operations, stockholders equity and cash flows for the year then ended. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of New Mexico Software, Inc. and subsidiaries as of December 31, 2005, and the consolidated results of its operations and cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

/s/ Epstein, Weber & Conover, PLC

Scottsdale, Arizona

March 27, 2006

New Mexico Software, Inc.

Consolidated Balance Sheets

(Rounded to the nearest thousand)

	December 31,	
	2006	2005
Assets		
Current assets:		
Cash and equivalents	$ 21,000	$ 157,000
Accounts receivable, net	166,000	151,000
Inventory	24,000	50,000
Prepaid expenses and other assets	21,000	607,000
Total current assets	232,000	965,000
Furniture, equipment and improvements, net	103,000	71,000
Security deposits	4,000	13,000
Total Assets	$ 339,000	$ 1,049,000
Liabilities and Stockholders' Equity (Deficit)		
Current liabilities:		
Accounts payable	$ 106,000	$ 152,000
Legal settlements payable	-	150,000
Accrued expenses	122,000	437,000
Deferred revenue	62,000	77,000
Stock subscriptions payable	21,000	105,000
Notes payable	51,000	101,000
Total current liabilities	362,000	1,022,000
Stockholders' equity (deficit):		
Preferred stock, $0.001 par value, 500,000 shares authorized, 0 and 75 shares issued and outstanding		

as of 12/31/06 and 12/31/05, respectively		-		-
Common stock, $0.001 par value, 200,000,000 shares authorized, 87,760,322 and 50,916,041 shares issued and outstanding as of 12/31/06 and 12/31/05, respectively		88,000		51,000
Additional paid-in capital		13,497,000		10,994,000
Deferred compensation paid with stock		(186,000)		(319,000)
Accumulated deficit		(13,422,000)		(10,699,000)
Total stockholders' equity (deficit)		(23,000)		27,000
Total Liabilities and Stockholders' Equity (Deficit)	$	339,000	$	1,049,000

New Mexico Software, Inc.

Consolidated Statements of Operations

(Rounded to the nearest thousand)

	For the year ended December 31, 2006	For the year ended December 31, 2005
Revenues		
Software sales and licenses	$ 113,000	$ 539,000
Software hosting and maintenance	458,000	410,000
Custom programming	50,000	277,000
XR-EXpress report fees	196,000	8,000
Scanning services	16,000	114,000
Hardware sales	78,000	48,000
Other	2,000	3,000
	913,000	1,399,000
Cost of services	467,000	583,000
Gross profit	446,000	816,000
Operating costs and expenses:		
General and administrative	2,875,000	1,308,000
Depreciation and amortization	31,000	40,000
Research and development	195,000	215,000
Bad debt	23,000	61,000
Total operating costs and expenses	3,124,000	1,624,000
Net operating loss	(2,678,000)	(808,000)

Other income (expense):				
Interest (expense)		(45,000)		(158,000)
Legal settlement		-		(82,000)
Total other income (expense)		(45,000)		(240,000)
Net loss	$	(2,723,000)	$	(1,048,000)
Loss per share - basic	$	(0.04)	$	(0.03)
Weighted average number of common shares outstanding - basic		63,424,938		40,539,127

New Mexico Software, Inc.

Consolidated Statements of Cash Flows

(Rounded to the nearest thousand)

	For the year ended December 31,	
	2006	2005
Cash flows from operating activities		
Net loss	$ (2,723,000)	$ (1,048,000)
Adjustments to reconcile net (loss) to net cash used by operating activities:		
Common stock issued for salaries	732,000	572,000
Common stock issued for services	1,183,000	312,000
Common stock issued for interest	20,000	6,000
Stock options issued for salaries	331,000	-
Depreciation and amortization	31,000	40,000
Depreciation and amortization allocated to cost of goods sold	5,000	-
Changes in operating assets and liabilities:		
Accounts receivable	(16,000)	282,000
Inventory	26,000	(43,000)
Prepaid expenses and other assets	587,000	(583,000)
Security deposits	8,000	-
Accounts payable	(46,000)	41,000
Legal settlements payable	(150,000)	82,000
Accrued expenses	(315,000)	5,000
Deferred revenue	(15,000)	(9,000)
Net cash used by operating activities	(342,000)	(343,000)
Cash flows from investing activities		
Acquisition of fixed assets	(67,000)	(26,000)
Net cash used by investing activities	(67,000)	(26,000)
Cash flows from financing activities		
Repayment of note payable	(50,000)	(50,000)

Net proceeds from the issuance of common stock		323,000		523,000
Net proceeds from warrants/options exercised		-		53,000
Net cash provided by financing activities		273,000		526,000
Net increase (decrease) in cash equivalents		(136,000)		157,000
Cash equivalents - beginning		157,000		-
Cash equivalents - ending	$	21,000	$	157,000
Supplemental disclosures:				
Interest paid	$	32,000	$	36,000
Supplemental schedule of noncash operating and investing activities:				
Inventory converted to fixed asset	$	15,000	$	-
Extinguishment of note payable obligation by conversion to common stock	$	-	$	25,000
Note payable converted to legal settlement liability	$	-	$	50,000
Extinguishment of note payable through foreclosure of collateral (common stock)	$	-	$	75,000
Common stock issued for subscriptions payable	$	84,000	$	-

New Mexico Software, Inc.

Consolidated Statements of Stockholders' Equity (Deficit)

(Rounded to the nearest thousand)

	Preferred Stock		Common Stock		Additional Paid-in	Deferred	Accumulated	Total Stockholders'
	Shares	Amount	Shares	Amount	Capital	Compensation	(Deficit)	Equity (Deficit)
Balance, December 31, 2004	135	$ -	32,834,458	$ 33,000	$ 9,279,000	$ (161,000)	$ (9,651,000)	$ (500,000)
Issuance of common stock for services	-	-	558,660	1,000	61,000	-	-	62,000
Issuance of common stock for services to be rendered	-	-	4,405,000	4,000	404,000	(408,000)	-	-
Issuance of common stock for cash	-	-	6,546,939	7,000	600,000	-	-	607,000
Issuance of common stock for exercise of warrants/options	-	-	720,517	1,000	52,000	-	-	53,000
Issuance of common stock for conversion of preferred convertible stock	(60)	-	912,108	1,000	(1,000)	-	-	-
Issuance of common stock								

for repayment of note plus interest	-	-	270,517	-	31,000	-	-	31,000
Issuance of common stock for salaries	-	-	4,867,842	5,000	567,000	-	-	572,000
Compensation earned	-	-	-	-	-	250,000	-	250,000
Net (loss) For the year ended December 31, 2005	-	-	-	-	-	-	(1,048,000)	(1,048,000)
Balance, December 31, 2005	75	-	51,116,041	52,000	10,993,000	(319,000)	(10,699,000)	27,000
Issuance of common stock for services	-	-	11,812,528	12,000	752,000	-	-	764,000
Issuance of common stock for services to be rendered	-	-	1,100,000	1,000	98,000	(99,000)	-	-

New Mexico Software, Inc.

Consolidated Statements of Stockholders' Equity (Deficit)

(Rounded to the nearest thousand)

-CONTINUED-

	Preferred Stock		Common Stock		Additional Paid-in Capital	Deferred Compensation	Accumulated (Deficit)	Total Stockholders' Equity (Deficit)
	Shares	Amount	Shares	Amount				
Issuance of common stock for cash	-	-	3,326,591	3,000	320,000	-	-	323,000
Issuance of common stock for conversion of preferred convertible stock	(75)	-	1,428,571	1,000	(1,000)	-	-	-
Issuance of common stock for repayment of shares foreclosed plus interest of $20,000	-	-	3,360,000	3,000	101,000	-	-	104,000
Issuance of common stock for salaries	-	-	13,587,468	14,000	718,000	-	-	732,000
Issuance of common stock for salaries to be earned	-	-	2,029,123	2,000	61,000	(63,000)	-	-

Issuance of stock options for salaries	-	-	-	-	331,000	-	-	331,000
Issuance of stock options for salaries to be earned	-	-	-	-	124,000	(124,000)	-	-
Compensation earned	-	-	-	-	-	150,000	-	150,000
Termination of consulting agreement resulting in expense of deferred compensation	-	-	-	-	-	269,000	-	269,000
Net (loss) For the year ended December 31, 2006	-	-	-	-	-	-	(2,723,000)	(2,723,000)
Balance, December 31, 2006	-	$ -	87,760,322	$ 88,000	$ 13,497,000	$ (186,000)	$ (13,422,000)	$ (23,000)

New Mexico Software, Inc.

Notes to Consolidated Financial Statements

NOTE A - ORGANIZATION AND OPERATIONS

[1] Description of business and history

New Mexico Software, Inc., a Nevada corporation, (the Company), develops and markets proprietary Internet technology-based software for the management of digital high-resolution graphic images, documents, video clips and audio recordings. The Company believes that its software has applications for any industry that has the need to track, organize and distribute information in a digital format efficiently and accurately.

New Mexico Software, Inc., was originally incorporated under the laws of the state of New Mexico in April 1996. The privately held company was involved in a reverse merger with Raddatz Exploration, Inc. on August 3, 1999, and the corporate name was changed to NMXS.com, Inc., with New Mexico Software, Inc. becoming a wholly-owned subsidiary. NMXS.com, Inc. went public at that time.

During April 2000, the Company purchased 100% of the capital stock of Working Knowledge, Inc. (WKI), a Kansas corporation located in California, for a total price of $152,000. The business combination has been accounted for using the purchase method. Tangible assets purchased were of nominal value. WKI provided services that were necessary to prepare, enter, and maintain the customer's data on the Company's digital asset management system. The Company recorded goodwill of $150,000 in connection with the acquisition, but was written off in 2004.

On January 1, 2006, the Company merged New Mexico Software, Inc. with NMXS.com, Inc. The new company was New Mexico Software, Inc., with Working Knowledge, Inc. its wholly-owned subsidiary. At the same time, the company registration for New Mexico Software, Inc. was transferred to Nevada.

[2] Going concern

The accompanying financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. The Company has incurred cumulative net losses of approximately $13,422,000 since its inception and requires capital for its contemplated operational and marketing activities to take place. The company s ability to raise additional capital through the future issuances of the common stock is unknown. The obtainment of additional financing, the successful development of the Company s contemplated plan of operations, and its transition, ultimately, to the attainment of profitable operations are necessary for the Company to continue operations. The ability to successfully resolve these factors raise substantial doubt about the Company s ability to continue as a going concern. The consolidated financial statements of the Company do not include any adjustments that may result from the outcome of these aforementioned uncertainties.

New Mexico Software, Inc.

Notes to Consolidated Financial Statements

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

[1] Principles of consolidation:

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary. All material inter-company accounts and transactions have been eliminated.

[2] Revenue recognition:

Our revenues are generally classified into three main categories: the sale of software licenses to end users, software hosting and maintenance contracts, and software licenses that require us to provide significant production, customization or modification to our core software product. The Company also derives revenue from scanning services, hardware sales, XR-EXpress customer usage fees, and other services such as consulting, training and installation. The Company recognizes revenue in accordance with Statement of Position (SOP) 97-2 *Software Revenue Recognition* as amended.

Revenue from proprietary software sales that does not require further commitment from the Company is recognized upon persuasive evidence of an arrangement as provided by agreements executed by both parties, delivery of the software, and determination that collection of a fixed or determinable fee is probable. These sales are generally direct purchases of a software product and there is no other involvement by the Company.

The Company offers with certain sales of its software products a software maintenance, upgrade and support arrangement. These contracts may be elements in a multiple-element arrangement or may be sold in a stand-alone basis. Revenues from maintenance and support services are recognized ratably on a straight-line basis over the term that the maintenance service is provided. The Company typically charges 17% to 21% of the software purchase price for a 12-month maintenance contract with discounts available for longer-term agreements. The complexity of the software determines the percentage that is charged to any individual customer, and that percentage remains consistent upon renewal unless there is a change in the software or the terms of the agreement.

Charges for hosting are likewise spread ratably over the term of the hosting agreement, with the typical hosting agreement having a term of 12 months, with renewal on an annual basis. The Company sells some hosting contracts in conjunction with the sale of software, and some hosting contracts without an associated software sale. When the hosting arrangement is sold in conjunction with a software sale, the Company allocates a portion of the fee to the software license. Hosting services do not require the customer to purchase the software license, and for those hosting contracts that are sold without an associated software sale, the customer does not have the right nor the ability to operate the software on its own.

New Mexico Software, Inc.

Notes to Consolidated Financial Statements

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

[2] Revenue recognition: (continued)

Should the sale of its software involve an arrangement with multiple elements (for example, the sale of a software license along with the sale of maintenance and support to be delivered over the contract period), the Company allocates revenue to each component of the arrangement using the residual value method based on the fair value of the undelivered elements. The Company defers revenue from the arrangement equivalent to the fair value of the undelivered elements and recognizes the remaining amount at the time of the delivery of the product or when all other revenue recognition criteria have been met. Fair values for the ongoing maintenance and support obligations are based upon separate sales of renewals of maintenance contracts. Fair value of services, such as training or consulting, is based upon separate sales of these services to other customers.

The Company follows the guidance in SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts* for custom software development arrangements that require significant production, customization or modification to its core software. Revenue is generally recognized for such arrangements under the percentage-of-completion method. Under percentage-of-completion accounting, both the product license and custom software development revenue are recognized as work progresses based on specific milestones in accordance with paragraphs 85 91 of SOP 97-2. The Company believes that project milestones based on completion of specific tasks provide the best approximation of progress toward the completion of the contract. At December 31, 2006 and December 31, 2005, there were no custom software development arrangements in progress.

From time to time, the Company has effected sales of its enterprise-level software in return for barter credits for advertising. The software was valued at the same price it would have been valued if it had been sold for cash. The revenue was recognized when the software was transferred to the customer, along with a corresponding receivable for the barter credits. The advertising expense is recognized as the ads are placed. The value of any remaining barter credits is reviewed at the end of each fiscal year for possible impairment, and any such impairment loss is recorded at that time. During the fiscal years ended December 31, 2006 and 2005, the Company recognized $0 and $600,000 in revenue from barter transactions. At December 31, 2006, the Company had $0 in prepaid barter credits.

The Company also derives revenue from the sale of third party hardware, which is billed as a separate deliverable under consulting or custom development contracts. Revenue from installation, training and consulting services is recognized when the services are rendered. They include services that are not essential to the functionality of the software. If these services are included in a software agreement with multiple elements, amounts are allocated to these categories based on the estimated number of hours required to complete the work, which is the same criteria used to bill for the services separately. License revenue is recognized ratably over the term of the license.

Amounts collected prior to satisfying the above revenue recognition criteria are included in deferred revenue.

New Mexico Software, Inc.

Notes to Consolidated Financial Statements

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

[2] Revenue recognition (continued):

The application of SOP 97-2, as amended, requires judgment, including a determination that collectibility is probable and the fee is fixed and determinable. On occasion, the Company has approved extended payment arrangements for certain customers. These arrangements generally do not exceed 120 days, therefore collectibility is considered probable at the time of delivery. If an installment payment is allowed which exceeds twelve months, revenue for that installment is recognized at the time payment is received.

The Company follows the guidance provided by SEC Staff Accounting Bulletin (SAB) No. 101, *Revenue Recognition in Financial Statements* and SAB No. 104, *Revenue Recognition*, which provide guidance on the recognition, presentation and disclosure of revenue in financial statements filed with the SEC.

Due to uncertainties inherent in the estimation process it is at least reasonably possible that completion costs for contracts in progress will be further revised in the near- term.

The cost of services, consisting of staff payroll, outside services, equipment rental, communication costs and supplies, is expensed as incurred.

[3] Cash and cash equivalents:

The Company considers all highly liquid instruments purchased with a maturity of three months or less to be cash equivalents. At December 31, 2006, the Company had approximately $0 in cash and equivalents that exceeded federally insured limits.

[4] Trade Accounts Receivable:

The Company extends unsecured credit to customers under normal trade agreements which generally require payment within 30 - 45 days. Accounts not paid within 15 days after their original due date are considered delinquent. Unless specified by the customer, payments are applied to the oldest unpaid invoice. Accounts receivable are presented at the amount billed.

The Company also estimates an allowance for doubtful accounts, which amounted to $25,000 and $15,000 at December 31, 2006 and 2005, respectively. The estimate is based upon management s review of all accounts and an assessment of the Company s historical evidence of collections. Specific accounts are charged directly to the reserve when management obtains evidence of a customer s insolvency. Charge-offs, net of recoveries, for the years ended December 31, 2006 and 2005 totaled $23,000 and $61,000, respectively.

New Mexico Software, Inc.

Notes to Consolidated Financial Statements

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

[5] Inventory:

Inventory, which is composed of component parts and finished goods, is valued at cost on a specific identity basis for those items with serial numbers. The remainder of the inventory is valued at the lower of first-in-first-out (FIFO) cost or market. On a quarterly basis, management compares the inventory on hand with our records to determine whether write-downs for excess or obsolete inventory are required.

[6] Furniture, equipment and improvements:

Furniture, equipment and improvements are recorded at cost. The cost of maintenance and repairs is charged against results of operations as incurred. Depreciation is charged against results of operations using the straight-line method over the estimated economic useful life. Leasehold improvements are amortized on a straight-line basis over the life of the related lease.

[7] Income taxes:

The Company recognizes deferred tax liabilities and assets for the expected future tax consequences of events that have been included in the financial statements or tax returns. Under this method, deferred tax liabilities and assets are determined on the basis of the differences between the tax basis of assets and liabilities and their respective financial reporting amount ("temporary differences") at enacted tax rates in effect for the years in which the differences are expected to reverse.

[8] Per share data:

The basic and diluted per share data has been computed on the basis of the net loss available to common stockholders for the period divided by the historic weighted average number of shares of common stock. All potentially dilutive securities have been excluded from the computations since they would be antidilutive, however, these dilutive securities could potentially dilute earnings per share in the future. Options and warrants exercisable for 7,806,545 and 5,041,045 shares of common stock have been excluded from the diluted loss per share calculation for the years ended December 31, 2006 and 2005 respectively, because inclusion of such would be antidilutive.

[9] Research and development expenses:

Costs of research and development activities are expensed as incurred.

[10] Advertising expenses:

The Company expenses advertising costs which consist primarily of direct mailings, promotional items and print media, as incurred. Advertising expenses amounted to $611,000 and $161,000 for the years ended December 31, 2006 and 2005, respectively.

New Mexico Software, Inc.

Notes to Consolidated Financial Statements

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

[11] Use of estimates:

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amount of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

[12] Stock-based compensation:

The Company adopted Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment (SFAS 123R), effective January 1, 2006. SFAS 123R requires the recognition of the fair value of stock-based compensation in net income. Stock-based compensation primarily consists of stock options. Stock options are granted to employees at exercise prices equal to the fair market value of our stock at the dates of grant. The Company now recognizes the stock-based compensation expense over the requisite service period of the individual grantees, which generally equals the vesting period. The Company provides newly issued shares to satisfy stock option exercises. There were 12,000,000 and 5,000,000 option awards granted to employees and directors in the years ended December 31, 2006 and 2005. Of the 5,000,000 option awards granted in 2005, 4,500,000 were cancelled in 2006. During the year ended December 31, 2006, the Company recorded $269,000 in expense related to option grants to employees and directors.

The following table summarizes the pro forma operating results of the Company for December 31, 2006 and 2005 had compensation costs for the stock options granted to employees been determined in accordance with the fair value based method of accounting for stock based compensation as prescribed by SFAS No. 123.

	2006	2005
Net income as reported	$ (2,723,000)	$ (1,048,000)
Pro forma effects of stock-based compensation	0	(16,000)
Net (loss) pro forma	$ (2,723,000)	$ (1,064,000)
(Loss) per share as reported	$ (0.04)	$ (0.03)
Pro forma effects of stock-based compensation	-	-
(Loss) per share pro forma	$ (0.04)	$ (0.03)

As of December 31, 2006, the Company has reserved 1,000,000 shares of its common stock for issuance upon exercise of stock options and warrants.

New Mexico Software, Inc.

Notes to Consolidated Financial Statements

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

[13] Software development:

The Company accounts for computer software development costs in accordance with Statement of Financial Accounting Standards No. 86, "Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed". As such, all costs incurred prior to the product achieving technological feasibility are expensed as research and development costs. Technological feasibility is generally achieved upon satisfactory beta test results. Upon achieving technological feasibility, programming costs are capitalized and amortized over the economic useful live which is estimated to be two years. There were no capitalized software development costs as of December 31, 2006 and 2005.

[14] Fair value of financial instruments

Financial accounting standards Statement No. 107, Disclosure About Fair Value of Financial Instruments , requires the Company to disclose, when reasonably attainable, the fair market values of its assets and liabilities which are deemed to be financial instruments. The carrying amounts and estimated fair values of the Company s financial instruments approximate their fair value due to the short-term nature.

[15] Recent pronouncements:

In May 2005, the FASB issued FASB Statement No. 154, "Accounting Changes and Error Corrections a replacement of APB Opinion No. 20 and FASB Statement No. 3". This statement replaces APB Opinion No. 20, "Accounting Changes", and FASB Statement No. 3, "Reporting Accounting Changes in Interim Financial Statements", and changes the requirements for the accounting for and reporting of a change in accounting principle. This statement applies to all voluntary changes in accounting principle. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. This statement is effective for accounting changes and correction of errors made in fiscal years beginning after December 15, 2005. Management believes the adoption of this pronouncement will not have a material effect on our financial statements.

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

New Mexico Software, Inc.

Notes to Consolidated Financial Statements

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

[15] Recent pronouncements (continued):

In March 2006, FASB issued SFAS No. 156, Accounting for Servicing of Financial Assets an amendment to FASB Statement No. 140. The new standard requires recognition of servicing assets in connection with any obligation to service a financial asset arising from 1) a servicing contract entered into as part of a transfer of assets meeting the requirements for sale accounting, 2) the transfer of assets to a special purpose entity in a guaranteed mortgage securitization where the transferor retains a controlling interest in the securitized asset, or 3) an acquisition or assumption of obligations to service financial assets not related to the servicer or its consolidated affiliates. The servicing assets and liabilities must be measured at fair value initially, if practicable, and the assets or liabilities must either be amortized or recorded at fair value at each reporting date. The statement allows a one-time reclassification for entities with servicing rights and subsequently requires separate presentation of servicing assets and liabilities at fair value in the statement of financial position. This statement is effective for the first fiscal year beginning after September 15, 2006, with earlier adoption permitted. The Company does not expect this implementation to have a material effect on our consolidated financial statements.

In September 2006, FASB issued SFAS 157 Fair Value Measurements . This Statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. This Statement applies under other accounting pronouncements that require or permit fair value measurements, the Board having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, this Statement does not require any new fair value measurements. However, for some entities, the application of this Statement will change current practice. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The management is currently evaluating the effect of this pronouncement on financial statements.

In September 2006, FASB issued SFAS 158 Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106, and 132(R) This Statement improves financial reporting by requiring an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income of a business entity or changes in unrestricted net assets of a not-for-profit organization. This Statement also improves financial reporting by requiring an employer to measure the funded status of a plan as of the date of its year-end statement of financial position, with limited exceptions. An employer with publicly traded equity securities is required to initially recognize the funded status of a defined benefit postretirement plan and to provide the required disclosures as of the end of the fiscal year ending after December 15, 2006. An employer without publicly traded equity securities is required to recognize the funded status of a defined benefit postretirement plan and to provide the required disclosures as of the end of the fiscal year ending after June 15, 2007. However, an employer without publicly traded equity securities is required to disclose the following information in the notes to financial statements for a fiscal year ending after December 15, 2006, but before June 16, 2007, unless it has applied the recognition provisions of this Statement in preparing those financial statements. The requirement to measure plan assets and benefit obligations as of the date of the employer s fiscal year-end statement of financial position is effective for fiscal years ending after December 15, 2008. The management is currently evaluating the effect of this pronouncement on financial statements.

New Mexico Software, Inc.

Notes to Consolidated Financial Statements

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

[15] Recent pronouncements (continued):

FASB Staff Position on FAS No. 115-1 and FAS No. 124-1 (the FSP), The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments, was issued in November 2005 and addresses the determination of when an investment is considered impaired, whether the impairment on an investment is other-than-temporary and how to measure an impairment loss. The FSP also addresses accounting considerations subsequent to the recognition of other-than-temporary impairments on a debt security, and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. The FSP replaces the impairment guidance on Emerging Issues Task Force (EITF) Issue No. 03-1 with references to existing authoritative literature concerning other-than-temporary determinations. Under the FSP, losses arising from impairment deemed to be other-than-temporary, must be recognized in earnings at an amount equal to the entire difference between the securities cost and its fair value at the financial statement date, without considering partial recoveries subsequent to that date.

The FSP also required that an investor recognize other-than-temporary impairment losses when a decision to sell a security has been made and the investor does not expect the fair value of the security to fully recover prior to the expected time of sale. The FSP is effective for reporting periods beginning after December 15, 2005. The adoption of this statement will not have a material impact on our consolidated financial statements.

FASB Interpretation 48 prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Benefits from tax positions should be recognized in the financial statements only when it is more likely than not that the tax position will be sustained upon examination by the appropriate taxing authority that would have full knowledge of all relevant information. The amount of tax benefits to be recognized for a tax position that meets the more-likely-than-not recognition threshold is measured as the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. Tax benefits relating to tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent financial reporting period in which that threshold is met or certain other events have occurred. Previously recognized tax benefits relating to tax positions that no longer meet the more-likely-than-not recognition threshold should be derecognized in the first subsequent financial reporting period in which that threshold is no longer met. Interpretation 48 also provides guidance on the accounting for and disclosure of tax reserves for unrecognized tax benefits, interest and penalties and accounting in interim periods. Interpretation 48 is effective for fiscal years beginning after December 15, 2006. The change in net assets as a result of applying this pronouncement will be a change in accounting principle with the cumulative effect of the change required to be treated as an adjustment to the opening balance of retained earnings on January 1, 2007, except in certain cases involving uncertainties relating to income taxes in purchase business combinations. In such instances, the impact of the adoption of Interpretation 48 will result in an adjustment to goodwill. While the Company analysis of the impact of adopting Interpretation 48 is not yet complete, it do not currently anticipate it will have a material impact on the Company s consolidated financial statements.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements, (SAB 108),which provides interpretive guidance on the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. The Company adopted SAB 108 in the fourth quarter of 2006 with no impact on its consolidated financial statements.

New Mexico Software, Inc.

Notes to Consolidated Financial Statements

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

[15] Recent pronouncements (continued):

In February of 2007 the FASB issued SFAS 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115. The statement permits entities to choose to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. The statement is effective as of the beginning of an entity s first fiscal year that begins after November 15, 2007. The company is analyzing the potential accounting treatment.

NOTE C - FURNITURE, EQUIPMENT, AND IMPROVEMENTS

Furniture, equipment, and improvements as of December 31, 2006 and 2005 consisted of the following:

	2006	2005
Computers	$ 373,000	$ 322,000
Furniture, fixtures and equipment	121,000	113,000
Automobiles	38,000	38,000
Leasehold improvements	20,000	11,000
	552,000	484,000
Accumulated depreciation	(449,000)	(413,000)
	$ 103,000	$ 71,000

NOTE D - NOTE PAYABLE

During January 2001, the Company borrowed $300,000. The loan is collateralized by substantially all of the Company's assets and personally guaranteed by an officer of the Company. The note was renewed with a due date of July 24, 2002 at a current interest rate of 7%. On July 24, 2002, the Company paid $50,000 of principal and $10,525 of interest. The remaining $250,000 of principal was extended to October 24, 2002 at a current interest rate of 7%. On October 24, 2002 the Company paid $25,000 of principal and $4,555 of interest. The remaining $225,000 of principal was extended until April 24, 2003 at a current interest rate of 7%. On April 24, 2003, the Company paid $12,000 of principal and $12,768 of interest. The remaining $213,000 of principal was extended until October 15, 2003 at a current interest rate of 7%. On October 20, 2003, the Company paid $25,000 in principal and $7,500 in interest and extended the note to April 23, 2004. On March 27, 2004, the Company received a notice from the bank to extend the note to October 15, 2004 upon payment of an additional $25,000 of principal and approximately $6,000 of accrued interest. On October 8, 2004, the Company paid $25,000 of principal and $6,000 of interest. The remaining $138,000 was extended until April 15, 2005. In May 2005, the Company paid $25,000 of principal and $5,000 of interest. The remaining $114,000 was extended until October 15, 2005. In October 2005, the Company paid $25,000 in principal and $5,000 in interest. The remaining $88,000 was extended until April 15, 2006. In April 2006, the Company paid $25,000 in principal and $3,000 in interest, and the remaining $63,000 was extended until October 15, 2006. In November 2006, the Company paid $24,000 in principal and $3,000 in interest, and the remaining $39,000 was extended until April 15, 2007 with a current interest rate of 9.25%. As of December 31, 2006, the Company had a balance due of $39,000 plus accrued interest of approximately $400.

New Mexico Software, Inc.

Notes to Consolidated Financial Statements

NOTE D - NOTE PAYABLE (CONTINUED)

In April 2002, the Company borrowed $12,500. The loan is due on demand and bears no interest. As of December 31, 2006, the Company had a balance due of $12,500.

NOTE E CAPITAL TRANSACTIONS

Series A convertible preferred stock:

The Series A convertible preferred shares are convertible at any time by the shareholder at a rate equal to 70% of the average bid price of the common stock on the conversion date, at a minimum of $0.05 and a maximum of $.25 per share. The Series A convertible preferred stock has no preference with respect to dividends declared by New Mexico Software.

During the year ended December 31, 2005, the Company issued 912,108 shares of its $0.001 par value common stock which were related to the conversion of 60 shares of convertible preferred stock.

During the year ended December 31, 2006, the Company issued 1,428,571 shares of its $0.001 par value common stock which were related to the conversion of 75 shares of convertible preferred stock.

At December 31, 2006, there are no convertible preferred shares outstanding.

Common stock:

During the year ended December 31, 2005, the Company effected the following stock transactions:

The Company issued a total of 4,867,842 shares of the Company s $0.001 par value common stock to employees in lieu of salary and bonuses which were valued at $572,000.

The Company issued a total of 1,325,000 shares of its $0.001 par value common stock to Brian McGowan of the Company as part of a five-year consulting agreement in the amount of $80,000. The amount is considered deferred compensation. During the year ended December 31, 2005, $60,000 of the compensation was earned.

The Company issued a total of 1,280,000 shares of its $0.001 par value common stock to Brian McGowan of the Company as part of a seven-year consulting agreement in the amount of $167,000. All of the compensation was earned and expensed as consulting services, and that contract has been terminated.

The Company issued a total of 1,800,000 shares of its $0.001 par value common stock to Brian McGowan of the Company as part of a five-year consulting agreement in the amount of $162,000. The amount is considered deferred compensation. During the year ended December 31, 2005, $23,000 of the compensation was earned.

The Company issued a total of 558,660 shares the Company s $0.001 par value common stock to outside contractors in exchange for services rendered of $62,000.

The Company issued a total of 6,546,939 shares of the Company s $0.001 par value common stock in exchange for cash of $607,000.

New Mexico Software, Inc.

Notes to Consolidated Financial Statements

NOTE E CAPITAL TRANSACTIONS (CONTINUED)

Common stock (continued):

The Company issued a total of 520,517 shares of the Company s $0.001 par value common stock which were related to the exercise of options/warrants in exchange for $42,000 cash.

The Company issued a total of 912,108 shares of the Company s $0.001 par value common stock which were related to the conversion of preferred convertible stock.

The Company issued a total of 270,517 shares of the Company s $0.001 par value common stock in repayment of notes and interest in the amount of $31,000.

During the year ended December 31, 2006, the Company effected the following stock transactions:

The Company issued a total of 1,100,000 shares of its $0.001 par value common stock to Brian McGowan as part of a seven year consulting agreement in the amount of $99,000. The entire amount is considered deferred compensation. During the year ended December 31, 2006, $150,000 of the compensation was earned. As of December 31, 2006, the contract was terminated, and the remaining balance of $269,000 of deferred compensation was expensed.

The Company issued a total of 15,616,591 shares of the Company s $0.001 par value common stock to employees in lieu of salary, which was valued at $669,000, net of deferred compensation of $63,000.

The Company issued a total of 11,812,528 shares the Company s $0.001 par value common stock to outside contractors in exchange for services rendered of $764,000.

The Company issued a total of 1,428,571 shares of the Company s $0.001 par value common stock which were related to the conversion of 75 shares of Series A convertible preferred stock.

The Company issued a total of 3,326,591 shares of the Company s $0.001 par value common stock in exchange for cash of $323,000.

The Company issued a total of 3,360,000 shares the Company s $0.001 par value common stock in reimbursement of shares relinquished in payment of a note and interest in the amount of $104,000.

New Mexico Software, Inc.

Notes to Consolidated Financial Statements

NOTE E CAPITAL TRANSACTIONS (CONTINUED)

Warrants:

During the year ended December 31, 2005 there were 110,000 warrants issued and 520,517 warrants exercised. The warrants were issued to an investor for his efforts in bringing in more investors. The warrants were valued at $14,000 using the Black-Scholes option pricing model using the following assumptions: term of 3 years, risk free interest rates ranging from 4.0% to 4.5%, a dividend yield of 0% and volatility rates ranging from 160% to 168%.

During the year ended December 31, 2006 there were 2,700,000 warrants issued and no warrants exercised. The warrants were issued to an investor for his efforts in bringing in more investors. The warrants were valued at $66,000 using the Black-Scholes option pricing model using the following assumptions: term of 5 years, risk free interest rates ranging from 3.75% to 4.0%, a dividend yield of 0% and volatility rates ranging from 150% to 158%.

The following is a summary of warrants outstanding as of December 31, 2006:

Number of Warrants	Exercise Price	Expiration Date
1,161,545	$0.21	July 24, 2009
110,000	$0.25	July 24, 2008
700,000	$0.15	June 29, 2011
2,000,000	$0.03	October 17, 2011

All warrants outstanding as of December 31, 2006 and 2005 are exercisable.

Stock options:

Stock options employees and directors During the year ended December 31, 2006 and 2005, the Company granted stock options to employees and directors totaling 12,000,000 and 5,000,000 shares of its common stock with a weighted average strike price of $0.03 and $0.093 per share, respectively. The stock options vest at the rate of 50% per year over two years and have a life ranging from 9 years to 10 years. The stock options have been valued at $368,269 and $471,069 using the Black-Scholes option pricing model based upon the following assumptions: term of 10 years, risk free interest rates ranging from 3.5% to 4.5%, a dividend yield of 0% and volatility rates ranging from 155% to 162%. The Company has recorded an expense of $392,375 for the year ended December 31, 2006 based upon the vested portion of the stock options totaling $392,375 through December 31, 2006.

Stock options non-employees and directors During the year ended December 31, 2006 and 2005, the Company granted stock options for services totaling 2,000,000 and -0- shares of its common stock with a weighted average strike price of $0.03 and $-0- per share, respectively. Certain stock options were exercisable upon grant and have a life of 10 years. The stock options have been valued at $61,397 using the Black-Scholes option pricing model based upon the following assumptions: term of 10 years, risk free interest rates ranging from 3.5% to 4.5%, a dividend yield of 0% and volatility rates of 155%.

New Mexico Software, Inc.

Notes to Consolidated Financial Statements

NOTE E CAPITAL TRANSACTIONS (CONTINUED)

Stock options: (continued)

In 1999 the Company adopted a Stock Option Plan which permits the grant of options exercisable for shares of common stock to corporate officers, directors, employees, and consultants upon such terms, including exercise price and conditions and timing of exercise, as may be determined by the Board of Directors. The plan authorizes the grants of awards up to a maximum of 3,000,000 shares of common stock. A total of 4,972,896 options have been granted under the plan, of which 2,665,627 have been forfeited as a result of employee terminations. At December 31, 2006, 100,000 options have been exercised and 2,207,269 options remain outstanding and unexercised, all of which have vested.

In August 2001, the Company adopted a Stock Issuance Plan which it thereafter amended five times. The plan as amended permits the grant of up to 4,900,000 shares of common stock to employees, non-employee members of the board, and consultants and other independent advisors who provide services to the Company, upon such terms and conditions as may be determined by the Board of Directors. At December 31, 2006, an aggregate of 5,947,196 shares had been issued under the plan, all of which were fully vested upon issuance.

In June 2004 the Company adopted a new Stock Issuance Plan. The plan permits the grant of shares of up to 3,000,000 shares of common stock to employees, non-employee members of the board, and consultants and other independent advisors who provide services to the Company, upon such terms and conditions as may be determined by the Board of Directors. At December 31, 2006, an aggregate of 3,074,143 shares had been granted under the plan, all of which were fully vested upon issuance.

In April 2005 the Company adopted a new Stock Issuance Plan. The plan permits the grant of up to 5,000,000 shares of common stock to employees, non-employee members of the board, and consultants and other independent advisors who provide services to the Company, upon such terms and conditions as may be determined by the Board of Directors. At December 31, 2006, an aggregate of 9,603,733 shares had been granted under the plan, all of which were fully vested upon issuance.

In April 2006 the Company adopted a new Stock Issuance Plan. The plan permits the grant of up to 15,000,000 shares of common stock to employees, non-employee members of the board, and consultants and other independent advisors who provide services to the Company, upon such terms and conditions as may be determined by the Board of Directors. At December 31, 2006, an aggregate of 17,361,419 shares had been granted under the plan, all of which were fully vested upon issuance.

New Mexico Software, Inc.

Notes to Consolidated Financial Statements

NOTE E CAPITAL TRANSACTIONS (CONTINUED)

Stock options (Continued):

As noted above, an aggregate of 8,086,491 shares have been issued in excess of the aggregate number of shares permitted under the 2001, 2004, 2005 and 2006 Stock Issuance Plans and in reliance upon registration statements filed on Form S-8. These over issues have been discovered in the audit for the year ended December 31, 2006. The Company believed that its transfer agent was tracking the number of shares issued under each plan in order to assure that no shares in excess of the maximum number of shares permitted under each plan were issued. This belief was based on discussions between Company personnel and personnel of the transfer agent, who has recently left its employment. The transfer agent has now advised the Company that it was never tracking compliance with the Stock Issuance Plans and the registration statements with respect thereto. Based on the over issues under every Stock Issuance Plan, the absence of monitoring by the transfer agent is now clear. The Company is beginning the immediate notification of the persons who under each plan received shares in excess to the plan aggregate that the shares they received are not registered, are restricted securities as defined in Rule 144 under the Securities Act of 1933 and, if not previously sold, should be sold only in compliance with Rule 144. The Company is notifying the U.S. Securities and Exchange Commission concurrently with filing this report that it has issued shares without restrictive legends which, even though they may otherwise qualify as private placements under one or more exemptions from registration under the Securities Act, may have resulted in violation of the registration requirements of the Securities Act as a result of the probable immediate resale of those shares into the public market by the recipients thereof in the public market. The Company is not able to predict what action, if any, the SEC may take against the Company under these circumstances. Such action may include, but are not limited to administrative proceeding, stop order, trading suspension, a consent order, including cease and desist, a civil fine and other penalties. The Company has instituted a program to assure that all issues of shares in the future are wither registered on an appropriate form under the Securities Act or in compliance with an exemption from such registration.

Exercise prices and weighted-average contractual lives of stock options outstanding as of December 31, 2006 are as follows:

Options Outstanding	Options Exercisable

Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life	Weighted Average Exercise Prices	Number Exercisable	Weighted Average Exercise Price
$0.01-$0.04	12,000,000	9.83	$0.03	0	$0.00
$0.05-$0.30	3,985,000	4.64	$0.06	3,735,000	$0.06
$0.31-$0.50	100,000	4.25	$0.39	100,000	$0.39

New Mexico Software, Inc.

Notes to Consolidated Financial Statements

NOTE E CAPITAL TRANSACTIONS (CONTINUED)

Stock options (Continued):

Summary of Options Granted and Outstanding:

	For the Years Ended December 31,			
	2006		2005	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Options:				
Outstanding at beginning of year	8,879,500	$0.09	4,183,030	$0.08
Granted	12,000,000	$0.03	5,000,000	$0.09
Cancelled	(4,794,500)	$0.10	(103,530)	$0.06
Exercised	0	$0.00	(200,000)	$0.06
Outstanding at end of year	16,085,000	$0.04	8,879,500	$0.09

During the year ended December 31, 2005, the Company granted 5,000,000 stock options at prices ranging from $0.09 to $0.10 per share.

During the year ended December 31, 2006, the Company granted 12,000,000 stock options at $0.03 per share.

NOTE F - INCOME TAXES

The Company accounts for income taxes using the liability method, under which deferred tax liabilities and assets are determined based on the difference between the financial statement carrying amounts and the tax basis of assets and liabilities using enacted tax rates in effect in the years in which the differences are expected to reverse.

As of December 31, 2006, the Company had net operating loss carryforwards of approximately $11,160,000, which expire in varying amounts between 2016 and 2026. Realization of this potential future tax benefit is dependent on generating sufficient taxable income prior to expiration of the loss carryforward. The deferred tax asset related to this potential future tax benefit has been offset by a

New Mexico Software, Inc.

Notes to Consolidated Financial Statements

NOTE F - INCOME TAXES (CONTINUED)

valuation allowance in the same amount. The amount of the deferred tax asset ultimately realizable could be increased in the near term if estimates of future taxable income during the carryforward period are revised.

Deferred income tax assets of $5,228,000 and $3,831,000 at December 31, 2006 and 2005, respectively were offset in full by a valuation allowance. The valuation allowance was increased by $1,397,000 in the year ended December 31, 2006.

The components of the Company s deferred tax assets and liabilities are as follows:

	As of December 31, 2006	As of December 31, 2005
Deferred tax assets:		
Net operating loss carryforwards	$ 4,464,000	$ 3,731,400
Stock based compensation	764,000	-
Deferred compensation	-	99,600
Total deferred tax assets	5,228,000	3,831,000
Net deferred tax assets before valuation allowance	5,228,000	3,831,000
Less: Valuation allowance	(5,228,000)	(3,831,000)
Net deferred tax assets	$ -	$ -

A reconciliation between the amounts of income tax benefit determined by applying the applicable U.S. and State statutory income tax rate to pre-tax loss is as follows:

	As of December 31, 2006	As of December 31, 2005
Statutory federal income tax	(35.0%)	(35.0%)
Statutory state income tax	(6.0%)	(6.0%)
Change in valuation allowance on deferred tax assets	40.0%	40.0%

NOTE G - RELATED PARTY TRANSACTIONS

Consulting agreement:

The Company entered into a consulting agreement with Brian McGowan to advise the CEO on business strategy and to formulate marketing ideas. The term of the employment agreement is for approximately five years commencing on July 1, 2003 and terminating on December 31, 2008. Mr. McGowan will receive a total of 5,500,000 shares at $0.09 per share totaling $330,000. As of December 31, 2005, he was paid a total of 5,500,000 shares of common stock, but he has earned only 2,500,000 shares and the difference of 3,000,000 shares is considered deferred compensation. During the year ended December 31, 2006, the Company has recorded $60,000 as earned compensation expense and $120,000 as an expense resulted from the termination of the consulting agreement.

New Mexico Software, Inc.

Notes to Consolidated Financial Statements

NOTE G - RELATED PARTY TRANSACTIONS (CONTINUED)

On October 4, 2005, the Company entered into a third consulting agreement with Brian McGowan to coordinate a number of material events for the purpose of presenting the Company and its products to potential investors and customers. The term of the agreement is for five years commencing on October 4, 2005 and terminating on September 30, 2010. Mr. McGowan will receive a total of 5,000,000 shares of the Company s $0.001 par value common stock valued at $450,000. As of December 31, 2005 he was paid a total of 1,800,000 shares of common stock, but he has earned only 250,000 shares and the difference of 1,550,000 shares is considered deferred compensation. During the year ended December 31, 2006, the Company has recorded $90,000 as earned compensation expense and $149,000 as an expense resulted from the termination of the consulting agreement.

NOTE H - MAJOR CUSTOMERS

During the year ended December 31, 2006, three customers accounted for 30% of the Company's revenue. During the year ended December 31, 2005, two customers accounted for 55% of the Company's revenue.

As of December 31, 2006, balances due from two customers comprised 43% of total accounts receivable. As of December 31, 2005, balances due from three customers comprised 75% of total accounts receivable.

NOTE I COMMITMENTS AND CONTINGENCIES

Leases:

The Company leases office space in New Mexico and California expiring through April 30, 2009. The Company also leases copier equipment and one automobile. Future minimum lease payments as of December 31, 2006 are as follows:

Year	Amount
2007	60,000
2008	60,000
2009	20,000

Rent expense for the years ended December 31, 2006 and 2005 amounted to $61,000 and $77,000, respectively.

Employment agreement:

The Company entered into an employment and non-competition agreement with a stockholder to act in the capacity of President and Chief Executive Officer (CEO). The term of the employment agreement is for three years commencing on January 1, 2003. The agreement allows for a one-year renewal option unless terminated by either party. Base salary for the year ended December 31, 2006 is $60,000 per annum with available additional cash compensation as defined in the agreement. Compensation under this agreement of $60,000 is included in general and administrative expenses for the year ended December 31, 2006. The non-competition agreement commences upon the termination of the employment agreement for a period of one year. As of December 31, 200, there was a total of $0 in accrued payroll for this executive.

New Mexico Software, Inc.

Notes to Consolidated Financial Statements

NOTE I COMMITMENTS AND CONTINGENCIES (CONTINUED)

Outstanding Payroll Taxes:

The Company has estimated unpaid Federal and State payroll taxes totaling $24,000 as of December 31, 2006, including estimated penalties and interest.

On June 1, 2003, the Company settled with the State of New Mexico and agreed to pay $1,000 per month of past due payroll taxes plus the current amount due. The remaining balance due of approximately $9,000 was paid in February 2007.

On October 17, 2003, the Company settled with the IRS and agreed to pay $5,000 per month of past due payroll taxes plus the current amount due. On September 1, 2005, the Company negotiated a final settlement with the IRS and agreed to pay $25,000 per month of past due payroll taxes plus the current amount due. During the year ended December 31, 2006, the Company paid a total of $260,000 of past due payroll taxes. The remaining balance due of approximately $15,000 is pending confirmation from the IRS of the final balance due.

NOTE J BARTER TRANSACTIONS

During the year ended December 31, 2005, the Company had two barter transactions totaling $600,000 for the sale of software to Forbes.com in return for advertising credits. In these barter transactions customized software was transferred to the customer in return for print advertising. The software and customization was valued at the same price it would have been valued if it had been sold for cash, so no impairment was recorded before the asset was transferred. The revenue was recognized when the software was transferred to the customer in accordance with paragraph 8 of SOP 97-2, and a corresponding receivable for the barter credits was recorded at that time. During the third quarter of 2005, the receivable was reclassified as prepaid advertising. The advertising expense was recognized as the ads are placed. At December 31, 2006, the Company expensed the remaining credits.

NOTE K LEGAL PROCEEDINGS

Grossman Lawsuit: Kurt Paul Grossman and Ann Grossman filed a complaint for Breach of Contract on a Promissory Note against us on November 25, 2003, in the Superior Court of California, Orange County Division, case # 03CC14074. There was a question of whether the complaint was properly served and whether the California courts have jurisdiction over us. The Grossmans filed an Application for Writ of Attachment which was denied on January 30. The Grossmans asked for $55,000 ($50,000 on the promissory note plus $5,000 interest); $304.40 in costs; and $24,000 in attorney s fees. The Grossmans, through a separate entity, Doctors Telehealth Network, purchased software from us, and it has not been paid for. We filed a motion to quash the service of summons for lack of personal jurisdiction and to vacate a default judgment against us. The court tentatively ruled in favor of the Grossmans. However, after our oral argument on April 23, 2004, the court withdrew its tentative ruling and ruled in favor of us. Specifically, the court ruled that we do not have sufficient contact with California to warrant the exercise of personal jurisdiction. The Grossmans then filed suit in the U.S. District Court in New Mexico alleging breach of a promissory note in the original principal balance of $50,000 and other causes of action. The case was mediated on February 8, 2006, resulting in a settlement of all claims and causes of action. Approximately $32,000 of expense was included in the statement of operations at December 31, 2005 for this settlement.

New Mexico Software, Inc.

Notes to Consolidated Financial Statements

NOTE K LEGAL PROCEEDINGS (CONTINUED)

Manhattan Scientifics Lawsuit: On March 9, 2004, our legal counsel received a letter from an attorney representing Manhattan Scientifics. The letter threatened litigation against us for alleged breach of contract and against Richard Govatski for alleged tortious interference with contract. This is based on the fact that we were alleged to have declined to honor Manhattan Scientifics request for a cashless exercise of 150,000 of our Common Stock Purchase Warrants (the Warrants) allegedly issued to Manhattan Scientifics. It is our position that the Warrants, among other things, were issued in a transaction that was not an arms-length transaction and therefore, the Warrants should be cancelled, and that in any event, the alleged cashless exercise was not properly done and itself is a nullity. In May 2004, Manhattan Scientifics filed a suit in Federal Court in New York against us and Mr. Govatski for damages in this matter. The case was dismissed by the Federal Court due to a lack of diversity jurisdiction. On June 25, 2004, we were served with a complaint filed in the Supreme Court of the State New York, County of New York, Index No. 601793/04, asserting the same claims. Manhattan Scientifics seeks damages against us for an alleged breach of contract for failure to allow the cashless exercise, in an amount of $1.5 million, and alleges a tortious interference claim against Mr. Govatski.

We served our Answer to the Complaint on August 16, 2004. Mr. Govatski is seeking dismissal of the claim against him for lack of personal jurisdiction and for failure to state a claim. Mr. Govatski s motion to dismiss has been fully submitted to the court, but has not yet been decided. Along with our Answer, we are asserting Counterclaims against Manhattan Scientifics for monies owed by Manhattan Scientifics and for a declaratory judgment, and against a former Company Director, Marvin Maslow for fraud and breach of fiduciary duty due to his persuading the Company to enter into the Warrant transaction with Manhattan Scientifics, which we contend was done for the benefit of Maslow and Manhattan Scientifics, and not for the benefit of the Company. We believe that due to the fact that Mr. Maslow and a second former Company director (Scott Bach), were also Directors of Manhattan Scientifics at the time of the transactions in dispute, and constituted two of the Company s three Directors at the time, Mr. Maslow and Mr. Bach should have excused themselves from participating in negotiating and voting on the issue of whether to approve the Warrants. Messrs. Maslow and Bach resigned as our Directors in December 2002. It is our position that such financial conflicts include Mr. Maslow s causing the Company to pay for third-party consulting services provided to Manhattan Scientifics, while stating that such services would be provided to, and were needed by, the Company as part of the transaction. It is our position that Mr. Maslow also misrepresented the fairness of the transaction in dispute at the time to us, which we contend was being done for the benefit of Mr. Maslow and Manhattan Scientifics, to the detriment of the Company In our counterclaims, we are seeking, among other relief, a determination that the Warrants should be declared null and void from inception, plus damages against Mr. Maslow. It is further our position that even if the Warrants were properly issued (we contend they were not), the Warrants were never properly exercised by Manhattan Scientifics. Manhattan Scientifics and Mr. Maslow have moved to dismiss certain of our Counterclaims alleged against them.

These claims were negotiated out of court on February 17, 2006, resulting in a settlement of all claims and causes of action. Approximately $50,000 of expense was included in the statement of operations at December 31, 2005 for this settlement.

NOTE L SUBSEQUENT EVENTS

During the period from January 1, 2007 to April 13, 2007, the Company issued 5,560,222 shares its $0.001 par value common stock in payment of salaries and contract labor fees.

ITEM 8. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

During the two most recent fiscal years, there have been no disagreements with De Joya Griffith & Company, LLC, our independent auditor for the year ended December 31, 2006, or Epstein, Weber and Conover, PLC, our independent auditor for the year ended December 31, 2005, on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure.

ITEM 8A. CONTROLS AND PROCEDURES

Evaluation of disclosure controls and procedures

Our Chief Executive Officer and Chief Financial Officer (collectively the   Certifying Officers) maintain a system of disclosure controls and procedures that are designed to ensure that information which is required to be disclosed by the Company in the reports that it files or submits under the Exchange Act (15 U.S.C. 78a et seq.) is recorded, processed, summarized and reported within the time periods specified in the Commission s rules and forms. Under the supervision and with the participation of management, at December 31, 2006, the Certifying Officers evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule [13a-15(e)/15d-15(e)] under the Exchange Act). Based upon that evaluation, the Certifying Officers concluded that our disclosure controls and procedures are effective in ensuring that information that is required to be reported is recorded, processed, summarized and reported, within the time periods specified in the Commission s rules and forms. Furthermore, the Certifying Officers concluded that our disclosure controls and procedures in place are designed to ensure that information required to be disclosed by us, including our consolidated subsidiaries, in reports that we file or submit under the Exchange Act is (i) recorded, processed, summarized and reported on a timely basis in accordance with applicable Commission rules and regulations; (ii) accumulated and communicated to our management, including our Certifying Officers and other persons that perform similar functions, if any, to allow us to make timely decisions regarding required disclosure in our periodic filings.

(b) Changes in internal controls

In connection with our evaluation of our internal controls during the period ended December 31, 2006, our Certifying Officers have not identified any material deficiencies or weaknesses or other factors that have materially affected or are reasonably likely to materially affect these controls, and therefore, we have not made any changes to these controls.

ITEM 8B. OTHER INFORMATION

None

PART III

ITEM 9. DIRECTORS, EXECUTIVE OFFICERS, PROMOTERS, CONTROL PERSONS AND CORPORATE GOVERNANCE; COMPLIANCE WITH SECTION 16(A) OF THE EXCHANGE ACT

Our directors and officers, as of April 9, 2007, are set forth below. The directors hold office for their respective term and until their successors are duly elected and qualified. Vacancies in the existing board are filled by a majority vote of the remaining directors. The officers serve at the will of the board of directors. The following is a biographical summary of our directors and officers:

Name	Age	Position	Director Since
Richard Govatski	62	Chairman, President & CEO	1999
Teresa B. Dickey	63	Director, Secretary & Treasurer	2003
John E. Handley	45	Director	2003
Frank A. Reidy	65	Director	2005

Set forth below is certain biographical information regarding our executive officers and directors:

RICHARD GOVATSKI has been the President of NMXS.com, Inc. since August 1999, and has been chairman, CEO, and President of New Mexico Software, Inc., since 1996. Mr. Govatski founded New Mexico Software in 1995 after identifying market inefficiencies in how intellectual property owners managed their image assets. Prior to New Mexico Software, Mr. Govatski spent 18 years in systems integration and publishing, both in sales management and software development. Mr. Govatski led the sales teams for Popular Electronics, Computer Shopper, Shutterbug, and MacWeek. Later he sold numerous solutions for vendors, including Kodak, Apple Computer, and Sun Microsystems. Mr. Govatski also spent several years in systems development as President of Media Publishing Group and built graphic applications for companies including Ferrari Color, Time Magazine, New York Daily News, and Getty Images. He received a Bachelor of Science Degree in Communications from Butler University, located in Indianapolis, Indiana in 1968.

TERESA B. DICKEY has been the Secretary/Treasurer of our company since August 1999. She became a member of our Board of Directors on December 19, 2002 and has held such position since such time. From 1988 until 1999 she was employed by Sandia National Laboratory as art director. Sandia National Laboratory is a U.S. Department of Energy national security laboratory. In 1964, Ms. Dickey received her Bachelor of Professional Arts from the Art Center College of Design in Pasadena, California.

JOHN E. HANDLEY has been our director since January 2003. He has been self-employed since September 2002 as a telecommunications consultant. From August 1987 until August 2002 he was employed, as an associate partner (from September 1997 until August 2000) and as a partner (September 2000 until August 2002), by Accenture LLP, a business and technology consulting and outsourcing company. He received his Bachelor of Arts degree in Psychology and Business from Roanoke College in 1983. Thereafter, he received his Masters in Business Administration from

Virginia Tech in 1987.

FRANK A. REIDY received his Bachelor of Science degree in Marketing from Oklahoma State University in 1964 and a Masters of Arts in Economics from the University of Toledo in 1972, where he taught micro and macro economics as an evening division adjunct professor for seventeen years. Full-time from 1973 - 1984 he was Chief Accountant for Tecumseh Products Company, Tecumseh, MI. From 1984 - 1989 he was Director of RETS Institute of Technology, Toledo, OH. From 1989 - 1998 he was the Business Manager for Plaza Medical Laboratory, Bartlesville, OK. Currently he is owner of a general construction business in Bartlesville.

ITEM 10. EXECUTIVE COMPENSATION

Compensation of Executive Officers

Summary Compensation Table. The following table sets forth information concerning the annual and long-term compensation awarded to, earned by, or paid to the named executive officer for all services rendered in all capacities to our company, or any of its subsidiaries, for the years ended December 31, 2007, 2006 and 2005:

SUMMARY COMPENSATION TABLE

Name and Principal Position	Year	Salary ($)	Bonus ($)	Stock Awards ($)	Options Awards ($)	Non-Equity Incentive Plan Compensation ($)	Nonqualified Deferred Compensation Earnings ($)	All Other Compensation ($)	Total ($)
Richard Govatski	2006	$60,000	$0	$63,000	$25,000	$0	$0	$0	$148,000
President, CEO and									
Chairman	2005	$44,000	$0	$0	$0	$0	$0	$0	$44,000

Option Grants Table. The following table sets forth information concerning individual grants of stock options to purchase our common stock made to the executive officer named in the Summary Compensation Table during fiscal 2006.

OPTIONS GRANTS IN LAST FISCAL YEAR

(Individual Grants)

Name	Number of securities underlying options/ SARs granted (#)	Percent of total options/SARs granted to employees in last fiscal year	Exercise or base price ($/Share)	Expiration date
Richard Govatski	3,000,000	100%	$0.025	October 16, 2016

Aggregated Option Exercises and Fiscal Year-End Option Value Table. The following table sets forth certain information regarding stock options exercised during fiscal 2006 and held as of December 31, 2006, by the executive officer named in the Summary Compensation Table.

AGGREGATED OPTION/SAR EXERCISES IN LAST FISCAL YEAR

AND FISCAL YEAR-END OPTION/SAR VALUES

			Number of securities underlying unexercised options/SARs at fiscal year-end (#)	Value of unexercised in-the-money options/SARs at fiscal year-end ($) (1)
Name	Shares acquired on exercise (#)	Value realized ($)	Exercisable/Unexercisable	Exercisable/Unexercisable
Richard Govatski	-0-	N/A	500,000/3,000,000	$5,000/$135,000 (2)

(1) Value is based on the closing sale price of the Common Stock on December 29, 2006, the last trading day of fiscal 2006 ($0.07), less the applicable option exercise price.

(2) Of these options, 500,000 were exercisable at $0.06 per share.

Employment Contracts

The Company entered into an employment and non-competition agreement with Mr. Govatski to act in the capacity of President and Chief Executive Officer (CEO). The term of the employment agreement is for three years commencing on January 1, 2003. The agreement allows for a one-year renewal option unless terminated by either party. Base salary is $44,000 per annum with available additional cash compensation as defined in the agreement. Base salary was raised to $60,000 for the year ended December 31, 2006. The non-competition agreement commences upon the termination of the employment agreement for a period of one year.

The Company entered into a new employment and non-competition agreement with Mr. Govatski to continue in the capacity of President and CEO. The term of the agreement is for three years commencing on January 1, 2007. Base salary is $60,000 per annum with available additional cash compensation as defined in the agreement. The non-competition agreement commences upon the termination of the employment agreement for a period of one year.

Compensation of Directors

Name	Fees Earned or Paid in Cash ($)	Stock Awards ($)	Options Awards ($)	Non-Equity Incentive Plan Compensation ($)	Nonqualified Deferred Compensation Earnings ($)	All Other Compensation ($)	Total ($)
Teresa B. Dickey	$0	$0	$25,000	$0	$0	$0	$25,000
John Handley	$0	$0	$25,000	$0	$0	$0	$25,000
Frank Reidy	$0	$0	$25,000	$0	$0	$0	$25,000

Directors are permitted to receive fixed fees and other compensation for their services to the company. The Board of Directors has the authority to fix the compensation of directors. During the year ended December 31, 2006, the Board awarded options to purchase 3,000,000 shares of the Company s common stock to each Director for services performed during the fiscal years ended December 31, 2005, 2006 and 2007. These options vest at the rate of 50% per year and are exercisable at $0.025 per share.

Stock Option and Stock Issuance Plans

Plan	Year	Options Outstanding and Exercisable (#)
Stock Option Plan	1999	1,037,750
Stock Issuance Plan	2001	2,547,250
Stock Incentive Plan	2005	500,000
Stock Incentive Plan	2006	12,000,000

ITEM 11. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The following table sets forth certain information derived from the named person, or from the transfer agent, concerning the ownership of common stock as of April 9, 2007, of (i) each person who is known to us to be the beneficial owner of more than 5 percent of the common stock; (ii) all directors and executive officers; and (iii) directors and executive officers as a group:

Title of Class	Name and Address of Beneficial Owner	Amount and Nature of Beneficial Owner (1)	Percent of Class (1)
Common stock	Richard Govatski	16,163,500 (2)	17.32%
	Teresa B. Dickey	1,040,563 (3)	1.12%
	John Handley	765,000	*
	Frank Reidy	785,000	*
	Executive Officers and Directors as a Group (4 Persons)	18,754,063	18.81%

* - Represents beneficial ownership of less than 1% of the total number of shares of common stock outstanding.

(1) All of the persons are believed to have sole voting and investment power over the shares of common stock listed or share voting and investment power with his or her spouse, except as otherwise provided. Percentage is based on 93,320,544 shares outstanding as of April 9, 2007. Percentage includes amounts which the listed beneficial owner has the right to acquire within sixty days.

(2) This number of shares includes options to purchase 500,000 shares. These options have vested and are currently exercisable. The shares underlying these options are included in the table and are considered to be outstanding for purposes of computing the percentage interest held by Mr. Govatski.

(3) This number of shares includes options to purchase 700,000 shares. These options have vested and are currently exercisable. The shares underlying these options are included in the table and are considered to be outstanding for purposes of computing the percentage interest held by Ms. Dickey.

ITEM 12. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

In March 2003 we borrowed $25,000 from an outside lender. To secure repayment of this loan Mr. Govatski pledged 400,000 of his personal shares as collateral. In March 2005, we received a demand notice for repayment of the loan. In order to settle the matter in the most expeditious manner, Mr. Govatski agreed to surrender his shares as repayment in full of the loan and all accumulated interest (approximately $82,000). In December 2006, we issued 3,360,000 restricted shares to Mr. Govatski in repayment of that note plus accumulated interest totaling $104,000.

ITEM 13. EXHIBITS

(a) The following documents are filed as part of this report:

1. Financial statements; see index to financial statement and schedules in Item 7 herein.

2. Financial statement schedules; see index to financial statements and schedules in Item 7 herein.

3. Exhibits: None

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

Audit Fees

For our fiscal year ended December 31, 2006 and 2005, respectively, we were billed approximately $24,000 and $25,000 for professional services rendered for the audit of our financial statements. We also were billed approximately $14,000 and $15,000 for the review of financial statements included in our periodic and other reports filed with the Securities and Exchange Commission for our year ended December 31, 2006 and 2005, respectively.

Audit-Related Fees

No fees other than those disclosed in the Audit Fees section above were incurred for the years ended December 31, 2006 and 2005.

Tax Fees

For our fiscal years ended December 31, 2006 and 2005, we were billed approximately $-0- and $-0- for professional services rendered for tax compliance, tax advice, and tax planning.

All Other Fees

We did not incur any other fees related to services rendered by our principal accountant for the fiscal year ended December 31, 2006.

SIGNATURES

In accordance with Section 13 or 15(d) of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

New Mexico Software, Inc.

Date: April 17, 2007	/s/ Richard Govatski Richard Govatski President, Chief Executive Officer and Chairman of the Board of Directors
Date: April 17, 2007	/s/ Teresa B. Dickey Teresa B. Dickey, Director, Secretary, Treasurer and Principal Financial Officer
Date: April 17, 2007	/s/ John Handley John E. Handley, Director
Date: April 17, 2007	/s/ Frank L. Reidy Frank L. Reidy, Director

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Total estimated future interest payments

171,637 126,456 45,181

Other commercial commitments

Capital commitments (note)

3,858,951 2,500,070 1,358,881

Total commercial commitments

3,858,951 2,500,070 1,358,881

Note: Capital commitments refer to commitments for purchase of property, plant and equipment and investment.

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G. Other Information

Employees

Our staff costs for 2007 were RMB1,209.0 million.

Capital Expenditures

In 2007, our capital expenditures amounted to RMB2,134.1 million, representing an increase of RMB125.3 million as compared with RMB2,008.8 million in 2006. The expenditures in 2007 were for the following projects:

Project	**Total Investment RMB 000**	**Progress**
600,000-ton aromatics unit	1,001,480	In progress
1.2 million-ton delayed coking unit	874,000	Completion
620-ton stream/hour boiler and 100 MW electric generating set project	672,692	Completion
Total	2,548,172	

The estimated capital expenditure for 2008 is RMB2,500 million, mainly for the construction of projects in progress such as the 600,000-ton aromatics unit and the 150,000-ton C5 segregation unit, and preparatory work related to other technological renovation projects.

Purchase, Sale and Investment

Except as disclosed in this report, during the year 2007, we engaged in no material purchase or sale of our subsidiaries or associated companies or any other material investments.

Pledge of Assets

As of December 31, 2007, we have not pledged any of our property or equipment.

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ITEM 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES.
A. Directors and Senior Management.

The following table sets forth certain information concerning our directors, executive officers and members of our supervisory committee (Supervisory Committee). The current term for our directors, executive officers and members of our Supervisory Committee is three years, which term will end in June 2011.

Name	Age	Position
Directors		
Rong Guangdao	52	Chairman of the Board of Directors and President
Du Chongjun	53	Vice Chairman of the Board of Directors and Vice President
Han Zhihao	56	Director and Chief Financial Officer
Li Honggen	52	Director and Vice President
Dai Jinbao	52	Director
Shi Wei	48	Director and Vice President
Lei Dianwu	45	External Director
Xiang Hanyin	53	External Director
Chen Xinyuan	43	Independent Director and Director of the Audit Committee
Sun Chiping	50	Independent Director
Jiang Zhiquan	57	Independent Director
Zhou Yunnong	66	Independent Director and Director of the Remuneration and Appraisal Committee
Other Executive Officers		
Zhang Jianping	45	Vice President
Tang Chengjian	52	Vice President
Zhang Jingming	50	Secretary of the Company
Supervisory Committee		
Gao Jinping	41	Chairman of the Supervisory Committee
Zhang Chenghua	52	Supervisor
Wang Yanjun	47	Supervisor
Zhai Yalin	44	External Supervisor
Wu Xiaoqi	51	External Supervisor
Liu Xiangdong	57	Independent Supervisor
Yin Yongli	68	Independent Supervisor

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Directors

Rong Guangdao, 52, is Chairman, President and Deputy Secretary of the Communist Party Committee of the Company. Mr. Rong joined the Shanghai Petrochemical Complex (the Complex) in 1973 and has held various positions, including Deputy Director of the No. 1 Chemical Plant and Deputy Director and Director of the Ethylene Plant. In April 1994 he was appointed Vice President of the Company, and in June 1995 he was elected Director of the Company. In October 2003, Mr. Rong was appointed President of the Company. In May 2004, Mr. Rong was elected Chairman of the China Jinshan Associated Trading Corporation. In June 2004, Mr. Rong was elected as Vice Chairman of the Company. In April 2005, Mr. Rong was elected as Deputy Secretary of the Communist Party Committee. In June 2005, Mr. Rong was elected as Chairman of the Company. In November 2006, Mr. Rong was appointed Director and Vice Chairman of Shanghai Secco Petrochemical Company Limited (Shanghai Secco). Mr. Rong has rich experience in management of large-scale petrochemical enterprise operations. In 1985 Mr. Rong graduated from the Automated Instrument Department of the Shanghai Petrochemical College for Workers and Staff Members. In 1997 he obtained an MBA from China Europe International Business School. He is a senior engineer by professional title.

Du Chongjun, 53, is Secretary of the Communist Party Committee, Vice Chairman and Vice President of the Company. He joined the Complex in 1974 and has held various positions, including General Manager, Deputy Secretary and Secretary of the Communist Party Committee of the Acrylic Fibre Plant of the Complex, General Manager and Secretary of the Communist Party Committee of Shanghai Jinyang Acrylic Fibre Plant and General Manager of the Acrylic Fibre Division of the Company. In May 1999 he was appointed Deputy Secretary of the Communist Party Committee and Secretary of the Communist Party Discipline Supervisory Committee. From June 1999 to June 2004 he was Chairman of the Supervisory Committee of the Company. In October 2003 he was appointed Secretary of the Communist Party Committee of the Company. In June 2004, Mr. Du was appointed Vice Chairman of the Company. In June 2005, Mr. Du was appointed Vice President of the Company. Mr. Du has extensive experience in large-scale enterprise operation, management and internal supervision. Mr. Du graduated, majoring in enterprise management, from East China Institute of Chemical Technology in 1986. In 1999 Mr. Du graduated, majoring in computer application management, from Shanghai Second Polytechnic University. He is a senior economist by professional title.

Han Zhihao, 56, is Executive Director and Chief Financial Officer of the Company. Mr. Han joined the Complex in 1976 and has held various positions including Deputy Director of the Vehicle Transportation Department, Deputy Director and Director of the Finance Department of the Complex, Director of the Finance Department and Deputy Chief Accountant of the Company. In 1998, he was appointed Chief Accountant of the Company. In October 2003, he was appointed Chief Financial Officer of the Company. In June 2004, he was elected Director of the Company. Mr. Han has rich experience in corporate finance and financial management. He graduated from Shanghai University of Finance and Economics majoring in financing and accounting in 1990. In 2002, he obtained an MBA from East China University of Science and Technology University of Canberra in Australia. Mr. Han is a senior accountant by professional title.

Li Honggen, 52, is Executive Director and Vice President of the Company. Mr. Li joined the Complex in 1973 and has held various positions including Deputy Director of No. 1 Chemical Plant of the Company, Deputy Director and Director of the Ethylene Plant of the Company and Deputy Manager and Manager of the Refining and Chemical Division of the Company. In August 2000, he was appointed Vice President of Shanghai Chemical Industrial Park Development Company Limited. In August 2002, he was appointed Vice President of Shanghai Secco. In March 2006, he was appointed Vice President of the Company. In June 2006, he was appointed Director of the Company. Mr. Li graduated from East China Institute of Chemical Technology majoring in engineering management and completed a post-graduate course majoring in engineering management at East China University of Science and Technology in 1998. He is an engineer by professional title.

Dai Jinbao, 52, is Executive Director of the Company, Deputy Secretary of the Communist Party Committee of the Company s Refining and Chemical Division and Chairman of the Labor Union. Mr. Dai joined

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the Complex in November 1973 and was Deputy Director of No. 1 Chemical Plant of the Company. In December 1997, he was appointed Director of No.1 ethylene Complex of the Refining and Chemical Division of the Company. In May 2003, he was appointed Chairman of the Labor Union of the Company s Refining and Chemical Division. In August 2005, he was appointed Deputy Secretary of the Communist Party Committee of the Company s Refining and Chemical Division. In June 2006, he was appointed Director of the Company. Mr. Dai graduated form the Shanghai Second Polytechnic University majoring in business management. Mr. Dai is an engineer by professional title.

Shi Wei, 48, is Executive Director and Vice President of the Company. Mr. Shi joined the Complex in 1982 and has held various positions including Assistant to the Manager and then Deputy Manager of the Refining and Chemical Division of the Company, and Manager of the Environmental Department. In April 2001, he was appointed Secretary of the Communist Party Committee and then Manager of the Refining and Chemical Division in July 2002. In October 2003, Mr. Shi was appointed Vice President of the Company. In June 2005, he was appointed Director of the Company. In 1982, Mr. Shi graduated from East China University of Science and Technology majoring in oil refining engineering and obtained a bachelor s degree in engineering. Mr. Shi completed the post-graduate studies in Business Management at East China University of Science and Technology in 1998. Mr. Shi is a senior engineer by professional title.

External Directors

Lei Dianwu, 45, is Director of Development and Planning Division of Sinopec Corp. In June 2005, Mr. Lei was elected External Director of the Company. Mr. Lei has held various positions including Deputy Director of Planning Division of Yangzi Petrochemical Company, Director of the Preparation Office of the Joint Venture of Yangzi Petrochemical Company, Vice President and Manager of production division of Yangzi BASF Stylene Company Limited. He acted as Deputy Manager and Deputy Director of the Joint Venture Office at Yangzi Petrochemical Company, Director of Project Development Department in China Dong Lian Petrochemical Limited Liabilities Company, Deputy General Manager of Yangzi Petrochemical Limited Liabilities Company and Deputy Director of Development and Planning Division of Sinopec Corp. In March 2001, he assumed the current position of Director of Development and Planning Division of Sinopec Corp. Mr. Lei has rich experience in enterprise planning and investment development management. Mr. Lei graduated from the East China Petroleum Institute with a major in basic organic chemicals and obtained a bachelor s degree in engineering. He is a senior engineer by professional title.

Xiang Hanyin, 53, is Deputy Director of Chemical Division of Sinopec Corp. In June 2005, Mr. Xiang was elected External Director of the Company. Mr. Xiang commenced work in February 1982 and was Deputy Director of the Chemical Plant of Yizheng Chemical Fibre Company and Director of Chemical Plant of Yizheng Chemical Fibre Co., Ltd. In February 2000, he assumed the current position of Deputy Director of Chemical Division of Sinopec Corp. Mr. Xiang has rich experience in management of chemical enterprise operating. Mr. Xiang graduated from Nanjing Chemical College with a major in basic organic chemicals and a bachelor s degree in engineering in 1982. In 2000, he completed post-graduate studies in enterprise management at Nanjing University. He is a senior engineer by professional title.

Independent Directors

Chen Xinyuan, 43, currently Dean, Professor and Tutor to doctoral students of the College of Accounting, Shanghai University of Finance and Economics, and was elected as an Independent Director of the Company in June 2003. Between June 2000 and June 2003 he was an Independent Supervisor of the Company. After graduation from the Accounting Faculty, Hangzhou College of Commerce in July 1985, Mr. Chen undertook post-graduate studies at the Accounting Faculty of Shanghai University of Finance and Economics and continued as a lecturer. He commenced his doctoral studies in accounting while teaching and received his doctorate in June 1994. He has been a tutor to doctoral students since December 1998. Mr. Chen has also studied in West Germany for one year. He is an expert in financial reporting and accounting, given his experience in the academic aspects of accounting and notable achievements in accounting research. He is also experienced in business management.

Sun Chiping, 50, is President and Secretary of the Communist Party Committee of the Industrial and Commercial Bank of China (ICBC), Shanghai Branch. In June 2005, Mr. Sun was elected Independent Director of the Company. Mr. Sun started to be involved in the finance industry in March 1979 and has held various positions including accountant, team leader and Deputy Director of the People s Bank of China, Shanghai Branch, sub-branch in both Huang Pu and Jing an Districts. He joined the ICBC, Shanghai Branch, operating division and was Deputy Secretary of the Communist Party Committee and Secretary of the Communist Party Discipline Supervisory Committee. He also acted as Deputy Director, President and Deputy Secretary of the Communist Party Committee of ICBC, Shanghai Branch, Rep. Office (Sub-branch) in Xu Hui District, General Manager of International Business Division of ICBC, Shanghai Branch, Assistant to the President of the ICBC, Shanghai Branch and concurrently General Manager of International Business Division of ICBC, Shanghai Branch and Deputy President of ICBC, Shanghai Branch. In November 2000, he became Deputy President, President and Secretary of the Communist Party Committee of ICBC, Guangdong Branch. In August 2002, he assumed the current position as President of ICBC, Shanghai Branch and Secretary of the Communist Party Committee. Mr. Sun graduated from Shanghai University of Finance and Economics with a major in Finance. He studied for a master s degree at Shanghai University of Finance and Economics and the Shanghai-Hong Kong Management School jointly organized by University of Hong Kong and Fudan University and obtained a Master in Economics and an MBA. Mr. Sun has been engaged in the management of banking business for many years and has extensive experience in finance practice. He is a senior economist by professional title.

Jiang Zhiquan, 57, is Secretary of the Communist Party Committee and Chairman of Shanghai Construction (Group) General Company. In June 2005, Mr. Jiang was elected Independent Director of the Company. Mr. Jiang started work in December 1968, and has held various positions including a cadre and Deputy Director of Shanghai Construction and Industry Bureau, Manager of the Fourth Construction Company of Shanghai, Deputy Secretary of the Communist Party Committee (executive) of Shanghai Construction Engineering Administration Bureau, Deputy Secretary of the Communist Party Committee (executive), Vice Chairman and General Manager of Shanghai Construction (Group). In March 2001, he assumed the current positions as Secretary of the Communist Party Committee and Chairman of Shanghai Construction (Group) General Company. Mr. Jiang is experienced in operational decision making and large-scale enterprise management. Mr. Jiang graduated from the Shanghai-Hong Kong Management School jointly run by University of Hong Kong and Fudan University in July 2000 and obtained an MBA. He is a senior economist by professional title.

Zhou Yunnong, 66, has been an Independent Director of the Company since June 2005. He joined the Complex in October 1972 and has held various positions including Deputy President of the Complex, Deputy Director of the Human Resource Department of China Petrochemical Corporation, Deputy Secretary of Communist Party Committee of the Complex, Vice President of the Company, Secretary of the Communist Party Committee of Sinopec Jinshan Industrial Company and the Governor of Jinshan District of Shanghai. From November 1999 to April 2002 he was a Senior Advisor to Shanghai Jinshan District. From June 2003 to June 2005, Mr. Zhou was appointed Independent Supervisor of the Company. Mr. Zhou has extensive experience in business management and public administration management. Mr. Zhou graduated from East China Normal University in August 1964, majoring in radio. He is a senior engineer by professional title.

Supervisory Committee

The Company has a Supervisory Committee whose primary duty is to supervise senior management of the Company that includes the Board of Directors, managers and senior officers. The function of the Supervisory Committee is to ensure that senior management of the Company act in the interests of the Company, its shareholders and employees and in compliance with PRC law. The Supervisory Committee reports to the

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shareholders in the general meeting. The Articles of Association provide the Supervisory Committee with the right to investigate the business and the financial affairs of the Company and to convene shareholder s meetings from time to time. The Supervisory Committee currently comprises of seven members, two of whom are employee representatives and five of whom are external supervisors, including two independent supervisors.

Gao Jinping, 41, is Chairman of the Supervisory Committee, Deputy Secretary of the Communist Party Committee, Secretary of the Communist Party Discipline Supervisory Committee of the Company and Chairman of the Labor Union of the Company. Mr. Gao joined the Complex in 1990 and has held various positions including Deputy Secretary of the Communist Youth League of the Complex, Deputy Secretary of the Communist Party Committee of the Experimental Plant and Chemical Division of the Company. In October 2001, Mr. Gao was elected as Director of the Propaganda Division of the Company. In May 2003, Mr. Gao was appointed Deputy Secretary of the Communist Party Committee of the Company and Chairman of the Labor Union of the Company. In June 2004, Mr. Gao was elected Director of the Company. In April 2006, Mr. Gao was appointed Secretary of the Communist Party Discipline Supervisory Committee of the Company. In June 2006, Mr. Gao was appointed Chairman of the Supervisory Committee of the Company. Mr. Gao graduated from the Food Processing Faculty of Shanghai Aquatic Products University with a major in cooling and cold storage technology and obtained a bachelor s degree in engineering in July 1990. In 2001, he completed his post-graduate studies in business administration in the aspect of industrial economics at Shanghai Academy of Social Sciences. He has senior professional title.

Zhang Chenghua, 52, is a Supervisor, Deputy Secretary of the Communist Party Discipline Supervisory Committee, Director of Supervisory Office, Director of Supervisory Committee Office and Director of the Communist Party Committee Office of the Company. Mr. Zhang joined the Complex in 1974 and worked in the Thermal Power Plant of the Complex as Deputy Secretary of the Communist Party Committee, Deputy Secretary of the Communist Party Committee cum Chairman of Labor Union of the Thermal Power Plant of the Complex. In December 1999, Mr. Zhang was appointed Deputy Secretary of the Communist Party Committee, Secretary of the Communist Party Discipline Supervisory Committee and Chairman of Labor Union of the Thermal Power Plant of the Complex. In March 2002, Mr. Zhang was appointed Deputy Secretary of the Communist Party Discipline Supervisory Committee and Director of Supervisory Division of the Company. In April 2002, Mr. Zhang was appointed Director of Supervisory Committee Office of the Company. In June 2002, Mr. Zhang was appointed Supervisor of the Company. In April 2004, Mr. Zhang was appointed Director of the Communist Party Committee Office. Mr. Zhang graduated, majoring in party administrative management, from Shanghai Party Institute in January 1999. In 2001, he completed his post-graduate studies in business administration in the aspect of industrial economics at Shanghai Academy of Social Sciences. He has senior professional title.

Wang Yanjun, 47, is a Supervisor and Vice Chairwoman of the Labor Union of the Company. Ms. Wang joined the Complex in July 1982 and was Chairwoman of the Labor Union of the Plastics Plant of the Company. In January 1999, Ms. Wang was appointed Chairwoman of the Labor Union of Plastics Division of the Company. In June 2002, Ms. Wang was Chairwoman of the Labor Union of Chemical Division of the Company. In July 2004, Ms. Wang was appointed Deputy Secretary of the Communist Party Committee, Secretary of Communist Party Discipline Supervisory Committee of the Communist Party Committee and Chairwoman of the Labor Union of Chemical Division of the Company. In January 2005, Ms. Wang was appointed Vice Chairwoman of the Labor Union of the Company. In June 2005, Ms. Wang was appointed Supervisor of the Company. Ms. Wang graduated from East China University of Science and Technology majoring in basic organic chemistry in July 1982. In 2001, she completed her post-graduate studies in business administration in the aspect of industrial economics at Shanghai Academy of Social Sciences. She has senior professional technical qualifications.

External Supervisors

Zhai Yalin, 44, is Deputy Director of the Auditing Bureau of China Petrochemical Corporation and Deputy Director of Auditing Department of Sinopec Corp. Mr. Zhai began his career in 1986 and had been successively

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Deputy Head of the Head Office and Director of the Auditing Department of Qianguo Refinery, Deputy Director of the General Office of Sinopec Huaxia Auditing Company and Deputy Manager of the Sinopec Huaxia Auditing Company, Deputy Director of the General Administrative Office of the Auditing Bureau of China Petrochemical Corporation, Director of the General Administrative Office of the Auditing Bureau of China Petrochemical Corporation, and Director of the General Administrative Office of the Auditing Bureau of China Petrochemical Corporation (Auditing Department of Sinopec Corp.). Since December 2001, Mr. Zhai has been holding concurrently the posts of Deputy Director of the Auditing Bureau of China Petrochemical Corporation and Deputy Director of Auditing Department of Sinopec Corp. Mr. Zhai graduated from Jilin Siping Normal College in 1986 and is a senior economist.

Wu Xiaoqi, 51, is Deputy Director of Supervisory Bureau of China Petrochemical Corporation and Deputy Director of Supervisory Department of Sinopec Corp. Mr. Wu began his career in 1971 and had been successively Deputy Office Head Class Disciplinary Monitor of Inspection Bureau of China Petrochemical Corporation s Disciplinary Division, Deputy Head (Deputy Director) and Head (Director) of the Office of Inspection Bureau of China Petrochemical Corporation s Disciplinary Division, and Director of Section 1 of Inspection Bureau of China Petrochemical Corporation s Disciplinary Division. From April 2004 to April 2005, he was a Deputy Bureau Director Class Disciplinary Inspector of Supervisory Bureau of China Petrochemical Corporation and a Deputy Bureau Director Class Supervisory Inspector of Supervisory Department of Sinopec Corp. Since April 2005, Mr. Wu has been Deputy Director of Supervisory Bureau of China Petrochemical Corporation and Deputy Director of Supervisory Department of Sinopec Corp. Mr. Wu graduated from Shijiazhuang Army Command Academy and has a senior professional title.

Independent Supervisors

Liu Xiangdong, 57, is President of Zhengda International Finance Corporation. He was elected as an Independent Supervisor of the Company in June 2000. Mr. Liu has held various positions including Planning and Credit Officer and Deputy Head and Head of the Credit Division of banks. He has also been Deputy Director and Director of the Planning Department of the Industrial and Commercial Bank of China, Shanghai Branch, Chief Economist and Director of the Planning Division of the Industrial and Commercial Bank of China, Shanghai Branch. He has been Deputy Director of the Industrial and Commercial Bank of China, Shanghai Branch since October 1997. He was appointed General Manager of Investment Division of the Industrial and Commercial Bank of China in June 2002. Mr. Liu has been working in the banking sector for many years and has abundant experience in business management practices. He holds a master s degree in economics and is a senior economist.

Yin Yongli, 68, is Chairman of Management Committee of Tianhua Certified Public Accountant. In June 2005, he was appointed Independent Supervisor of the Company. Mr. Yin has held various positions including Deputy Chief and Chief of finance section of Shandong Shengli Refinery, Deputy Chief Accountant of Qliu Petrochemical Company, Chief Accountant of Planning and Financing Department of China Petrochemical Corporation and Chief Accountant and Deputy Director of Financing Department of China Petrochemical Corporation and Director of Shihua Auditing Firm. In September 2001, he was Chairman of China Rightson Certified Public Accountants. Since June 2004, Mr. Yin has been appointed Chairman of Huazheng Certified Public Accountant. Since June 2005, Mr. Yin has been Chairman of Management Committee of Tianhua Certified Public Accountant. Mr. Yin has engaged in financing and auditing for many years and has rich experience in financing management and enterprise auditing. Mr. Yin graduated from Shandong Institute of Finance and Economics in 1964. Mr. Yin is a professional accountant and is a certified accountant.

Senior Management

Zhang Jianping, 45, is a Vice President of the company. He joined the Complex in 1987, and successively held the positions of Vice Chief Engineer of Oil Refining Chemical Department Arene Factory, Vice Director of the Plastic Factory, Deputy Manager of Plastics Department of Shanghai Petrochemical, Director of the

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Chemical Institute, Director of Production Department of Shanghai Petrochemical. In February 2002, he became the assistant to the President of our company and Director of Production Department. In July 2004, he was appointed Vice President of our company. Mr. Zhang graduated from East China Chemical Institute specializing in Petroleum Refinery and received a Master s Degree in Petroleum Processing from the same school in 1987. He is a qualified senior engineer.

Tang Chengjian, 52, is a Vice President of our company. He joined the Complex in 1974, and successively held the positions of Deputy Secretary of Communist Party Committee, Trade Union Director, Deputy Director and Director of Thermal Power Factory at the Complex. He was appointed the Vice President of our company in July 2004. Mr. Tang graduated from Shanghai Power Technology School with a specialization in power plant steam turbines; received a graduate diploma from Shanghai Power College in power plant and power systems; received a bachelor degree from Shanghai No. 2 Industry University in project management; and a MBA from China Europe International Industrial and Commercial Institute in 2001. He is a qualified engineer.

Zhang Jingming, 50, is Secretary to the Board of directors and General Counsel of the Company. Mr. Zhang joined the Complex in 1978. He has held various positions including Project Manager of the International Department, the Company s Securities Affairs Representative in Hong Kong, Deputy Director of the International Department and Deputy Director of the Board Secretariat. In June 1999, Mr. Zhang was appointed Secretary to the Board and Director of the Board Secretariat. In June 2001, Mr. Zhang was appointed Director of Strategic Research Department of the Company. In January 2005, Mr. Zhang was appointed General Counsel of the Company. Mr. Zhang graduated from the Shanghai Foreign Language Institute in 1987. During 1992 and 1993, he enrolled at the fourth Sino-British joint MBA program at Northwestern Polytechnic University. Mr. Zhang subsequently left for the University of Hull in the United Kingdom to pursue his studies in an MBA program, and in July 1995, he earned an MBA by the University of Hull. In 2002, Mr. Zhang completed his studies in a master program in international economic law at East China University of Politics and Law. He is a senior economist by professional title.

B. Compensation.

The aggregate amount of cash compensation we paid to our directors, supervisors and executive officers during the year ended December 31, 2007 was approximately RMB5.12 million. In addition, directors and supervisors who are also officers or employees receive certain other benefits-in-kind, such as subsidized or free health care services, housing and transportation, which large Chinese enterprises customarily provide to their employees. No benefits are payable to members of the board or the Supervisory Committee or the executive officers upon termination of their relationship with us.

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The following table sets forth the compensation on an individual basis for our directors, supervisors and executive officers who received compensation from us in 2007.

Name	Position with the Company	Remuneration in 2007 (RMB 000)
Rong Guangdao	Chairman of the Board of Directors and President	544
Du Chongjun	Vice Chairman of the Board of Directors and Vice President	544
Han Zhihao	Director and Chief Financial Officer	466
Shi Wei	Director and Vice President	466
Li Honggen	Director and Vice President	440
Dai Jinbao	Director	219
Lei Dianwu	External Director	0
Xiang Hanyin	External Director	0
Chen Xinyuan	Independent Director	80
Sun Chiping	Independent Director	80
Jiang Zhiquan	Independent Director	80
Zhou Yunnong	Independent Director	80
Gao Jinping	Chairman of the Supervisory Committee	458
Zhang Chenghua	Supervisor	233
Wang Yanjun	Supervisor	217
Zhai Yalin	External Supervisor	0
Wu Xiaoqi	External Supervisor	0
Liu Xiangdong	Independent Supervisor	0
Yin Yongli	Independent Supervisor	0
Zhang Jianping	Vice President	465
Tang Chengjian	Vice President	459
Zhang Jingming	Company Secretary and Corporate Counselor	289

C. Board Practices.

Board of Directors

Our board of directors consists of twelve members. Our directors are elected at meetings of our shareholders, and, unless they resign at an earlier date, are deceased or removed, will serve three-year terms. The term of our current board of directors will expire in 2011. None of our directors, have entered into any service contracts with us or any of our subsidiaries providing for benefits upon termination of appointment or employment.

Supervisory Committee

The Supervisory Committee is responsible for ensuring that our directors and senior officers act in the interests of our company or those of our shareholders or employees and that they do not abuse their positions and powers. The Supervisory Committee has no power to overturn the decisions or actions of our directors or officers and may only recommend that they correct any acts that are harmful to our interests or the interests of our shareholders or employees. The Supervisory Committee is currently composed of seven members appointed for a three year term. The term of the current members will expire in June 2011. Supervisory Committee members have the right to attend meetings of our board of directors, inspect our financial affairs and perform other supervisory functions.

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Audit Committee

Pursuant to Paragraph 14 of the Code of Best Practices set out in Appendix 14 of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Ltd, we formed an audit committee on June 15, 1999 which consists of three directors. The current members are Chen Xinyuan, Zhou Yunnong and Sun Chiping according to the Resolutions of the First Meeting of the Sixth Session of the Board of Directors. The principal duty of the audit committee is to review and supervise our financial reporting process and internal controls. The members of the audit committee will hold office for the same term as their directorships which will expire in 2011.

Remuneration Committee

We formed a remuneration committee on December 25, 2001 which consists of three directors. The current members are Dai Jinbao, Jiang Zhiquan and Zhou Yunnong. The key responsibility of the Remuneration Committee is to formulate and review the remuneration policy and plan for the directors and executive officers, formulate the standards for evaluation of the directors and executive officers and conduct such evaluations.

Summary Corporate Governance Differences

There are significant differences between our corporate governance practices and those of U.S. issuers listed on the New York Stock Exchange. Pursuant to Section 303A.11 of the NYSE listing Manual, we have disclosed certain of these differences on our website at www.spc.com.cn/enspc/spc/newsroomlook.php?Did=1650&cid=69dD1ev=5.

D. Employees.

As of December 31, 2007, we had 19,252 employees.

The following table shows the approximate number of employees we had at the end of our last three years by the principal business function they performed:

	December 31,		
	2007	**2006**	**2005**
Management	1,533	1,580	2,004
Engineers, technicians and factory personnel	11,067	14,163	16,427
Accounting, marketing and other	6,652	7,179	7,050
Total	19,252	22,922	25,481

Approximately 30.1% of our work force graduated from university or technical colleges. In addition, we offer our employees opportunities for education and training based upon our development and the individual performance of each employee.

A system of labor contracts has been adopted in our company. The contract system imposes discipline, provides incentives to adopt better work habits and gives us greater management control over our work force. We believe that by linking remuneration to productivity, the contract system has also improved employee morale. As of December 31, 2007, almost all of the work force was employed pursuant to labor contracts which specify the employee s position, responsibilities, remuneration and grounds for termination. The contracts generally have short terms of one to five years and may be renewed with the agreement of both parties. The remaining personnel are employed for an indefinite term.

We have a trade union that protects employees rights, aims to assist in the fulfillment of our economic objectives, encourages employee participation in management decisions and assists in mediating disputes

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between us and union members. We have not been subject to any strikes or other labor disturbances which have interfered with our operations, and we believe that our relations with our employees are good.

Total remuneration of our employees includes salary and bonuses. Employees also receive certain benefits in terms of housing, education and health services that we subsidize, and other miscellaneous subsidies. In 2007, we paid RMB1,209 million in employment costs.

In compliance with Shanghai regulations, we and our employees participate in a defined contribution government pension scheme under which all employees upon retirement are entitled to receive pensions. Pursuant to government regulations, we established a supplementary defined contribution retirement scheme for all employees in 1995. This scheme provides for a supplementary pension funded by voluntary payments by employees that are matched by payments we make. Each year s level of matching payments is based upon our profitability and the employee s performance and attitude. The supplementary pension is intended to provide a further incentive to employees.

We do not carry worker s compensation or other similar insurance. However, all employees (both contract and non-contract employees) who are unable to work due to illness or disability, whether or not such illness or disability is job-related, will continue, based on seniority, to receive most or all of their base salary and certain subsidies (but not bonuses) throughout the period of their absence, subject to certain time limitations. Employees who are unable to work due to job-related illnesses or disabilities will receive certain additional compensation from us. The compensation varies depending on the severity of the illness or disability. Structural changes being implemented by the Chinese and Shanghai governments and our own implementation of joint stock limited company accounting and financial principles may result in certain adjustments of the funding, management and payment methods for these types of worker s compensation arrangements over time.

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E. Share Ownership.

The following table shows the ownership interests of our Directors, Supervisors and senior officers in our shares as of June 16, 2008. All shares indicated are A shares and are directly owned by the relevant persons. In each case, they represent less than 1% of the outstanding A shares. No change in shareholdings occurred. Except as disclosed below, none of the Directors, Supervisors or senior officers or their affiliates had any other beneficial interest in our issued share capital as of June 16, 2008.

Name	Position	Shares held at December 31, 2007
Rong Guangdao	Chairman and President	3,600
Du Chongjun	Vice Chairman	1,000
Han Zhihao	Director and Chief Financial Officer	0
Li Honggen	Director and Vice President	0
Dai Jinbao	Director	0
Shi Wei	Director and Vice President	0
Lei Dianwu	External Director	0
Xiang Hanyin	External Director	0
Sun Chiping	Independent Director	0
Jiang Zhiquan	Independent Director	0
Zhou Yunnong	Independent Director	0
Chen Xinyuan	Independent Director	0
Gao Jinping	Chairman of Supervisory Committee	0
Zhang Chenghua	Supervisor	0
Wang Yanjun	Supervisor	0
Zhai Yalin	External Supervisor	0
Wu Xiaoqi	External Supervisor	0
Liu Xiangdong	Independent Supervisor	0
Yin Yongli	Independent Supervisor	0
Zhang Jianping	Vice President	0
Tang Chengjian	Vice President	0
Zhang Jingming	Company Secretary	0

We have no employee share purchase plan, share option plan or other arrangement to involve employees in our share capital.

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ITEM 7. MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS.

A. Major Shareholders.

Sinopec Corp owns 55.56% of our share capital and is able to exercise all the rights of a controlling shareholder, including the election of directors and voting on amendments to our Articles of Association.

The table below sets forth information regarding ownership of our capital stock as of June 1, 2008 by (i) all persons who we know own more than five percent of our capital stock and (ii) our officers and directors as a group. We are not aware that any such shareholder had voting rights different from those of our other shareholders.

Title of Class	Identity of Person or Group	Number of Shares Held	Percent of Total Share Capital
Domestic Shares	China Petroleum & Chemical Corporation [1]	4,000,000,000	55.56%
H Shares	HKSCC nominees Ltd.	2,303,698,101	32.00%
A Shares	Directors and Officers	4,600	less than 1%

(1) This company is controlled by China Petrochemical Corporation which is itself controlled by the Chinese government.

As of June 1, 2008, a total of 2,330,000,000 H Shares were outstanding. As of June 1, 2008, a total of 3,339,543 ADSs, representing the equivalent of 333,954,300 H Shares, were outstanding and held by 115 holders of record. A total of 720,000,000 A Shares were outstanding on June 1, 2008.

To the best of our knowledge, except as disclosed above, we are not directly or indirectly controlled by another corporation, any foreign government, or any other natural or legal person, severally or jointly.

We are not aware of any arrangement that may at a subsequent date result in a change of control of our company.

B. Related Party Transactions.

Intercompany service agreements

Prior to its restructuring, JI provided machinery, maintenance, transportation, medical care, technical training and other services to us, and we provided public utility services, such as water, electricity and steam, to JI. Following the restructuring of JI in August 1997 and the transfer of some of its subsidiaries to Sinopec and rest of its subsidiaries to Shanghai Jinshan District, the services agreement between us and JI was terminated. In March 1998, we entered into a new services agreement with Sinopec to replace the terminated services agreement. The new services agreement contains the same terms and conditions as those contained in the previous services agreement and the services are to be provided either at market prices or prices set by governmental authorities. Those services are currently provided by Sinopec Group. See Item 4. Information on the Company History.

Business-related dealings

We have entered into transactions with each of Sinopec Corp, Sinopec Group and its predecessor, Sinopec, JI and their respective affiliated entities, all of which are our affiliates, and will continue to enter into transactions with each of Sinopec Corp, Sinopec Group and their affiliated entities. Transactions with Sinopec Corp and its affiliated entities include the allocation of crude oil and certain raw materials, the exclusive sale of our acrylic fibers production, and the sale of certain of our products pursuant to the State Plan.

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Upon approval and authorization by the 2005 Extraordinary General Meeting held on June 28, 2005, we entered into a Sales and Purchases Framework Agreement with Sinopec Corp and a Comprehensive Services Framework Agreement with Sinopec. As these agreements were set to expire on December 31, 2007, we entered into a new Product Supply and Sales Services Framework Agreement with Sinopec Corp and a new Comprehensive Services Framework Agreement with Sinopec upon approval and authorization by the 2007 Extraordinary General Meeting held on December 13, 2007. Under the Product Supply and Sales Services Framework Agreement, we purchase raw materials from and sell petroleum products and petrochemicals to Sinopec Corp and its associates. Under the Comprehensive Services Framework Agreement, we accept transportation, design, construction and installation, insurance agency and financial services provided by Sinopec Corp and its associates. The directors, including each of the independent non-executive directors confirm that these continuing connected transactions were conducted in accordance with the terms of the Product Supply and Sales Services Framework Agreement and the Comprehensive Services Framework Agreements throughout 2007. At the Second 2005 Extraordinary General Meeting held on December 30, 2005, our shareholders approved certain caps on the annual transaction values of certain on-going connected transactions for the years ended December 31, 2005, December 31, 2006 and December 31, 2007. The directors, including each of the independent non-executive directors confirm that such continuing connected transaction values did not exceed the caps so approved. At the 2007 Extraordinary General Meeting held on December 13, 2007, our shareholders also approved certain caps on the annual transaction values of certain on-going connected transactions for the years ended December 31, 2008, December 31, 2009 and December 31, 2010.

On August 25, 2005, the petrochemical products agency sales contract with Sinopec Corp was considered and approved at the second meeting of the fifth session of the Board. Pursuant to the contract, we appoint Sinopec Corp as a non-exclusive sales agent for the sales of synthetic resins, synthetic fibers, synthetic fiber monomers and polymers, organic petrochemical products and by- products from ethylene cracking and aromatic plants and other substandard products related to the above five products.

The purchases by us of crude oil-related materials from and sales of petroleum products by us to Sinopec Corp and its associates were conducted in accordance with the State s relevant policy and applicable State tariffs or State guidance prices. As long as the State does not lift its control over purchases of crude oil, sales of petroleum products and pricing thereof, such connected transactions will continue to occur. We sell petrochemicals to Sinopec Corp and its associates and Sinopec Corp and its associates act as agents for the sale of petrochemicals in order to reduce our inventories, expand their trading, distribution and sales networks and improve our bargaining power with our customers. We accept transportation, design, construction and installation, insurance agency and financial services from Sinopec and its associates in order to secure steady and reliable services at reasonable prices.

Unit: RMB 000

Type of transactions	**Related parties**	**Amount**	**Percentage of total amount of the type of transaction** *(%)*
Income from sale of products and services	Sinopec Huadong China Sales Company	17,884,389	32.28
	Other related parties	5,022,696	9.07
Purchases	Sinopec Transport and Storage Company	22,377,518	41.58
	Other related parties	16,356,661	30.39
Installation fees	Sinopec and its subsidiaries	206,256	34.78
Transportation costs	Sinopec Transport and Storage Company	254,128	67.58

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This includes: an amount of RMB20,853,142,000 for the connected transactions in respect of the sale of products or the provision of labor services to the controlling shareholder and its subsidiaries by the listed company during 2007.

Other related party transactions

We transferred to Sinopec Corp. a 81.97% equity interest owned by our wholly owned subsidiary Shanghai Petrochemical Investment Development Company Limited in Shanghai Jin Hua Industrial Company Limited for a consideration of RMB61,600,400. The relevant transfer agreement was entered into on February 8, 2006. The transaction generated a gain of RMB24,307,946 in 2006. The pricing principle was determined on the basis of a valuation report prepared by a qualified asset valuer independent of the Company and Sinopec Corp. and upon arm s length negotiations between the parties. On the asset disposal date, the book value of the assets was RMB37,292,454, while the appraised value of the assets was RMB53,600,422 as at March 31, 2005.

We entered into equity transfer agreements with Sinopec Finance Co., Ltd to transfer our respective equity interests in China Everbright Bank and Bank of Shanghai to Sinopec Finance Co., Ltd. The considerations for the China Everbright Bank transfer and Bank of Shanghai transfer were RMB66,993,800 and RMB14,729,600, respectively. The relevant transfer agreements were entered into on December 7, 2006. As at the asset appraisal date, the book value of the equity interests held by the respective parties in China Everbright Bank and Bank of Shanghai totaled RMB55,449,641. The increase in the fair value of those equity interests of RMB26,228,500 as a result of the above transaction was recognized in the reserve, net of deferred tax, in 2006. The transaction prices were determined by way of a bidding process on the China Beijing Equity Exchange. The transfer of equity interest in China Everbright Bank was completed in April 2007. The transfer of equity interest in Bank of Shanghai was completed in July 2007.

We signed an agreement on December 30, 2005 to transfer our 2% equity interest in Sinopec Finance to Sinopec Corp for a purchase price of RMB82,000,000. In accordance with the payment terms of the agreement, we were paid the consideration on February 28, 2006.

We paid an amount of RMB164,763,000 to Sinopec Corp and its subsidiary which consisted of equipment pre-payments and progress payments for the 380,000 tons per year glycol project and the long-cycle facility of the 3,300,000 tons per year diesel hydrogenization project. Both facilities were delivered in the first half of the year in 2006.

We transferred 12.67% of our equity interest in China Jin Shan United Trading Co., Ltd., to China Petrochemical International Co., Ltd., a wholly-owned subsidiary of our controlling shareholder, Sinopec Corp, on April 28, 2005 for a purchase price of RMB10,000,000. RMB3,140,116 in gain was generated from the transaction in 2005. The pricing principle was based on a value appraised by a qualified asset appraiser independent to us and China Petrochemical International Co., Ltd. The face value of such portion of assets amounted to RMB6,859,883.70 and its assessed value amounted to RMB9,999,300.00. The transaction represented an opportunity for China Petrochemical International Co., Ltd. to increase its sales of products by expanding its trading, distribution and marketing network.

We transferred our land use rights in land covering an area of 690,000 sq. meters located at Zhusimen, Nanao Village, Cezi Township, Dinghai District, Zhoushan Municipality, Zhejiang Province, to China Petrochemical Corporation Pipelines Transportation Co., a branch company of our controlling shareholder, Sinopec Corp, on September 29, 2005, at a consideration of RMB62,741,700. RMB36,815,994 in gain was generated from the transaction in 2005. The pricing principle was based on a value appraised by a qualified property appraiser that was independent to both us and China Petrochemical Corporation Pipelines Transportation Co. The face value of such portion of assets amounted to RMB21,795,807 and its assessed value amounted to RMB62,741,700. We were of the view that the disposal of the surplus land generated immediate working capital to us. The discrepancy between the face value and the assessed value was due to the increase in property valuation.

Equity joint venture

Late in 2001, we established Secco, a Sino-foreign equity joint venture, together with BP and Sinopec Corp. We own a 20% interest in Secco, while BP and Sinopec Corp own 50% and 30% interests in Secco, respectively. Secco was established to build and operate a 900,000 ton Rated Capacity ethylene petrochemical manufacturing facility to manufacture and market ethylene, polyethylene, styrene, polystyrene, propylene, acrylonitrile, polypropylene, butadiene, aromatics and by-products; provide related after-sales services and technical advice with respect to such petrochemical products and by products; and engage in polymers application development. Secco completed construction in 2005. Secco s total registered capital is US$901,440,964, of which we provided the Renminbi equivalent of US$180,287,952.

HKSE connected transactions waivers

The HKSE has granted two waivers from HKSE requirements that would require us to seek advance shareholder approval for transactions with related parties.

Transactions under the State Plan Transactions entered into pursuant to the State Plan are exempt, provided that we disclose them to shareholders in our next annual report filed in Hong Kong (HK Annual Report).

Transactions with Sinopec Corp The HKSE has confirmed that transactions with Sinopec Corp or its associates which were previously carried out with Sinopec and its associates and were covered by the waivers, continue to be exempt following the reorganization of Sinopec on the basis that there is no change in our ultimate controlling shareholder, provided that we satisfy the following conditions (such transactions will include transactions with Sinopec Group since Sinopec Group is the controlling company of Sinopec Corp):

- we disclose details of the transactions to shareholders in our next HK Annual Report,
- our independent non-executive directors certify in our next HK Annual Report that the transactions have been entered into (1) in the ordinary course of business of the relevant companies, (2) on normal commercial terms or on terms that are fair and reasonable so far as our shareholders are concerned and (3) the transactions have been entered into either in accordance with the terms of the agreement governing them or, where there is no such agreement, on terms no less favorable than terms available to third parties, and
- our auditors review the transactions each year.

If, however, disclosure of any such transactions is necessary to enable investors to appraise our position or to avoid the establishment of a fraudulent market in our shares or if such transactions may have any material effect on the trading of our shares on the HKSE, we are required to disclose the relevant transaction to the HKSE as soon as practicable. The expression ordinary course of business will be determined in the context of the actual business of the relevant company and the expression normal commercial terms will be applied by reference to transactions of a similar nature and to be made by similar entities within China or, in the absence of available comparison, by reference to our history and pattern of dealings. Please also see Note 28 to our consolidated financial statements included in Item 18. Financial Statements.

Other related party transactions

He Fei, a non-executive Director prior to June 18, 2002, is a partner of Haiwen & Partners, our legal advisor on Chinese laws, which has received and will continue to receive legal fees in connection with their representation of us.

C. Interests of Experts and Counsel.

Not applicable.

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ITEM 8. FINANCIAL INFORMATION.
A. Consolidated Statements and Other Financial Information.

Please see Item 18. Financial Statements for our audited consolidated financial statements filed as part of this annual report.

Please see Item 17. Financial Statements for the separate financial statements and notes for Shanghai Secco Petrochemical Co., Ltd., which are being filed pursuant to Rule 3-09 of Regulation S-X.

Export Sales

In 2007, export sales accounted for RMB201.0 million (US$27.55 million) or 0.37% of our total net sales.

Litigation

Neither we nor any of our subsidiaries is a party to, nor is any of our or their property the subject of any legal or arbitration proceedings which may have significant effects on our financial position or profitability. We are not aware of any litigation or arbitration proceedings in which any of our directors, any member of our senior management or any of our affiliates is an adverse party or has a material adverse interest.

Dividend Policy

Our board of directors may propose dividend distributions subject to the approval of the shareholders. The Articles of Association also provide that, unless the shareholders otherwise resolve, our board of directors is authorized in advance to distribute interim dividends each year of up to 50% of our distributable profits. Shareholders receive dividends in proportion to their shareholdings.

The Articles of Association require that cash dividends and other distributions in respect of H shares be declared in Renminbi and paid by us in Hong Kong dollars while cash dividends and other distributions in respect of our H shares be paid in Renminbi. If we record no profit for the year, we may not distribute dividends in such year.

We expect to continue to pay dividends, although there can be no assurance as to the particular amounts that might be paid from year to year. Payment of future dividends will depend upon our revenue, financial condition, future earnings and other factors. See Item 5. Operating and Financial Review and Prospects and Item 3. Key Information Selected Financial Data Dividends.

B. Significant Changes.

No significant change has occurred since the date of the financial statements included in this Annual Report.

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ITEM 9. THE OFFER AND LISTING.
A. Offer and Listing Details

Set forth below is certain market information relating to our H Shares, ADSs and A Shares for the periods indicated.

	Price per H Share (HK$)		Price per ADS (US$)		Price per A Share (RMB)	
	High	**Low**	**High**	**Low**	**High**	**Low**
2002	1.28	0.69	15.61	8.74	4.46	2.80
2003	3.45	1.70	46.26	14.35	6.02	3.07
2004	4.07	1.86	53.90	24.30	8.15	4.37
2005	3.58	2.25	45.20	29.55	5.07	3.11
2006	5.00	2.97	64.60	38.60	7.18	4.03
2007	7.38	3.26	102.77	31.37	22.49	6.05
2006						
First Quarter	5.00	2.97	64.60	38.60	6.20	4.03
Second Quarter	4.75	3.28	62.00	41.49	7.18	5.21
Third Quarter	4.23	3.40	53.20	44.20	6.76	5.48
Fourth Quarter	4.04	3.13	51.44	40.85	6.55	4.72
2007						
First Quarter	4.42	3.49	54.90	44.55	9.65	6.05
Second Quarter	6.18	3.99	75.95	51.50	15.77	8.70
Third Quarter	6.54	3.26	84.50	46.10	20.42	10.55
Fourth Quarter	7.38	4.20	102.77	54.74	22.49	14.48
Most Recent Six Months						
January 2008	4.88	3.34	61.88	41.77	17.60	12.56
February 2008	3.88	3.50	50.18	44.77	13.80	12.00
March 2008	3.68	2.37	47.08	31.37	12.93	9.32
April 2008	3.50	2.63	43.95	33.93	9.80	6.70
May 2008	3.39	2.83	43.65	36.92	8.30	7.70

B. Plan of Distribution

Not applicable.

C. Markets

The principal trading market for our H Shares is the HKSE. The ADSs, each representing 100 H Shares, have been issued by The Bank of New York as a depositary under a Deposit Agreement with us and are listed on the NYSE under the symbol SHI. We have also listed our A Shares on the Shanghai Securities Exchange. Prior to our initial public offering on July 26, 1993 and subsequent listings on the HKSE and NYSE, there was no market for our H Shares or the ADSs. Public trading in our A Shares commenced on November 8, 1993.

D. Selling Shareholders

Not applicable.

E. Dilution

Not applicable.

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F. Expenses of the issue

Not applicable.

ITEM 10. ADDITIONAL INFORMATION.

A. Share Capital

Not applicable.

B. Memorandum and Articles of Association.

The following is a summary based upon provisions of our Articles of Association as currently in effect, the Company Law of the People s Republic of China (1993) and other selected laws and regulations applicable to us. You should refer to the text of the Articles of Association and to the texts of applicable laws and regulations for further information.

We are a joint stock limited company established in accordance with the Company Law and certain other laws and regulations of the PRC. We are registered with the Shanghai Administration of Industry and Commerce with business license number 310000000021453. Our Articles of Association provide, at article 12, that our purpose is:

- to build and operate a diversified industrial company which will be one of the world s leading petrochemical companies;
- to promote the development of the petrochemical industry in China through the production of a broad variety of outstanding products; and
- to practice advanced, scientific management and apply flexible business principles, and to develop overseas markets for our products so that we and our shareholders receive reasonable economic benefits.

Our scope of business is limited to matters approved by Chinese authorities. Article 13 provides that our primary business scope includes:

- refining crude oil, a wide range of petroleum products, petrochemical products, basic organic chemicals, synthetic fibers and monomers, plastic products, polyester fibers and yarns, raw materials for knitting and textile products and finished products; and
- production and operation of industrial fuels, production and operation of other by-products and refining and processing of platinum metals.

Our secondary scope of operation includes: electricity generation, supply of heat, supply of liquefied petroleum gas, water treatment, railways, ocean and inland water transport, warehousing, real estate, technical consultation, import and export, research and all other activities incidental and consistent with our primary and secondary operation and business scope. We may adjust these subject to approval by governmental authorities.

The following discussion primarily concerns our shares and the rights of our shareholders. Holders of our ADSs will not be treated as our shareholders and will be required to surrender their ADSs for cancellation and withdrawal from the depositary facility in which the H shares are held in order to exercise shareholder rights in respect of H shares.

Domestic shares and overseas-listed foreign invested H shares are both ordinary shares in our share capital. Domestic shares are shares we issue to domestic Chinese investors for subscription in Renminbi, while H shares are shares we issue for subscription in other currencies to investors from Hong Kong, Macau, Taiwan and outside of China.

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Sources of Shareholders Rights

China s legal system is based on written statutes and is a system in which decided legal cases have little precedent value. China s legal system is similar to civil law systems in this regard. In 1979, China began the process of developing its legal system by undertaking to promulgate a comprehensive system of laws. In December 1993, the Standing Committee of the 8th National People s Congress adopted the Chinese Company Law. Although the Chinese Company Law is expected to serve as the core of a body of regulatory measures, which will impose a uniform standard of corporate behavior on companies and their directors and shareholders, only a limited portion of this body of regulatory measures has so far been promulgated.

Currently, the primary sources of shareholder rights are the Articles of Association, the Chinese Company Law and the HKSE listing rules, which, among other things, impose standards of conduct, fairness and disclosure on us, our directors and our controlling shareholder. To facilitate the offering and listing of shares of Chinese companies overseas, and to regulate the behavior of companies whose shares are listed overseas, the State Council Securities Committee and the State Commission for Restructuring the Economic System issued the Mandatory Provisions for articles of association of Companies Listing Overseas on August 27, 1994. These provisions have been incorporated into our Articles of Association and any amendment to those provisions will only become effective after approval by the companies approval department of local government authorized by the State Economic and Trade Commission and the China Securities Regulatory Commission.

In addition, upon the listing of and for so long as the H shares are listed on the HKSE, we will be subject to those relevant ordinance, rules and regulations applicable to companies listed on the HKSE, the Securities (Disclosure of Interests) Ordinance and the Hong Kong Codes on Takeovers and Mergers and Share Repurchases.

Unless otherwise specified, all rights, obligations and protections discussed below derive from our Articles of Association and/or the Chinese Company Law.

Enforceability of Shareholders Rights

There has not been any public disclosure in relation to the enforcement by holders of H shares of their rights under the charter documents of joint stock limited companies or the Chinese Company Law or in the application or interpretation of the Chinese or Hong Kong regulatory provisions applicable to Chinese joint stock limited companies.

In most states of the United States, shareholders may sue a corporation derivatively . A derivative suit involves the commencement by a shareholder of a corporate cause of action against persons who have allegedly wronged the corporation, where the corporation itself has failed to enforce the claims directly. This would include suits against corporate officers, directors, or controlling shareholders. This type of action is brought based upon a primary right of the corporation, but is asserted by a shareholder on behalf of the corporation. Because the right to sue derivatively is not available under Chinese law, our shareholders may have to rely on other means to enforce the rights of shareholders, such as through administrative proceedings.

Our Articles of Association provide that all differences or claims

- between a holder of H shares and us;
- between a holder of H shares and any of our directors, supervisors, manager or other senior officers; or
- between a holder of H shares and a holder of domestic shares,

involving any right or obligation provided in the Articles of Association, the Chinese Company Law or any other relevant law or administrative regulation which concerns our affairs must, with certain exceptions, be referred to arbitration at either the China International Economic and Trade Arbitration Commission in China or the Hong Kong International Arbitration Center. Our Articles of Association also provide that the arbitration will be final

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and conclusive. On June 21, 1999, an arrangement was made between Hong Kong and China for the summary mutual enforcement of each other s arbitration awards in a manner consistent with the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards and practices that occurred before the handover of Hong Kong to China. This arrangement was approved by the Supreme Court of China and the Hong Kong Legislative Council, and became effective on February 1, 2000.

All of our directors and officers reside outside the United States (principally in China) and substantially all of our assets and of those persons are located outside the United States. Therefore, you may not be able to effect service of process within the United States against any of those persons. In addition, China does not have treaties providing for the reciprocal recognition and enforcement of judgments of courts within the United States or most other countries that are members of the Organization for Economic Cooperation and Development. This means that administrative actions brought by regulatory authorities such as the Securities and Exchange Commission, and other actions which result in foreign court judgments could only be enforced in China if the judgments or rulings do not violate the basic principles of the law of China or the sovereignty, security and social public interest of the society of China, as determined by a People s Court of China which has jurisdiction for recognition and enforcement of judgments. We have been advised by our Chinese counsel, Haiwen & Partners, that there is doubt as to the enforceability in China of any actions to enforce judgments of United States courts arising out of or based on the ownership of our H shares or ADSs, including judgments arising out of or based on the civil liability provisions of United States federal or state securities laws.

Restrictions on Transferability and the Share Register

All fully paid up H shares will be freely transferable in accordance with the Articles of Association unless otherwise prescribed by law and/or administrative regulations. Under current laws and regulations, H shares may be traded only among investors who are not Chinese persons, and may not be sold to Chinese investors. Consequences under Chinese law of a purported transfer of H shares to Chinese investors are unclear.

As provided in our Articles of Association, we may refuse to register a transfer of H shares without providing any reason unless:

- all relevant transfer fees and stamp duties are paid;
- the instrument of transfer is accompanied by the share certificates to which it relates and any other evidence reasonably required by our board to prove the transferor s right to make the transfer;
- there are no more than four joint holders as transferees; and
- the H shares are free from any lien of ours.

Additionally, no transfers of shares may be registered within the 30 days prior to a shareholders general meeting or within five days before we decide on the distribution of dividends.

We are required to keep a register of our shareholders which shall be comprised of various parts, including one part which is to be maintained in Hong Kong in relation to H shares listed on the HKSE. Shareholders have the right to inspect the share register. For a reasonable fee, shareholders may copy any part of the share register, obtain background information regarding our directors, supervisors, manager and other senior officers, minutes of shareholder general meetings and reports regarding our share capital and any share repurchases in the prior year.

Dividends

Our Articles of Association require the Company to distribute dividends annually in the second quarter of the year following that in which the Company made the profits from which the dividend is paid. The Articles of Association allow for distribution of dividends in the form of cash or shares. A distribution of shares, however, must be approved by special resolution of the shareholders.

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Dividends may only be distributed, however, after allowance has been made for:

- recovery of losses, if any;
- allocations to the statutory common reserve fund;
- payment of dividends on any preference shares we issue in the future; and
- allocations to a discretionary common reserve fund.

The Articles of Association require us to appoint on behalf of the holders of H shares a receiving agent which is registered as a trust corporation under the Trustee Ordinance of Hong Kong to receive dividends we declare in respect of the H shares on behalf of the H shareholders. The Articles of Association require that cash dividends and other distributions in respect of H shares be declared in Renminbi and paid by us in Hong Kong dollars while cash dividends and other distributions of the domestic shares shall be paid in Renminbi.

If we record no profit for the year, we may not normally distribute dividends for the year.

Dividend payments may be subject to Chinese withholding tax. See Item 10. Additional Information Taxation.

Voting Rights and Shareholders Meetings

Our board of directors must convene a shareholders annual general meeting once every year within six months from the end of the preceding financial year. Our board must convene an extraordinary general meeting within two months of the occurrence of any one of the following events:

- where the number of directors is less than 10 or two-thirds of the number specified in our Articles of Association;
- if the number of directors is less than five, the number stipulated in the Chinese Company Law;
- where our unrecovered losses reach one-third of the total amount of our share capital;
- where shareholder(s) holding 10% or more of our issued and outstanding voting shares request(s) in writing; or
- whenever our board deems necessary or our Supervisory Committee so requests.

Meetings of a special class of shareholders must be called in specified situations when the rights of the holders of that class of shares may be varied or abrogated, as discussed below. Resolutions proposed by our Supervisory Committee or shareholder(s) holding 5% or more of the total number of voting shares shall be included in the agenda for the relevant annual general meeting if they are matters which fall within the scope of the functions and powers of shareholders in general meeting.

All shareholders meetings must be convened by our board by notice given to shareholders by personal service, mail or announcement in the newspaper not less than 45 days before the meeting. Based on the written replies we receive 20 days before a shareholders meeting, we will calculate the number of voting shares represented by shareholders who have indicated that they intend to attend the meeting. We can convene the shareholders general meeting if the number of voting shares represented by those shareholders is more than one-half of our total voting shares, regardless of the number of shareholders who actually attend the meeting. Otherwise, we shall, within five days, inform the shareholders again of the motions to be considered and the date and venue of the meeting by way of public announcement. After the announcement is made, the shareholders meeting may be convened. Our accidental omission to give notice of a meeting to, or the non-receipt of notice of a meeting by, a shareholder will not invalidate the proceedings at that shareholders meeting. However, an extraordinary shareholders meeting cannot conduct any business not contained in the notice of meeting.

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Shareholders at meetings have the power, among other things, to decide on our operational policies and investment plans, to approve or reject our proposed annual budget, approve or reject our profit distribution plans, an increase or decrease in share capital, the issuance of debentures, our merger or liquidation and any amendment to our Articles of Association. Shareholders also have the right to review any proposals by a shareholder owning 5% or more of our shares. In general, holders of H shares and domestic shares vote together as a single class at all meetings and on all matters. However, the rights of a class of shareholders may not be varied or abrogated, unless approved by both a special resolution of all shareholders at a general shareholders meeting and by a special resolution of shareholders of that class of shares at a separate meeting. Our Articles of Association specify, without limitation, that the following amendments would be deemed to be a variation or abrogation of the rights of a class of shareholders:

- increasing or decreasing the number of shares of a class or of a class having voting or distribution rights or privileges equal or superior to that class;
- removing or reducing rights to receive dividends in a particular currency;
- creating shares with voting or distribution rights superior to shares of that class;
- restricting or adding restrictions to the transfer of ownership of shares of that class;
- allotting and issuing rights to subscribe for, or to convert into, shares of that class or another class;
- increasing the rights or privileges of any other class; or
- modifying the provision of our Articles of Association that specifies which amendments would be deemed a variation or abrogation of the rights of a class of shareholder.

For votes on any of these matters, or any other matter that would vary or abrogate the rights of the domestic shares or H shares, the holders of domestic shares and H shares are deemed to be separate classes and vote separately. However, Interested Shareholders are not entitled to vote at class meetings. The meaning of Interested Shareholder depends on the proposal to be voted on at the class meeting:

- If the proposal is for us to repurchase our shares either from all shareholders proportionately or by purchasing share on a stock exchange, an Interested Shareholder is our controlling shareholder;
- If the proposal is for us to repurchase our shares from a shareholder by a private contract, an Interested Shareholder is the shareholder whose shares would be repurchased;
- If the proposal is for our restructuring, an Interested Shareholder is any shareholder that has an interest in the restructuring different from the other shareholders of the class or who bears a burden under the proposed restructuring that is less than proportionate to his shareholdings of the class.

Our Articles of Association specifically provide that an issue of up to 20% of domestic and H shares would not be a variation or abrogation of the rights of domestic shareholders or H shareholders, therefore, separate approval of the domestic shareholders or H Shareholders would not be required.

Each share is entitled to one vote on all matters submitted to a vote of our shareholders at all shareholders meetings, except for meetings of a special class of shareholders where only holders of shares of the affected class are entitled to vote on the basis of one vote per share of the affected class.

Shareholders are entitled to attend and vote at meetings either in person or by proxy. Proxy authorization forms must be in writing and deposited at our company s principal offices, or at such other place specified in the notice of shareholders meeting not less than 24 hours before the time that the such meeting will be held or the time appointed for passing upon the relevant resolutions. If a proxy authorization form is signed by a third party on behalf of the relevant shareholder, then such proxy authorization form must be accompanied by the signature authorization letter or other such document authorizing such third party to sign on behalf of the shareholder.

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Except for those actions discussed below, which require supermajority votes, or special resolutions, resolutions of the shareholders are passed by a simple majority of the voting shares held by shareholders who are present in person or by proxy. Special resolutions must be passed by more than two-thirds of the voting rights represented by shareholders who are present in person or by proxy.

The following decisions must be adopted by special resolution:

- an increase or reduction of our share capital or the issue of shares of any class, warrants and other similar securities;
- the issue of our debentures;
- our division, merger, dissolution and liquidation;
- amendments to our Articles of Association;
- significant acquisition or disposal of material assets or provision of guarantees conducted within the period of one year with a value exceeding 30% of our latest audited total assets;
- share incentive schemes; and
- any other matters considered by the shareholders in a general meeting and which they have resolved by way of an ordinary resolution to be material and should be adopted by special resolution.

All other actions taken by the shareholders, including the appointment and removal of our directors and independent auditors and the declaration of normal dividend payments, will be decided by an ordinary resolution of the shareholders.

Our listing agreement with the HKSE provides that we may not permit amendments to certain sections of our Articles of Association that are subject to the Mandatory Provisions. These sections include provisions relating to (i) varying the rights of existing classes of shares, (ii) voting rights, (iii) our ability to purchase our own shares, (iv) rights of minority shareholders and (v) procedures on liquidation. In addition, certain amendments to the Articles of Association require the approval and assent of Chinese authorities.

Board of Directors

Our Articles of Association authorize up to 19 directors. Directors are elected by shareholders at a general meeting for a three year term from among candidates nominated by the board of directors or by shareholders holding 5% or more of our shares. Because our directors do not serve staggered terms, the entire board of directors will stand for election, and could be replaced, every three years. Our directors are not required to hold any shares in us, and there is no age limit requirement for the retirement or non- retirement of our directors.

In addition to obligations imposed by laws, administrative regulations or the listing rules of the stock exchanges on which our shares are listed, the Articles of Association place on each of our directors, supervisors, manager and any other senior officers a duty to each shareholder, in the exercise of our functions and powers entrusted to them:

- not to cause us to exceed the scope of business stipulated in our business license;

to act honestly in what he considers our best interests;

not to expropriate our assets in any way, including (without limitation) usurpation of opportunities which may benefit us; and

not to expropriate the individual rights of shareholders, including (without limitation) rights to distributions and voting rights, except according to a restructuring which has been submitted to the shareholders for their approval in accordance with the Articles of Association.

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Our Articles of Association further place on each of our directors, supervisors, manager and other senior officers:

- a duty, in the exercise of their powers and discharge of their duties, to exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances;
- a fiduciary obligation, in the discharge of his duties, not to place himself or herself in a position where his or her interests may conflict with his or her duty to us; and
- a duty not to cause a person or an organization related or connected to him or her in specified relationships to do what they are prohibited from doing.

We pay all expenses that our directors incur for their services as directors. Directors also receive compensation for their services under service contracts that are negotiated by the supervisory committee and approved by the shareholders.

Subject to the stipulations of relevant laws and regulations, the shareholders in a general meeting may by ordinary resolution remove any director before the expiration of his term of office. Except for the restrictions placed on controlling shareholders, discussed below, our shareholders in general meeting have the power to relieve a director, supervisor, manager or senior officer from liability for specific breaches of duty.

Cumulative voting is required for election of our directors as long as more than 30% of our outstanding shares are held by a single shareholder. Cumulative voting allows shareholders to cast a number of votes for a candidate equal to the number of shares held multiplied by the number of directors being elected at the shareholders meeting. If a shareholder attempts to cast more votes than he is entitled to under this system, all of the shareholder s votes will be invalid and will be deemed an abstention.

More than one third of our directors of board must be independent from our shareholders and not hold any office with us (each, Independent Director). At least one Independent Director must be an accounting professional and all Independent Directors must possess a basic knowledge of the operations of a listed company and be familiar with relevant laws and rules and have at least five years working experience in law, economics or other area required for the fulfillment of responsibilities as an Independent Director. Independent Directors may not serve for terms exceeding six years. In addition, there are specific persons who are disqualified from acting as Independent Director. These include:

- immediate family members of persons who work for us or our associated entities;
- persons or their immediate family who hold one percent or more of our shares or are among our ten largest shareholders;
- any persons that satisfied the foregoing conditions within the past one year;
- persons providing financial, legal, consultation or other services to us or our associated entities;
- persons who already serve as Independent Director for five other listed companies; and
- anyone designated by the China Securities Regulatory Commission.

If the resignation of an Independent Director would cause our Board of Directors to have less than one third Independent Directors, the resignation will only become effective after a new Independent Director has been appointed.

Our Board will be required to meet at least four times each year. Directors who miss two consecutive Board meetings without appointing an alternate director to attend on their behalf will be proposed for removal at the next shareholders meeting, provided that Independent Directors may miss three consecutive meetings before being proposed for removal. Otherwise, Independent Directors cannot be removed without cause.

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Directors may not vote on any matter in which he has a material interest, nor will he be counted for purposes of forming a quorum on such a matter.

Board resolutions are passed by a simple majority of the Directors except for the following matters which require the consent of more than two thirds of the Directors:

- proposals for our financial policies;
- the increase or reduction of our registered capital;
- the issue of securities of any kind and their listing;
- any repurchase of our shares;
- significant acquisitions or disposals;
- our merger, division or dissolution; and
- any amendment to our Articles of Association.

Our Board of Directors or Supervisory Committee may nominate candidates for our Board of Directors and Supervisory Committee. In addition, shareholders holding one percent or more of our shares have the right to nominate candidates for Independent Director or Independent Supervisor and shareholders holding five percent or more of our shares have the right to nominate other candidates for Director or Supervisor. For Director candidates, the nominator and candidate will be responsible for providing truthful and complete information about the candidate for disclosure. Candidates for Independent Director must publicly declare that there does not exist any relationship between himself and us that may influence his independent, objective judgment. The China Securities Regulatory Commission may veto any candidate for Independent Director.

Our Independent Directors must approve any connected transactions. Connected transactions are those defined by the HKSE and by Chinese rules and regulations, but would generally include transactions with any of the following:

- any company that, directly or indirectly, controls us or is under common control with us;
- any shareholders owning 5% or more of our shares;
- our directors, supervisors and other senior management;
- any of our key technical personnel or key technology suppliers; and
- any close relative or associate of any of the above.

Our independent directors can also propose to the Board of Directors the appointment or removal of our auditors, the convening of a Board meeting, independently appoint external auditors, solicit votes from shareholders and report circumstances directly to shareholders, Chinese securities regulatory authorities or other government departments. Two or more may request that the Board convene an extraordinary meeting of shareholders.

Our Independent Directors will have to express their opinion on specified matters to the Board or to the shareholders at a shareholders meeting, either by a single unanimous statement or individually. These matters are:

- the nomination, removal and remuneration of directors or senior management;

- any major loans or financial transactions with our shareholders or related enterprises and whether we have taken adequate steps to ensure repayment;

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- matters that the Independent Director believes may harm the rights and interests of minority shareholders; and
- any other matter that they are required to opine on by applicable law or rules.

These opinions must be expressed as either, agree, qualified agreement, opposition or unable to form an opinion. All but agreement must also be accompanied by a supporting explanation. If public disclosure of the matter is required, we must also disclose the opinions of our Independent Directors.

Any Independent Director may engage independent institutions to provide independent opinions as the basis of their decision. We must arrange the engagement and bear any costs.

Supervisory Committee

The Supervisory Committee is responsible for supervising our directors and senior officers and preventing them from abusing their positions and powers or infringing upon the rights and interests of our company or those of our shareholders and employees. The Supervisory Committee has no power over the decisions or actions of our directors or officers to correct any acts that are harmful to our interests. The Supervisory Committee is currently composed of seven members appointed for a three year term. It has the right to:

- attend the meetings of our board of directors;
- inspect our financial affairs;
- supervise and evaluate the conduct of our directors, general manager and other senior officers in order to determine whether they violate any laws, regulations or the Articles of Association in performing their duties;
- require our directors, general manager or other senior officers to correct any act harmful to our interests and those of our shareholders and employees;
- verify financial reports, accounting reports, business reports, profit distribution plans and other financial information proposed to be tabled at the shareholders general meeting;
- require the board of directors to convene an extraordinary general meeting of shareholders;
- represent us in negotiations with directors or in initiating legal proceedings against a director on our company s behalf;
- conduct investigation into any identified irregularities in our operations, and where necessary, to engage accountants, legal advisers or other professionals to assist in the investigation; and
- any other matters authorized by the Articles of Association.

Our Supervisory Committee must include two employee representatives appointed by our employees. The remaining members are appointed by the shareholders in a general meeting, provided that our directors, general manager and senior officers are not eligible to serve as supervisors. The Supervisory Committee must meet at least once a year. Decisions of the Supervisory Committee must be made by a one-half vote. We will pay all reasonable expenses incurred by the Supervisory Committee in appointing professional advisors, such as lawyers, accountants or auditors.

Liquidation Rights

In the event of our liquidation, payment of debts out of our remaining assets will be made in the order of priority prescribed by applicable laws and regulations. After payment of debts, we will distribute the remaining property to shareholders according to the class and proportion of their shareholdings. For this purpose, the H shares will rank equally with the domestic shares.

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Obligation of Shareholders

Shareholders are not obligated to make any further contributions to our share capital other than as agreed by the subscriber of the relevant shares on subscription. This provision means that holders of ADSs will also not be obligated to make further contributions to our share capital.

Duration

We are organized as a joint stock limited company of indefinite duration.

Increase in Share Capital

The Articles of Association require that approval by a resolution of the shareholders be obtained prior to issuing new shares. New issues of shares must also be approved by the relevant Chinese authorities.

Reduction of Share Capital and Purchase by Us of Our Shares

We may reduce our registered share capital only upon obtaining the approval of the shareholders and, when applicable, relevant Chinese authorities. Repurchases may be made either by way of a general offer to all shareholders in proportion to their shareholdings, by purchasing our shares on a stock exchange or by an off-market contract with individual shareholders.

Restrictions on Large or Controlling Shareholders

Our Articles of Association provide that, in addition to any obligation imposed by laws and administrative regulations or required by the listing rules of the stock exchanges on which our shares are listed, a controlling shareholder cannot exercise voting rights in a manner prejudicial to the interests of the shareholders generally or of some part of the shareholders:

- to relieve a director or supervisor from his or her duty to act honestly in our best interest;
- to approve the expropriation by a director or supervisor (for his or her own benefit or for the benefit of another person) of our assets in any way, including, without limitation, opportunities which may benefit us; or
- to approve the expropriation by a director or supervisor (for his or her own benefit or for the benefit of another person) of the individual rights of other shareholders, including, without limitation, rights to distributions and voting rights (but not according to a restructuring of our company which has been submitted for approval by the shareholders in a general meeting in accordance with our Articles of Association).

A controlling shareholder, however, will not be precluded by our Articles of Association or any laws and administrative regulations or the listing rules of the stock exchanges on which our shares are listed from voting on these matters.

A controlling shareholder is defined by our Articles of Association as any person who, acting alone or together with others:

- has the power to elect more than one-half of the board of directors;
- has the power to exercise, or to control the exercise of, 30% or more of our voting rights;
- holds 30% or more of our issued and outstanding shares; or

has *de facto* control of us in any other way.

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Minutes, Accounts and Annual Report

Our shareholders may inspect copies of the minutes of the shareholders general meetings during our business hours free of charge. Shareholders are also entitled to receive copies of these minutes within seven days of receipt of the reasonable charges we may require.

Our fiscal year is the calendar year ending December 31. Each fiscal year, we must mail our financial report to shareholders not less than 21 days before the date of the shareholders annual general meeting. These and any interim financial statements must be prepared in accordance with Chinese accounting standards and, for so long as H shares are listed on the HKSE, must also be prepared in accordance with or reconciled to either Hong Kong accounting standards or international accounting standards. The financial statements must be approved by an ordinary resolution of the shareholders at the annual general meeting.

Independent auditors are appointed each year by the shareholders at the annual meeting.

C. Material Contracts.

We have not entered into any material contracts other than in the ordinary course of business and other than those described in Item 4. Information on the Company or elsewhere in this annual report on Form 20-F.

D. Exchange Controls.

Our Articles of Association require that cash dividends on our H Shares be declared in Renminbi and paid in HK dollars. The Articles of Association further stipulate that such dividends must be converted to HK dollars at a rate equal to the average of the closing exchange rates for HK dollars as announced by the Chinese Foreign Exchange Trading Center for the calendar week preceding the date on which the dividends are declared.

The Renminbi currently is not a freely convertible currency. The State Administration of Foreign Exchange (SAFE), under supervision of the People s Bank of China (PBOC) controls the conversion of Renminbi into foreign currency. Although PRC governmental policies were introduced in 1996 to reduce restrictions on the convertibility of Renminbi into foreign currency for current account items, conversion of Renminbi into foreign exchange for capital items, such as foreign direct investment, loans or securities, requires the approval of SAFE and other relevant authorities. These limitations could affect our ability to obtain foreign exchange through debt or equity financing, or to obtain foreign exchange for capital expenditures.

On July 21, 2005, the Chinese government changed its policy of pegging the Renminbi to the U.S. dollar. Under the new policy, the Renminbi is permitted to fluctuate within a narrow and managed band against a basket of certain foreign currencies. Since the adoption of this new policy, the value of the Renminbi has fluctuated daily within a narrow band, but overall has appreciated against the US dollar. Nevertheless, the PRC government continues to receive significant international pressure to further liberalize its currency policy which could result in a further and more significant appreciation in the value of the Renminbi against the US dollar.

While the impact of the foregoing developments is not entirely clear, it appears that the trend in the Chinese government s foreign exchange policy is toward easier convertibility of the Renminbi.

The holders of the ADSs will receive the HK dollar dividend payments in US dollars at conversion rates related to market rates and subject to fees as set forth in our Deposit Agreement with The Bank of New York, as Depositary. The HK dollar is currently linked to and trades within a narrow band against the US dollar at a rate that does not deviate significantly from HK$7.80 = US$1.00. The Hong Kong government has stated its intention to maintain such link, although there can be no guarantee that such link will be maintained.

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E. Taxation

PRC Taxation

The following is a summary of those taxes, including withholding provisions, to which United States security holders are subject under existing Chinese laws and regulations. The summary is subject to changes in Chinese law, including changes that could have retroactive effect. The summary does not take into account or discuss the tax laws of any country other than China, nor does it take into account the individual circumstances of a security holder. This summary does not purport to be a complete technical analysis or an examination of all potential tax effects under such laws and regulations.

Tax on Dividends

For an Individual Investor

According to the Individual Income Tax Law of the People s Republic of China, as amended on December 29, 2007 (the Individual Income Tax Law) dividends paid by Chinese companies to foreign individuals are ordinarily subject to Chinese withholding tax at a flat rate of 20%.

However, pursuant to the Notice Concerning the Taxation of Gains on Transfer and Dividends from Shares (Equities) Received by Foreign Investment Enterprises, Foreign Enterprises and Foreign Individuals (the Tax Notice), issued by the State Tax Bureau (now the State Administration of Taxation or SAT) on July 21, 1993, dividends paid by Chinese companies to foreign individuals, with respect to their shares listed on an overseas stock exchange (Overseas Shares), such as H Shares (including H Shares represented by ADSs), or on domestically-listed foreign invested shares (B Shares) are temporarily exempt from Chinese withholding tax. The Tax Notice remains in force and the relevant tax authority has thus far not collected withholding tax on dividends paid by Chinese companies, with respect to their Overseas Shares and B Shares, to foreign individuals.

In the event that the Tax Notice is withdrawn, a 20% withholding tax may be imposed in accordance with the Individual Income Tax Law, subject to reduction by an applicable income tax treaty.

For a Corporation

According to the New Enterprise Income Tax Law and its implementation rules, effective January 1, 2008, dividends by Chinese companies to foreign enterprises, which have no establishment or residence in China or whose dividends from China do not relate to their establishment or residence in China, are ordinarily subject to a Chinese withholding tax levied at a flat rate of 10%. However, according to the Tax Notice, a foreign enterprise with no permanent establishment in China receiving dividends paid with respect to a Chinese company s Overseas Shares and B Shares will temporarily not be subject to the 10% withholding tax. In the event that the Tax Notice is withdrawn, a 10% withholding tax may be imposed in accordance with the New Enterprise Income Tax Law, subject to reduction by an applicable income tax treaty.

Capital Gains Tax

According to the Individual Income Tax Law, the New Enterprise Income Tax Law, their respective implementing regulations, and the Notice on Questions Relating to Reduced Income Tax on Foreign Enterprise Income in China from Interest, issued by the State Council on November 18, 2000 (the Rate Reduction Notice), capital gains recognized by foreign individuals and foreign corporations, with respect to their sale of equity shares of Chinese companies, are ordinarily subject to Chinese tax, purportedly in the form of withholding tax, at a flat rate of 20% and 10% respectively.

However, pursuant to the Tax Notice, capital gains recognized by foreign individuals and foreign corporations, with respect to their sale of Overseas Shares and B Shares are temporarily exempt from Chinese

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tax. As discussed above, the relevant tax authority has thus far not sought to collect Chinese tax on capital gains recognized by foreign individuals and foreign corporations with respect to their sale of Overseas Shares and B Shares.

In the event that the Tax Notice is withdrawn, Chinese tax, at a rate of 20% for individuals or 10% for corporations may be imposed in accordance with the Individual Income Tax Law, the New Enterprise Income Tax Law, their respective implementing regulations and the Rate Reduction Notice, subject to reduction by an applicable income tax treaty.

Tax Treaties

China has an income tax treaty with the United States that currently limits the rate of Chinese withholding tax to 10% for dividends paid to individuals and corporations that qualify for treaty benefits. However, this treaty does not offer reduced tax rates for capital gains. Since the Tax Notice remains in force to temporarily exempt dividends and capital gains from the Chinese taxes described above, it may not be necessary for foreign individuals and corporations to rely on this treaty at this time.

Stamp Tax

While no express exemption exists for the imposition of Chinese stamp tax on transfers of Overseas Shares pursuant to the Provisional Regulations of the People s Republic of China Concerning Stamp Tax effective on July 1, 1989, we are not aware of any circumstance under which Chinese stamp tax has actually been imposed on the transfer of Overseas Shares.

Estate or Gift Tax

China does not currently impose any estate or gift tax.

U.S. Taxation

The following is a summary of the material U.S. federal income tax consequences of the ownership and disposition of H Shares or ADSs. The following discussion is not exhaustive of all possible tax considerations. This summary is based upon the Internal Revenue Code of 1986, as amended (the Code), regulations promulgated under the Code by the U.S. Treasury Department (including proposed and temporary regulations), rulings, current administrative interpretations and official pronouncements of the Internal Revenue Service (the IRS), and judicial decisions, all as currently in effect and all of which are subject to differing interpretations or to change, possibly with retroactive effect. Such change could materially and adversely affect the tax consequences described below. No assurance can be given that the IRS will not assert, or that a court will not sustain, a position contrary to any of the tax consequences described below.

This discussion does not address state, local, or foreign tax consequences of the ownership and disposition of H Shares or ADSs. (See PRC Taxation above).

This summary is for general information only and does not address all aspects of the U.S. federal income taxation that may be important to a particular holder in light of its investment or tax circumstances or to holders subject to special tax rules, such as: banks; financial institutions; insurance companies; dealers in stocks, securities, or currencies; traders in securities that elect to use a mark-to- market method of accounting for their securities holdings; tax-exempt organizations; real estate investment trusts; regulated investment companies; qualified retirement plans, individual retirement accounts, and other tax-deferred accounts; expatriates of the United States; persons subject to the alternative minimum tax; persons holding H Shares or ADSs as part of a straddle, hedge, conversion transaction, or other integrated transaction; persons who acquired H Shares or ADSs pursuant to the exercise of any employee stock option or otherwise as compensation for services; persons

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actually or constructively holding 10% or more of our voting stock; and U.S. Holders (as defined below) whose functional currency is other than the U.S. dollar.

This discussion is not a comprehensive description of all of the U.S. federal tax consequences that may be relevant with respect to the ownership and disposition of H Shares or ADSs. We urge you to consult your own tax advisor regarding your particular circumstances and the U.S. federal income and estate tax consequences to you of owning and disposing of H Shares or ADSs, as well as any tax consequences arising under the laws of any state, local, or foreign or other tax jurisdiction and the possible effects of changes in U.S. federal or other tax laws.

This summary is directed solely to persons who hold their H Shares or ADSs as capital assets within the meaning of Section 1221 of the Code, which generally means as property held for investment. For purposes of this discussion, the term U.S. Holder means a beneficial owner of H Shares or ADSs that is any of the following:

- a citizen or resident of the United States or someone treated as a U.S. citizen or resident for U.S. federal income tax purposes;
- a corporation (or other entity taxable as a corporation for U.S. federal income tax purposes) created or organized in or under the laws of the United States, any state thereof, or the District of Columbia;
- an estate, the income of which is subject to U.S. federal income taxation regardless of its source;
- a trust if a U.S. court can exercise primary supervision over the trust s administration and one or more U.S. persons have the authority to control all substantial decisions of the trust; or
- a trust in existence on August 20, 1996 that has a valid election in effect under applicable Treasury Regulations to be treated as a U.S. person.

The term Non-U.S. Holder means a beneficial owner of H Shares or ADSs that is not a U.S. Holder. As described in Taxation of Non-U.S. Holders below, the tax consequences to a Non-U.S. Holder may differ substantially from the tax consequences to a U.S. Holder.

If a partnership (including for this purpose any entity treated as a partnership for U.S. federal income tax purposes) is a beneficial owner of H Shares or ADSs, the U.S. federal income tax consequences to a partner in the partnership will generally depend on the status of the partner and the activities of the partnership. A holder of H Shares or ADSs that is a partnership and the partners in such partnership should consult their own tax advisors regarding the U.S. federal income tax consequences of the ownership and disposition of H Shares or ADSs.

ADSs

As relates to the ADSs, this discussion is based in part upon the representations of the depositary and the assumption that each obligation in the deposit agreement and any related agreement will be performed in accordance to its terms.

Generally, a holder of ADSs will be treated as the owner of the underlying H Shares represented by those ADSs for U.S. federal income tax purposes. Accordingly, no gain or loss will be recognized if the holder exchanges ADSs for the underlying H Shares represented by those ADSs. The holder s adjusted tax basis in the H Shares will be the same as the adjusted tax basis of the ADSs surrendered in exchange therefor, and the holding period for the H Shares will include the holding period for the surrendered ADSs.

TAXATION OF U.S. HOLDERS

The discussion in Distributions on H Shares or ADSs and Dispositions of H Shares or ADSs below assumes that we will not be treated as a passive foreign investment company (PFIC) for U.S. federal income

tax purposes. For a discussion of the rules that apply if we are treated as a PFIC, see the discussion in Passive Foreign Investment Company below.

Distributions on H Shares or ADSs

General. Subject to the discussion in Passive Foreign Investment Company below, if you actually or constructively receive a distribution on H Shares or ADSs, you must include the distribution in gross income as a taxable dividend on the date of your (or in the case of ADSs, the depositary s) receipt of the distribution, but only to the extent of our current or accumulated earnings and profits, as calculated under U.S. federal income tax principles. Such amount must be included without reduction for any foreign taxes withheld. Dividends paid by us will not be eligible for the dividends received deduction allowed to corporations with respect to dividends received from certain domestic corporations. Dividends paid by us may or may not be eligible for preferential rates applicable to qualified dividend income, as described below.

To the extent a distribution exceeds our current and accumulated earnings and profits, it will be treated first as a non-taxable return of capital to the extent of your adjusted tax basis in the H Shares or ADSs, and thereafter as capital gain. Preferential tax rates for long-term capital gain may be applicable to non-corporate U.S. Holders.

We do not intend to calculate our earnings and profits under U.S. federal income tax principles. Therefore, you should expect that a distribution will generally be reported as a dividend even if that distribution would otherwise be treated as a non-taxable return of capital or as capital gain under the rules described above.

Qualified Dividend Income. With respect to non-corporate U.S. Holders (i.e., individuals, trusts, and estates), for taxable years beginning before January 1, 2011, dividends that are treated as qualified dividend income (QDI) are taxable at a maximum tax rate of 15%. Among other requirements, dividends generally will be treated as QDI if either (i) our H Shares or ADSs are readily tradable on an established securities market in the United States, or (ii) we are eligible for the benefits of a comprehensive income tax treaty with the United States which includes an information exchange program and which is determined to be satisfactory by the U.S. Treasury. It is expected that our ADSs will be readily tradable as a result of being listed on the New York Stock Exchange.

In addition, for dividends to be treated as QDI, we must not be a PFIC (as discussed below) for either the taxable year in which the dividend was paid or the preceding taxable year. We do not believe that we will be a PFIC for our current taxable year. However, please see the discussion under Passive Foreign Investment Company below. Additionally, in order to qualify for QDI treatment, you generally must have held the H Shares or ADSs for more than 60 days during the 121-day period beginning 60 days prior to the ex-dividend date. However, your holding period will be reduced for any period during which the risk of loss is diminished.

Moreover, a dividend will not be treated as QDI to the extent you are under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property. Since the QDI rules are complex, you should consult your own tax advisor regarding the availability of the preferential tax rates for dividends paid on H Shares or ADSs.

Foreign Currency Distributions. A dividend paid in foreign currency (e.g., Hong Kong dollars or Chinese renminbi) must be included in your income as a U.S. dollar amount based on the exchange rate in effect on the date such dividend is received, regardless of whether the payment is in fact converted to U.S. dollars. If the dividend is converted to U.S. dollars on the date of receipt, you generally will not recognize a foreign currency gain or loss. However, if you convert the foreign currency to U.S. dollars on a later date, you must include in income any gain or loss resulting from any exchange rate fluctuations. The gain or loss will be equal to the difference between (i) the U.S. dollar value of the amount you included in income when the dividend was received and (ii) the amount that you receive on the conversion of the foreign currency to U.S. dollars. Such gain or loss will generally be ordinary income or loss and U.S. source for U.S. foreign tax credit purposes.

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In-Kind Distributions. Distributions to you of new H Shares or ADSs or rights to subscribe for new H Shares or ADSs that are received as part of a pro rata distribution to all of our shareholders will not be subject to U.S. federal income tax. The adjusted tax basis of the new H Shares or ADSs or rights so received will be determined by allocating your adjusted tax basis in the old H Shares or ADSs between the old H Shares or ADSs and the new H Shares or ADSs or rights received, based on their relative fair market values on the date of distribution. However, in the case of a distribution of rights to subscribe for H Shares or ADSs, the adjusted tax basis of the rights will be zero if the fair market value of the rights is less than 15% of the fair market value of the old H Shares or ADSs on the date of distribution and you do not make an election to determine the adjusted tax basis of the rights by allocation as described above. Your holding period for the new H Shares or ADSs or rights will generally include the holding period for the old H Shares or ADSs on which the distribution was made.

Foreign Tax Credits. Subject to certain conditions and limitations, any foreign taxes paid on or withheld from distributions from us and not refundable to you may be credited against your U.S. federal income tax liability or, alternatively, may be deducted from your taxable income. This election is made on a year-by-year basis and applies to all foreign taxes paid by you or withheld from you that year. No Chinese withholding tax currently is imposed on dividends on the H Shares and ADSs, although Chinese withholding taxes could be imposed in the future.

Distributions will constitute foreign source income for foreign tax credit limitation purposes. The foreign tax credit limitation is calculated separately with respect to two specific classes of income. For this purpose, distributions characterized as dividends distributed by us will generally constitute passive category income or, in the case of certain U.S. Holders, general category income. Special limitations may apply if a dividend is treated as QDI (as defined above).

Special rules may apply to electing individuals whose foreign source income during the taxable year consists entirely of qualified passive income and whose creditable foreign taxes paid or accrued during the taxable year do not exceed $300 ($600 in the case of a joint return).

Since the rules governing foreign tax credits are complex, you should consult your own tax advisor regarding the availability of foreign tax credits in your particular circumstances.

The U.S. Treasury has expressed concerns that parties to whom ADSs are pre-released may be taking actions that are inconsistent with the claiming of foreign tax credits by U.S. Holders of ADSs. Such actions would also be inconsistent with the claiming of the preferential tax rates applicable to QDI, as defined above. Accordingly, the creditability of any foreign taxes and the availability of such preferential tax rates could be affected by future actions that may be taken by the U.S. Treasury or parties to whom ADSs are pre-released.

Dispositions of H Shares or ADSs

Subject to the discussion in Passive Foreign Investment Company below, you generally will recognize taxable gain or loss realized on the sale or other taxable disposition of H Shares or ADSs equal to the difference between the U.S. dollar value of (i) the amount realized on the disposition (i.e., the amount of cash plus the fair market value of any property received), and (ii) your adjusted tax basis in the H Shares or ADSs. Such gain or loss will be capital gain or loss.

If you have held the H Shares or ADSs for more than one year at the time of disposition, such capital gain or loss will be long- term capital gain or loss. Preferential tax rates for long-term capital gain (currently, with a maximum rate of 15% for taxable years beginning before January 1, 2011) will apply to non-corporate U.S. Holders. If you have held the H Shares or ADSs for one year or less, such capital gain or loss will be short-term capital gain or loss taxable as ordinary income at your marginal income tax rate. The deductibility of capital losses is subject to limitations.

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Generally, any gain or loss recognized will not give rise to foreign source income for U.S. foreign tax credit purposes.

You should consult your own tax advisor regarding the U.S. federal income tax consequences if you receive currency other than U.S. dollars upon the disposition of H Shares or ADSs.

Passive Foreign Investment Company

We generally will be a PFIC under Section 1297 of the Code if, for a taxable year, either (a) 75% or more of our gross income for such taxable year is passive income (the income test) or (b) 50% or more of the average percentage, generally determined by fair market value, of our assets during such taxable year either produce passive income or are held for the production of passive income (the asset test). Passive income includes, for example, dividends, interest, certain rents and royalties, certain gains from the sale of stock and securities, and certain gains from commodities transactions.

Certain look through rules apply for purposes of the income and asset tests described above. If we own, directly or indirectly, 25% or more of the total value of the outstanding shares of another corporation, we will be treated as if we (a) held directly a proportionate share of the other corporation s assets, and (b) received directly a proportionate share of the other corporation s income. In addition, passive income does not include any interest, dividends, rents, or royalties that are received or accrued by us from a related person (as defined in Section 954(d)(3) of the Code), to the extent such items are properly allocable to income of such related person that is not passive income.

Under the income and asset tests, whether or not we are a PFIC will be determined annually based upon the composition of our income and the composition and valuation of our assets, all of which are subject to change. In determining that we are not a PFIC, we are relying on our projected revenues and projected capital expenditures. If our actual revenues and capital expenditures do not match our projections, we may become a PFIC. For example, if we do not spend enough of the cash (a passive asset) we raise from any financing transactions we may undertake, the relative percentage of our passive assets will increase. In addition, our determination is based on a current valuation of our assets, including goodwill (an active asset). In calculating goodwill, we have valued our total assets based on our market capitalization, determined using the market price of our shares. Such market price may fluctuate. If our market capitalization is less than anticipated or subsequently declines, this will decrease the value of our goodwill and we may become a PFIC. Furthermore, we have made a number of assumptions regarding the amount of value allocable to goodwill. We believe our valuation approach is reasonable. However, it is possible that the IRS will challenge the valuation of our assets, including goodwill, which may result in our being a PFIC.

We do not believe that we are currently a PFIC. However, because the PFIC determination is highly fact intensive and made at the end of each taxable year, there can be no assurance that we will not be a PFIC for the current or any future taxable year or that the IRS will not challenge our determination concerning our PFIC status.

Default PFIC Rules under Section 1291 of the Code. If we are a PFIC, the U.S. federal income tax consequences to a U.S. Holder of the ownership and disposition of H Shares or ADSs will depend on whether such U.S. Holder makes an election to treat us as a qualified electing fund (QEF) under Section 1295 of the Code (a QEF Election) or a mark-to-market election under Section 1296 of the Code (a Mark-to-Market Election). A U.S. Holder owning H Shares or ADSs while we were or are a PFIC that has not made either a QEF Election or a Mark-to-Market Election will be referred to in this summary as a Non-Electing U.S. Holder.

If you are a Non-Electing U.S. Holder, you will be subject to the default tax rules of Section 1291 of the Code with respect to:

- any excess distribution paid on H Shares or ADSs, which means the excess (if any) of the total distributions received by you during the current taxable year over 125% of the average distributions received by you during the three preceding taxable years (or during the portion of your holding period for the H Shares or ADSs prior to the current taxable year, if shorter); and
- any gain recognized on the sale or other taxable disposition (including a pledge) of H Shares or ADSs.

Under these default tax rules:

- any excess distribution or gain will be allocated ratably over your holding period for the H Shares or ADSs;
- the amount allocated to the current taxable year and any period prior to the first day of the first taxable year in which we were a PFIC will be treated as ordinary income in the current taxable year;
- the amount allocated to each of the other years will be treated as ordinary income and taxed at the highest applicable tax rate in effect for that year; and
- the resulting tax liability from any such prior years will be subject to the interest charge applicable to underpayments of tax.

In addition, notwithstanding any election you may make, dividends that you receive from us will not be eligible for the preferential tax rates applicable to QDI (as discussed above in Distributions on H Shares or ADSs) if we are a PFIC either in the taxable year of the distribution or the preceding taxable year, but will instead be taxable at rates applicable to ordinary income.

Special rules for Non-Electing U.S. Holders will apply to determine U.S. foreign tax credits with respect to foreign taxes imposed on distributions on H Shares or ADSs.

If we are a PFIC for any taxable year during which you hold H Shares or ADSs, we will continue to be treated as a PFIC with respect to you for all succeeding years during which you hold H Shares or ADSs, regardless of whether we actually continue to be a PFIC. You may terminate this deemed PFIC status by electing to recognize gain (which will be taxed under the default tax rules of Section 1291 of the Code discussed above) as if your H Shares or ADSs had been sold on the last day of the last taxable year for which we were a PFIC.

If we are a PFIC in any year with respect to you, you will be required to file an annual return on IRS Form 8621 regarding distributions received on H Shares or ADSs and any gain realized on the disposition of H Shares or ADSs.

QEF Election. If you make a QEF Election, you generally will not be subject to the default rules of Section 1291 of the Code discussed above. Instead, you will be subject to current U.S. federal income tax on your pro rata share of our ordinary earnings and net capital gain, regardless of whether such amounts are actually distributed to you by us. However, you can make a QEF Election only if we agree to furnish you annually with certain tax information, and we currently do not intend to prepare or provide such information.

Mark-to-Market Election. U.S. Holders may make a Mark-to-Market Election, but only if the H Shares or ADSs are marketable stock. The H Shares or ADSs will be marketable stock as long as they are regularly traded on a qualified exchange. Stock is considered regularly traded for any calendar year during which it is traded (other than in de minimis quantities) on at least 15 days during each calendar quarter. Qualified exchanges include (a) a national securities exchange that is registered with the Securities and Exchange Commission, (b) the national market system established pursuant to section 11A of the Securities and Exchange Act of 1934, and (c) a foreign securities exchange that is regulated or supervised by a governmental authority of the country in which

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the market is located, provided that (i) such foreign exchange has trading volume, listing, financial disclosure, surveillance, and other requirements and the laws of the country in which such foreign exchange is located, together with the rules of such foreign exchange, ensure that such requirements are actually enforced, and (ii) the rules of such foreign exchange effectively promote active trading of listed stocks.

Since the H Shares are listed on a foreign exchange (i.e., the Stock Exchange of Hong Kong Limited) and the IRS has yet to identify specific foreign exchanges that are qualified for this purpose, there can be no assurances that the H Shares will be marketable stock and will be regularly traded. As for the ADSs, they will be marketable stock as long as they remain listed on the New York Stock Exchange and are regularly traded. There can be no assurances, however, that the ADSs will be treated, or continue to be treated, as regularly traded.

If you make a Mark-to-Market Election, you generally will not be subject to the default rules of Section 1291 of the Code discussed above. Rather, you generally will be required to recognize ordinary income for any increase in the fair market value of the ADSs for each taxable year that we are a PFIC. You will also be allowed to deduct as an ordinary loss any decrease in the fair market value to the extent of net marked-to-market gain previously included in prior years. Your adjusted tax basis in the ADSs will be adjusted to reflect the amount included or deducted.

The Mark-to-Market Election will be effective for the taxable year for which the election is made and all subsequent taxable years, unless the ADSs cease to be marketable stock or the IRS consents to the revocation of the election. You should consult your own tax advisor regarding the availability of, and procedure for making, a Mark-to-Market Election.

Since the PFIC rules are complex, you should consult your own tax advisor regarding them and how they may affect the U.S. federal income tax consequences of the ownership and disposition of H Shares or ADSs.

Information Reporting and Backup Withholding

Generally, information reporting requirements will apply to distributions on H Shares or ADSs or proceeds from the disposition of H Shares or ADSs paid within the United States (and, in certain cases, outside the United States) to a U.S. Holder unless such U.S. Holder is an exempt recipient, such as a corporation. Furthermore, backup withholding (currently at 28%) may apply to such amounts unless such U.S. Holder (i) is an exempt recipient that, if required, establishes its right to an exemption, or (ii) provides its taxpayer identification number, certifies that it is not currently subject to backup withholding, and complies with other applicable requirements.

A U.S. Holder may generally avoid backup withholding by furnishing a properly completed IRS Form W-9.

Backup withholding is not an additional tax. Rather, amounts withheld under the backup withholding rules may be credited against your U.S. federal income tax liability. Furthermore, you may obtain a refund of any excess amounts withheld by filing an appropriate claim for refund with the IRS and furnishing any required information in a timely manner.

TAXATION OF NON-U.S. HOLDERS

Distributions on H Shares or ADSs

Subject to the discussion in Information Reporting and Backup Withholding below, as a Non-U.S. Holder, you generally will not be subject to U.S. federal income tax, including withholding tax, on distributions received on H Shares or ADSs, unless the distributions are effectively connected with your conduct of a trade or business in the United States (and, if an applicable income tax treaty so requires, attributable to a permanent establishment that you maintain in the United States).

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If distributions are effectively connected with a U.S. trade or business (and, if applicable, attributable to a U.S. permanent establishment), you generally will be subject to tax on such distributions in the same manner as a U.S. Holder, as described in Taxation of U.S. Holders Distributions on H Shares or ADSs above. In addition, any such distributions received by a corporate Non-U.S. Holder may also, under certain circumstances, be subject to an additional branch profits tax at a 30% rate or such lower rate as may be specified by an applicable income tax treaty.

Dispositions of H Shares or ADSs

Subject to the discussion in Information Reporting and Backup Withholding below, as a Non-U.S. Holder, you generally will not be subject to U.S. federal income tax, including withholding tax, on any gain recognized on a sale or other taxable disposition of H Shares or ADSs, unless (i) the gain is effectively connected with your conduct of a trade or business in the United States (and, if an applicable income tax treaty so requires, attributable to a permanent establishment that you maintain in the United States), or (ii) you are an individual and are present in the United States for at least 183 days in the taxable year of the disposition, and certain other conditions are met.

If you meet the test in clause (i) above, you generally will be subject to tax on any gain that is effectively connected with your conduct of a trade or business in the United States in the same manner as a U.S. Holder, as described in Taxation of U.S. Holders Dispositions of H Shares or ADSs above. Effectively connected gain realized by a corporate Non-U.S. Holder may also, under certain circumstances, be subject to an additional branch profits tax at a 30% rate or such lower rate as may be specified by an applicable income tax treaty.

If you meet the test in clause (ii) above, you generally will be subject to tax at a 30% rate on the amount by which your U.S. source capital gain exceeds your U.S. source capital loss.

Information Reporting and Backup Withholding

Payments to Non-U.S. Holders of distributions on, or proceeds from the disposition of, H Shares or ADSs are generally exempt from information reporting and backup withholding. However, a Non-U.S. Holder may be required to establish that exemption by providing certification of non-U.S. status on an appropriate IRS Form W-8.

Backup withholding is not an additional tax. Rather, amounts withheld under the backup withholding rules may be credited against your U.S. federal income tax liability. Furthermore, you may obtain a refund of any excess amounts withheld by filing an appropriate claim for refund with the IRS and furnishing any required information in a timely manner.

F. Dividends and Paying Agents.

Not applicable.

G. Statement by Experts.

Not applicable.

H. Documents on Display.

We are subject to the periodic reporting and other informational requirements of the Securities Exchange Act of 1934, as amended, or the Exchange Act. Under the Exchange Act, we are required to file reports and other information with the Securities and Exchange Commission. Specifically, we are required to file annually a Form 20-F no later than six months after the close of each fiscal year, which is December 31 of each year. Copies of reports and other information, when so filed, may be inspected without charge and may be obtained at prescribed rates at the public reference facilities maintained by the Securities and Exchange Commission at Room 1024, Judiciary Plaza, 450 Fifth Street, N.W., Washington, D.C. 20549. You can request copies of these documents upon payment of a duplicating fee, by writing to the SEC. Please call the SEC at 1-800-SEC-0330 for further information on the operation of the public reference rooms. The SEC also maintains a Web site at www.sec.gov that contains reports, proxy and information statements, and other information regarding registrants that make electronic filings with the SEC using its EDGAR system. As a foreign private issuer, we are exempt from the rules under the Exchange Act prescribing the furnishing and content of quarterly reports and proxy statements, and officers, directors and principal shareholders are exempt from the reporting and short- swing profit recovery provisions contained in Section 16 of the Exchange Act.

I. Subsidiary Information.

Not applicable.

ITEM 11. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.
Interest Rate Sensitivity

We are subject to risk resulting from fluctuations in interest rates. Our debts are fixed and variable rate bank and other loans, with original maturities ranging from 1 to 13 years. Accordingly, fluctuations in interest rates can lead to significant fluctuations in the fair value of such debt instruments. We have no program of interest rate hedging activities and did not engage in any such activities in 2007 or 2006.

The following table provides information, by maturity date, regarding our interest rate sensitive financial instruments, which consist of fixed and variable rate short-term and long-term debt obligations, as of December 31, 2007 and 2006.

	As of December 31, 2007							
	2008	**2009**	**2010**	**2011**	**2012**	**2013**	**Total Recorded Amount**	**Fair Value**
	(RMB equivalent in thousands, except interest rates)							
Fixed rate bank and other loans								
In U.S. Dollars	9,097						9,097	8,641
Average interest rate	1.80%						1.80%	
Variable rate bank and other loans								
In U.S. Dollars	612,642						612,642	612,642
Average interest rate (1)	5.77%						5.77%	
In RMB	3,445,300	485,000	100,000				4,030,300	4,015,929
Average interest rate (1)	5.41%	6.88%	5.91%				5.60%	

(1) The average interest rates for variable rate bank and other loans are calculated based on the year end indices.

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	As of December 31, 2006							
	2007	2008	2009	2010	2011	Thereafter	Total Recorded Amount	Fair Value
	(RMB equivalent in thousands, except interest rates)							
Fixed rate bank and other loans								
In U.S. Dollars	14,056	9,654					23,710	22,410
Average interest rate	1.80%	1.80%					1.80%	
Variable rate bank and other loans								
In U.S. Dollars	2,001,726						2,001,726	2,001,726
Average interest rate (1)	5.90%						5.90%	
In RMB	2,243,500	510,000	450,000				3,203,500	3,185,978
Average interest rate (1)	4.00%	5.48%	5.51%				4.45%	

(1) The average interest rates for variable rate bank and other loans are calculated based on the year end indices.

Exchange Rate Sensitivity

We are also exposed to foreign currency exchange rate risk as a result of our foreign currency denominated long-term debt and, to a limited extent, cash and cash equivalents denominated in foreign currencies. We have no program of foreign currency hedging activities and did not engage in any foreign currency hedging activities in 2007 or 2006.

The following table provides information, by maturity date, regarding our foreign currency exchange rate sensitive financial instruments, which consist of cash and cash equivalents, short-term and long-term debt obligations as of December 31, 2007 and 2006.

	As of December 31, 2007							
	2008	2009	2010	2011	2012	Thereafter	Total Recorded Amount	Fair Value
	(RMB equivalent in thousands, except interest rates)							
On-balance sheet financial instruments								
Cash and cash equivalents:								
In Hong Kong Dollars	12,382						12,382	12,382
In U.S. Dollars	347						347	347
In Euro								
In Japanese Yen								
In Swiss Frank	841						841	841
Debt:								
Fixed rate bank and other loans in U.S. Dollars	9,097						9,097	8,641
Average interest rate	1.80%						1.80%	
Variable rate bank and other loans in U.S. Dollars	612,642						612,642	612,642
Average interest rate (1)	5.77%						5.77%	
Interest free bank and other loans in U.S. Dollars	2,630	2,630	2,630	2,629			10,519	9,150

(1) The average interest rates for variable rate bank and other loans are calculated based on the year end indices.

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	As of December 31, 2006							
	2007	2008	2009	2010	2011	Thereafter	Total Recorded Amount	Fair Value
	(RMB equivalent in thousands, except interest rates)							
On-balance sheet financial instruments								
Cash and cash equivalents:								
In Hong Kong Dollars	11,834						11,834	11,834
In U.S. Dollars	40,121						40,121	40,121
In Euro	1,201						1,201	1,201
In Japanese Yen	4						4	4
Debt:								
Fixed rate bank and other loans In U.S. Dollars	14,056	9,654					23,710	22,410
Average interest rate	1.80%	1.80%					1.80%	
Variable rate bank and other loans in U.S. Dollars	2,001,726						2,001,726	2,001,726
Average interest rate (1)	5.90%						5.90%	
Interest free bank and other loans in U.S. Dollars	2,811	2,811	2,811	2,811	2,811		14,055	11,783

(1) The average interest rates for variable rate bank and other loans are calculated based on the year end indices.

ITEM 12. DESCRIPTION OF SECURITIES OTHER THAN EQUITY SECURITIES.

Not applicable.

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PART II

ITEM 13. DEFAULTS, DIVIDEND ARREARAGES AND DELINQUENCIES.

None.

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

None.

ITEM 15. CONTROLS AND PROCEDURES

A. Evaluation of disclosure controls and procedures.

We maintain a written policy adopted by our board of directors that governs the collection, coordination and disclosure of information to our shareholders, the public and to governmental and other regulatory bodies. All such disclosures are coordinated by the Secretary and subject to execution by either the Chairman of the Board or, for disclosures by our Supervisory Board, the Chairman of the Supervisory Board. Under the policy, all material issues must be disclosed and our disclosures must be true, accurate, complete and timely without any false or misleading statements. Each of our departments and subsidiaries have their own supplemental policies which may be both written and unwritten.

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer has evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) of the Securities Exchange Act of 1934) as of the end of the fiscal year covered by this annual report. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of the fiscal year covered by this annual report, our disclosure controls and procedures were adequate and effective to ensure that material information relating to our company, including our consolidated subsidiaries, was made known to them by others within our company and our consolidated subsidiaries.

B. Management s report on internal control over financial reporting.

Our management is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rules 13a-15(f) of the Securities Exchange Act of 1934). The Company s internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with International Financial Reporting Standards.

Internal control over financial reporting cannot provide absolute assurance of achieving financial reporting objectives because of its inherent limitations. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Our management assessed the effectiveness of our internal control over financial reporting based upon the criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission as of December 31, 2007. Based on that evaluation, our management has concluded that our internal control over financial reporting was effective as of December 31, 2007 based on these criteria.

KPMG, an independent registered public accounting firm, has audited the consolidated financial statements included in this annual report on Form 20-F and, as part of the audit, has issued a report, included herein, on the effectiveness of our internal control over financial reporting.

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Subsequent to the date of the evaluation described above, we have not made any significant changes, including corrective actions with regard to significant deficiencies or material weaknesses, in our internal controls or in other factors that could significantly affect these controls.

C. Report of Independent Registered Public Accounting Firm.

The Board of Directors and Shareholders of

Sinopec Shanghai Petrochemical Company Limited:

We have audited Sinopec Shanghai Petrochemical Company Limited and subsidiaries (the Group) s internal control over financial reporting as of December 31, 2007, based on criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Group s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management s Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Group s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the Group maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007, based on criteria established in *Internal* Control-*Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of the Group as of December 31, 2006 and 2007, and the related consolidated statements of income, equity and cash flows for each of the years in the three-year period ended December 31, 2007, and our report dated April 7, 2008 expressed an unqualified opinion on those consolidated financial statements.

/S/ KPMG

Hong Kong, China

April 7, 2008

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D. Changes in internal control over financial reporting.

For the year ended December 31, 2007, there have been no significant changes to our internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect our internal control over financial reporting.

ITEM 16A. AUDIT COMMITTEE FINANCIAL EXPERT

We currently have an audit committee financial expert, Chen Xinyuan, serving on our audit committee and he is an independent director as defined in 17 CFR 240.10A-3.

ITEM 16B. CODE OF ETHICS

We have not adopted a code of ethics as defined by the applicable U.S. securities regulations that applies to our principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions since it is not a customary practice for a PRC company to adopt such code of ethics.

ITEM 16C. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The following table summarizes the fees charged by KPMG, our principal accountant, for certain services rendered to us during 2006 and 2007.

	For the year ended December 31, (in thousands of RMB)	
	2006	2007
Audit fees (1)	7,721	8,727
Audit-related fees (2)		
Tax fees (3)		
All other fees (4)	300	
Total	8,021	8,727

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

(2) Audit-related fees means the aggregate fees billed in each of the fiscal years listed for assurance and related services rendered by our principal auditors for the audit of our financial information.

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

(4) All other fees means the aggregate fees billed in each of the fiscal years listed for products and services provided by the our principal accountant, other than the services reported under audit fees, audit-related fees and tax fees.

Audit Committee Pre-approval Policies and Procedures

Our audit committee has adopted procedures which set forth the manner in which the committee will review and approve all audit and non-audit services to be provided by KPMG. The pre-approval procedures are as follows:

Any audit or non-audit service to be provided to us by the independent accountant must be (i) pre-approved by the audit committee; or (ii) pre-approved by one or several committee members designated by the committee and rectified by the audit committee.

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ITEM 16D. EXEMPTIONS FROM THE LISTING STANDARDS FOR AUDIT COMMITTEES.
We have not been granted an exemption from the applicable listing standards for the audit committee of our board of directors.

ITEM 16E. PURCHASES OF EQUITY SECURITIES BY THE ISSUER AND AFFILIATED PURCHASERS.
None.

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PART III

ITEM 17. FINANCIAL STATEMENTS.

Separate financial statements and notes thereto for Shanghai Secco Petrochemical Co., Ltd. are being filed pursuant to Rule 3-09 of Regulation S-X. See pages F-62 to F-105.

ITEM 18. FINANCIAL STATEMENTS.

See pages F-1 to F-61.

ITEM 19. EXHIBITS

12.1	Certification of Chairman Required by Rule 13a-14(a).
12.2	Certification of Chief Financial Officer Required by Rule 13a-14(a).
13.1	Certification of Chairman Required by Rule 13a-14(b) and Section 1350 of Chapter 63 of Title 18 of the United States Code.
13.2	Certification of Chief Financial Officer Required by Rule 13a-14(b) and Section 1350 of Chapter 63 of Title 18 of the United States Code.

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SIGNATURES

The registrant hereby certifies that it meets all of the requirements for filing on Form 20-F and that it has duly caused and authorized the undersigned to sign this annual report on its behalf.

SINOPEC SHANGHAI PETROCHEMICAL COMPANY LIMITED

Date: June 25, 2008

/s/ RONG GUANGDAO
Rong Guangdao, Chairman

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SINOPEC SHANGHAI PETROCHEMICAL COMPANY LIMITED

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(1) The financial statements of Shanghai Secco Petrochemical Company Limited, an investee of Sinopec Shanghai Petrochemical Company Limited, are included in this Annual Report on Form 20-F of Sinopec Shanghai Petrochemical Company Limited to comply with Rule 3-09 of Regulation S-X of the U.S. Federal Securities Laws.

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Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders of

Sinopec Shanghai Petrochemical Company Limited:

We have audited the accompanying consolidated balance sheets of Sinopec Shanghai Petrochemical Company Limited and subsidiaries (the Group) as of December 31, 2006 and 2007, and the related consolidated statements of income, equity, and cash flows for each of the years in the three-year period ended December 31, 2007. These consolidated financial statements are the responsibility of the Group s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. 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 consolidated financial statements referred to above present fairly, in all material respects, the financial position of Sinopec Shanghai Petrochemical Company Limited and subsidiaries as of December 31, 2006 and 2007, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2007, in conformity with International Financial Reporting Standards as issued by the International Accounting Standards Board.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Group s internal control over financial reporting as of December 31, 2007, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated April 7, 2008 expressed an unqualified opinion on the effectiveness of the Group s internal control over financial reporting.

KPMG

Hong Kong, China

April 7, 2008

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SINOPEC SHANGHAI PETROCHEMICAL COMPANY LIMITED

AND SUBSIDIARIES

Consolidated Balance Sheets

As of December 31, 2006 and 2007

(Amounts in thousands)

	Note	December 31, 2006 Renminbi	December 31, 2007 Renminbi
Assets			
Current assets:			
Cash and cash equivalents		894,650	893,165
Inventories	14	4,163,256	5,197,849
Amounts due from related companies	28	695,286	515,222
Trade debtors, net	15	358,690	212,257
Bills receivable		1,212,110	1,757,131
Other debtors and prepayments	16	239,114	262,918
Income tax recoverable			98,222
Total current assets		7,563,106	8,936,764
Non-current assets:			
Property, plant and equipment, net	17	13,359,862	14,977,237
Investment property	18	501,904	512,793
Construction in progress	19	2,008,447	962,313
Lease prepayments and other assets		603,290	649,337
Interest in associates and jointly controlled entities	20	2,787,795	3,068,135
Other investments	21	528,931	714,427
Deferred tax assets	11	30,310	9,629
Goodwill	22	22,415	22,415
Total non-current assets		19,842,954	20,916,286
Total assets		27,406,060	29,853,050
Liabilities and Shareholders Equity			
Current liabilities:			
Loans and borrowings	23	4,270,337	4,091,969
Amounts due to related companies	28	599,773	904,870
Trade creditors		1,385,577	1,504,454
Bills payable		7,026	300,575
Accrued expenses and other creditors		732,951	1,442,284
Income tax payable		34,386	17,580
Total current liabilities		7,030,050	8,261,732
Non-current liabilities:			
Loans and borrowings	23	1,063,654	639,289
Total non-current liabilities		1,063,654	639,289

Total liabilities		8,093,704	8,901,021
Shareholders equity:			
Share capital	24	7,200,000	7,200,000
Share premium and reserves	25	11,776,343	13,448,038
Total equity attributable to equity shareholders of the Company		18,976,343	20,648,038
Minority interests		336,013	303,991
Total equity		19,312,356	20,952,029
Total liabilities and shareholders equity		27,406,060	29,853,050

See accompanying notes to consolidated financial statements.

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SINOPEC SHANGHAI PETROCHEMICAL COMPANY LIMITED

AND SUBSIDIARIES

Consolidated Statements of Income

Years ended December 31, 2005, 2006 and 2007

(Amounts in thousands, except per share data)

		Years ended December 31,		
		2005	**2006**	**2007**
	Note	**Renminbi**	**Renminbi**	**Renminbi**
Sales		45,955,903	50,599,485	55,328,384
Less Sales taxes and surcharges		(765,689)	(681,362)	(1,073,695)
Net sales		45,190,214	49,918,123	54,254,689
Other income	4	632,820	282,142	93,900
Cost of sales	5	(42,887,742)	(49,182,232)	(52,646,516)
Gross profit		2,935,292	1,018,033	1,702,073
Selling and administrative expenses		(444,449)	(521,990)	(504,712)
		2,490,843	496,043	1,197,361
Other operating income	6	238,611	297,394	216,553
Other operating expenses	7	(201,494)	(240,530)	(521,258)
Income from operations		2,527,960	552,907	892,656
Financial income		96,776	137,997	82,280
Financial expenses		(276,174)	(303,386)	(260,206)
Net financing costs	9	(179,398)	(165,389)	(177,926)
Investment income	10			770,725
Share of (losses) / profits of associates and jointly controlled entities		(60,968)	576,682	665,897
Income before income tax		2,287,594	964,200	2,151,352
Income tax	11	(366,300)	(53,238)	(468,216)
Net income		1,921,294	910,962	1,683,136
Attributable to:				
Equity shareholders of the Company		1,850,449	844,407	1,634,080
Minority interests		70,845	66,555	49,056
Net income		1,921,294	910,962	1,683,136
Basic earnings per share	12	RMB 0.26	RMB 0.12	RMB 0.23
Dividends attributable to the year	13	720,000	288,000	648,000

See accompanying notes to consolidated financial statements.

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SINOPEC SHANGHAI PETROCHEMICAL COMPANY LIMITED

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Consolidated Statements of Equity

For the years ended December 31, 2005, 2006 and 2007

(Amounts in thousands)

	Note	Share capital Renminbi	Share premium Renminbi	Reserves Renminbi	Retained earnings Renminbi	Total equity attributable to equity shareholders of the Company Renminbi	Minority interests Renminbi	Total Renminbi
Balances at January 1, 2005		7,200,000	2,420,841	4,051,672	4,744,476	18,416,989	373,084	18,790,073
Derecognition of negative goodwill					2,549	2,549		2,549
Balances at January 1, 2005 (adjusted)		7,200,000	2,420,841	4,051,672	4,747,025	18,419,538	373,084	18,792,622
Profit attributable to shareholders					1,850,449	1,850,449	70,845	1,921,294
Total recognized income and expense					**1,850,449**	**1,850,449**	**70,845**	**1,921,294**
Appropriation	25			340,926	(340,926)			
Dividends approved in respect of previous year	13(b)				(1,440,000)	(1,440,000)		(1,440,000)
Dividends paid to minority shareholders							(96,476)	(96,476)
Balances at December 31, 2005		7,200,000	2,420,841	4,392,598	4,816,548	18,829,987	347,453	19,177,440
Balances at January 1, 2006		7,200,000	2,420,841	4,392,598	4,816,548	18,829,987	347,453	19,177,440
Unrealized gain for changes in fair values of available-for-sale securities, net of deferred tax				21,949		21,949		21,949
Total income and expense recognized directly in equity				**21,949**		**21,949**		**21,949**
Profit attributable to shareholders					844,407	844,407	66,555	910,962
Total recognized income and expense				**21,949**	**844,407**	**866,356**	**66,555**	**932,911**
Appropriation	25			73,685	(73,685)			
Dividends approved in respect of previous year	13(b)				(720,000)	(720,000)		(720,000)
Dividends paid to minority shareholders							(77,995)	(77,995)
Balances at December 31, 2006		7,200,000	2,420,841	4,488,232	4,867,270	18,976,343	336,013	19,312,356
Balances at January 1, 2007		7,200,000	2,420,841	4,488,232	4,867,270	18,976,343	336,013	19,312,356
Unrealized gains for changes in fair value of available-for-sale securities, net of deferred tax				842,002		842,002		842,002
Transfer to profit or loss on disposal of available-for-sale securities, net of deferred tax				(516,387)		(516,387)		(516,387)
Total income and expense recognized directly in equity				**325,615**		**325,615**		**325,615**
Profit attributable to shareholders					1,634,080	1,634,080	49,056	1,683,136
Total recognized income and expense				**325,615**	**1,634,080**	**1,959,695**	**49,056**	**2,008,751**
Adjustment to Reserves	25			(36,733)	36,733			
Appropriation	25			192,434	(192,434)			
Dividends approved in respect of previous year	13(b)				(288,000)	(288,000)		(288,000)
Dividends paid to minority shareholders							(81,078)	(81,078)

Balances at December 31, 2007	7,200,000	2,420,841	4,969,548	6,057,649	20,648,038	303,991	20,952,029

See accompanying notes to consolidated financial statements.

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SINOPEC SHANGHAI PETROCHEMICAL COMPANY LIMITED

AND SUBSIDIARIES

Consolidated Statements of Cash Flows

For the years ended December 31, 2005, 2006 and 2007

(Amounts in thousands)

		Years ended December 31,		
		2005 Renminbi	2006 Renminbi	2007 Renminbi
Net cash generated from operating activities	(a)	3,943,578	1,696,615	1,441,998
Cash flows from investing activities:				
Interest income received		39,631	56,827	46,421
Investment income received		79,688	47,596	393,062
Capital expenditure		(1,142,927)	(2,008,779)	(2,134,123)
Proceeds from disposal of property, plant and equipment		131,845	254,843	68,708
Purchase of investments and addition of interests in associates		(347,170)	(54,206)	
Proceeds from disposal of investments		45,691	351,178	1,114,701
Proceeds from maturities of time deposits		4,000		
Net cash used in investing activities		(1,189,242)	(1,352,541)	(511,231)
Cash flows from financing activities:				
Net proceeds from issue of corporate bonds			2,977,800	
Proceeds from loans		9,836,199	13,936,126	17,605,887
Repayment of loans		(11,393,941)	(15,910,127)	(16,166,938)
Redemption of corporate bonds			(1,000,000)	(2,000,000)
Dividends paid to equity shareholders of the Company		(1,440,000)	(720,000)	(288,000)
Dividends paid to minority shareholders		(96,476)	(77,995)	(81,078)
Net cash used in financing activities		(3,094,218)	(794,196)	(930,129)
Net (decrease) / increase in cash and cash equivalents		(339,882)	(450,122)	638
Cash and cash equivalents at beginning of year		1,690,500	1,347,237	894,650
Effect of foreign exchange rate changes		(3,381)	(2,465)	(2,123)
Cash and cash equivalents at end of year		1,347,237	894,650	893,165

See accompanying notes to consolidated financial statements.

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SINOPEC SHANGHAI PETROCHEMICAL COMPANY LIMITED

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Notes to the Consolidated Statements of Cash Flows

For the years ended December 31, 2005, 2006 and 2007

(Amounts in thousands)

(a) Reconciliation of income before income tax and minority interests to cash generated from operations

	Years ended December 31,		
	2005 Renminbi	2006 Renminbi	2007 Renminbi
Income before income tax	2,287,594	964,200	2,151,352
Interest income	(39,631)	(56,827)	(46,421)
Income from unlisted investments	(101,350)	(97,179)	(122,709)
Share of losses / (profits) of associates and jointly controlled entities	60,968	(576,682)	(665,897)
Transfer from equity on disposal of available-for-sale securities			(770,725)
Interest expense	276,174	303,386	260,206
Depreciation for property, plant and equipment	1,692,213	1,810,990	1,687,435
Depreciation for investment property	12,847	12,678	14,879
Impairment losses for property, plant and equipment		50,000	200,295
Amortization of lease prepayments	13,441	29,400	16,972
Unrealized exchange gain	(53,174)	(78,841)	(16,535)
(Gain) / loss on disposal of property, plant and equipment	(15,298)	(19,569)	44,045
Increase in inventories	(387,229)	(48,278)	(1,034,593)
Decrease / (increase) in debtors, bills receivable and deposits	1,170,872	(585,256)	(387,688)
(Decrease) / increase in creditors, other creditors and bills payable	(33,850)	345,628	643,342
(Decrease) / increase in balances with related companies	(207,470)	(1,870)	485,161
Cash generated from operations	4,676,107	2,051,780	2,459,119
Interest paid	(301,537)	(344,064)	(342,574)
Income tax paid	(430,992)	(63,386)	(674,547)
Income tax refund		52,285	
Net cash generated from operating activities	3,943,578	1,696,615	1,441,998

See accompanying notes to consolidated financial statements.

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SINOPEC SHANGHAI PETROCHEMICAL COMPANY LIMITED

AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(All Renminbi amounts in thousands, except per share data and except otherwise stated)

1. ORGANIZATION, PRINCIPAL ACTIVITIES AND BASIS OF PREPARATION

Sinopec Shanghai Petrochemical Company Limited (the Company), formerly Shanghai Petrochemical Company Limited, was established in the People s Republic of China (the PRC or the State) on June 29, 1993 as a joint stock limited company to hold the assets and liabilities of the production divisions and certain other units of the Shanghai Petrochemical Complex (SPC). SPC was established in 1972 and owned and managed the production divisions as well as the related housing, stores, schools, hotels, transportation, hospitals and other municipal services in the community of Jinshanwei.

The Company s former controlling shareholder, China Petrochemical Corporation (CPC) completed its reorganization on February 25, 2000 in which its interests in the Company were transferred to its subsidiary, China Petroleum & Chemical Corporation (Sinopec Corp). In connection with the reorganization, CPC transferred its 4,000,000,000 of the Company s state owned legal shares, which represented 55.56 per cent of the issued share capital of the Company, to Sinopec Corp. On October 12, 2000, the Company changed its name to Sinopec Shanghai Petrochemical Company Limited.

The principal activity of the Company and its subsidiaries (the Group) is the processing of crude oil into petrochemical products for sale. The Group is one of the largest petrochemical enterprises in the PRC, with a highly integrated petrochemical complex which processes crude oil into a broad range of synthetic fibers, resins and plastics, intermediate petrochemicals and petroleum products. Substantially all of its products are sold in the PRC domestic market.

At December 31, 2007, the following list contains the particulars of subsidiaries, all of which are limited companies established and operated in the PRC, which principally affected the results and assets of the Group.

Company	Registered Capital		Percentage of equity held by the Company %	Percentage of equity held by subsidiaries %	Principal activities
Shanghai Petrochemical Investment Development Company Limited	RMB	800,000	100		Investment management
China Jinshan Associated Trading Corporation	RMB	25,000	67.33		Import and export of petrochemical products and equipment
Shanghai Jinchang Engineering Plastics Company Limited	US$	4,750		50.38	Production of polypropylene compound products
Shanghai Golden Phillips Petrochemical Company Limited	US$	50,000		60	Production of polypropylene products
Zhejiang Jin Yong Acrylic Fibre Company Limited	RMB	250,000	75		Production of acrylic fiber products
Shanghai Petrochemical Enterprise Development Company Limited	RMB	455,000	100		Investment management
Shanghai Golden Conti Petrochemical Company Limited	RMB	545,776		100	Production of petrochemical products

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SINOPEC SHANGHAI PETROCHEMICAL COMPANY LIMITED

AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

(All Renminbi amounts in thousands, except per share data and except otherwise stated)

None of the subsidiaries have issued any debt securities.

The consolidated financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB), and interpretations issued by the International Financial Reporting Interpretations Committee of the IASB.

The consolidated financial statements are prepared on the historical cost basis except for certain property, plant and equipment which are modified by the revaluation and the available-for-sale equity securities which are stated at fair value. The accounting policies have been consistently applied by the Group.

The preparation of financial statements in conformity with IFRS requires management to make judgements, estimates and assumptions that affect the application of policies and reported amounts of assets and liabilities, income and expenses. The estimates and associated assumptions are based on historical experience and various other factors that are believed to be reasonable under the circumstances, the results of which form the basis of making the judgements about carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

The estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognized in the period in which the estimate is revised if the revision affects only that period, or in the period of the revision and future periods if the revision affects both current and future periods.

Key assumptions and estimation made by management in the application of IFRS that have significant effect on the financial statements and have a significant risk of causing a material adjustment to the carrying amount of assets and liabilities in the next financial year are disclosed in note 30.

2. PRINCIPAL ACCOUNTING POLICIES

(a) Basis of consolidation

(i) Subsidiaries and minority interests

The consolidated financial statements of the Group include the financial statements of the Company and all of its principal subsidiaries. Subsidiaries are entities controlled by the Group. Control exists when the Group has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. In assessing control, potential voting rights that presently are exercisable are taken into account.

An investment in a subsidiary is consolidated into the consolidated financial statements from the date that control commences until the date that control ceases. Intra-group balances and transactions and any unrealized profits arising from intra-group transactions are eliminated in full in preparing the consolidated financial statements. Unrealized losses resulting from intra-group transactions are eliminated in the same way as unrealized gains but only to the extent that there is no evidence of impairment.

Minority interests represent the portion of the net assets of subsidiaries attributable to equity interests that are not owned by the Company, whether directly or indirectly through subsidiaries, and in respect of which the Group has not agreed any additional terms with the holders of those interests which would result in the Group as a whole having a contractual obligation in respect of those interests that meets the definition of a financial liability. Minority interests are presented in the consolidated balance sheet within equity, separately from equity attributable to the equity

SINOPEC SHANGHAI PETROCHEMICAL COMPANY LIMITED

AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

(All Renminbi amounts in thousands, except per share data and except otherwise stated)

shareholders of the Company. Minority interests in the results of the Group are presented on the face of the consolidated income statement as an allocation of the total profit or loss for the year between minority interests and the equity shareholders of the Company.

(ii) Associates and jointly controlled entities

An associate is an entity in which the Group or the Company has significant influence, but not control or joint control, over its management, including participation in the financial and operating policy decisions.

A jointly controlled entity is an entity which operates under a contractual arrangement between the Group or Company and other parties, where the contractual arrangement establishes that the Group or Company and one or more of the other parties share joint control over the economic activity of the entity.

An investment in an associate or a jointly controlled entity is accounted for in the consolidated financial statements under the equity method and is initially recorded at cost and adjusted thereafter for the post acquisition change in the Group s share of the associate s or the jointly controlled entity s net assets.

When the Group s share of losses exceeds its interest in the associate or the jointly controlled entity, the Group s interest is reduced to nil and recognition of further losses is discontinued except to the extent that the Group has incurred legal or constructive obligations or made payments on behalf of the associate or the jointly controlled entity.

Unrealized profits and losses resulting from transactions between the Group and its associates and jointly controlled entities are eliminated to the extent of the Group s interest in the associate or jointly controlled entity, except where unrealized losses provide evidence of an impairment of the asset transferred, in which case they are recognized immediately in the profit or loss.

(b) Goodwill

Goodwill represents the excess of the cost of a business combination or an investment in an associate or a jointly controlled entity over the Group s interest in the net fair value of the acquiree s identifiable assets, liabilities and contingent liabilities.

Goodwill is stated at cost less any accumulated impairment losses. Goodwill is allocated to cash-generating units and is tested annually for impairment (see note 2(t)). In respect of associates or jointly controlled entities, the carrying amount of goodwill is included in the carrying amount of the interest in the associate or jointly controlled entities.

Any excess of the Group s interest in the net fair value of the acquiree s identifiable assets, liabilities and contingent liabilities over the cost of a business combination or an investment in an associate or a jointly controlled entity is recognized immediately in profit or loss.

(c) Other investments in equity securities

The Group s policies for investments in equity securities, other than investments in associates and jointly controlled entities, are as follows:

Investments in available-for-sale equity securities are carried at fair value with any change in fair value recognized directly in equity. When these investments are derecognized or impaired, the cumulative gain or loss previously recognized directly in equity is recognized as investment income in profit or

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SINOPEC SHANGHAI PETROCHEMICAL COMPANY LIMITED

AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

(All Renminbi amounts in thousands, except per share data and except otherwise stated)

loss. Investments in equity securities, that do not have a quoted market price in an active market and whose fair value cannot be reliably measured are recognized in the balance sheet at cost less impairment losses (see note 2(t)).

(d) Property, plant and equipment

Property, plant and equipment are stated in the balance sheet at cost or valuation (see note 17) less accumulated depreciation and impairment losses (see note 2(t)). Revaluations are performed with sufficient regularity to ensure that the carrying amount of these assets does not differ materially from that which would be determined using fair value at balance sheet date.

The cost of self-constructed assets includes the cost of materials, direct labor, the initial estimate, where relevant, of the costs of dismantling and removing the items and restoring the site on which they are located, and an appropriate proportion of production overheads and borrowing costs.

Gains or losses arising from the retirement or disposal of items of property, plant and equipment are determined as the difference between the net disposal proceeds and the carrying amount of the items and are recognized as other operating income or expenses in profit or loss on the date of retirement or disposal.

Depreciation is calculated to write off the costs / revalued amount of property, plant and equipment over their estimated useful lives on a straight-line basis, after taking into account their estimated residual values, as follows:

Buildings	15 to 40 years
Plant, machinery, equipment and others	5 to 26 years

Where parts of an item of property, plant and equipment have different useful lives, the cost or valuation of the item is allocated on a reasonable basis between the parts and each part is depreciated separately. Both the useful life of an asset and its residual value are reviewed annually.

(e) Investment property

Investment properties are properties which are owned or held under a leasehold interest either to earn rental income and / or for capital appreciation.

Investment properties are stated in the balance sheet at cost less accumulated depreciation. Depreciation is provided over their estimated useful lives on a straight-line basis, after taking into account their estimated residual values. Estimated useful life of the investment property is 40 years.

(f) Lease prepayments and other assets

Lease prepayments and other assets represent prepayments for land use rights and catalysts used in production. They are carried at cost less accumulated amortization and impairment losses (see note 2(t)). The cost of lease prepayments and other assets are charged to cost of sales on a straight-line basis over the respective periods of the rights and the estimated useful lives of the catalysts.

(g) Construction in progress

Construction in progress represents buildings, various plant and equipment under construction and pending installation, and is stated at cost less government grants that compensate the Company for the cost of construction, and impairment losses (see note 2(t)). Cost comprises direct costs of construction as well as interest charges, and foreign exchange differences on related borrowed funds to the extent that they are regarded as an adjustment to interest charges, during the period of construction.

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SINOPEC SHANGHAI PETROCHEMICAL COMPANY LIMITED

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Notes to Consolidated Financial Statements (Continued)

(All Renminbi amounts in thousands, except per share data and except otherwise stated)

Construction in progress is transferred to property, plant and equipment when the asset is substantially ready for its intended use.

No depreciation is provided in respect of construction in progress.

(h) Inventories

Inventories, other than spare parts and consumables, are carried at the lower of cost and net realizable value. Cost is calculated using the weighted average cost formula and comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition. Net realizable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

When inventories are sold, the carrying amount of the inventories is recognized as an expense in the period in which the related revenue is recognized. The amount of any write-down of inventories to net realizable value and all losses of inventories are recognized as cost of sales in the period the write-down or loss occurs. The amount of any reversal of any write-down of inventories is recognized as a reduction in the amount of inventories recognized as an expense in the period in which the reversal occurs.

Spare parts and consumables are stated at cost less any provision for obsolescence.

(i) Trade receivables, bills and other receivables

Trade receivables, bills and other receivables are initially recognized at fair value and thereafter stated at amortized cost less allowance for impairment of doubtful debts (see note 2(t)), except where the receivables are interest-free loans made to related parties without any fixed repayment terms or the effect of discounting would be immaterial. In such cases, the receivables are stated at cost less allowance for impairment of doubtful debts.

Trade receivables, bills and other receivables are derecognized if the Group s contractual rights to the cash flows from these financial assets expire or if the Group transfers these financial assets to another party without retaining control or substantially all risks and rewards of the assets.

(j) Interest-bearing borrowings

Interest-bearing borrowings are recognized initially at fair value less attributable transaction costs. Subsequent to initial recognition, interest-bearing borrowings are stated at amortized cost with any difference between the amount initially recognized and redemption value being recognized in profit or loss over the period of the borrowings, together with any interest and fees payable, using the effective interest method.

(k) Trade and other payables

Trade and other payables are initially recognized at fair value and thereafter stated at amortized cost unless the effect of discounting would be immaterial, in which case they are stated at cost.

(l) Cash and cash equivalents

Cash and cash equivalents comprise cash at bank and on hand and time deposits with banks and other financial institutions with an initial term of less than three months at acquisition. Cash equivalents are stated at cost, which approximates fair value.

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SINOPEC SHANGHAI PETROCHEMICAL COMPANY LIMITED

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Notes to Consolidated Financial Statements (Continued)

(All Renminbi amounts in thousands, except per share data and except otherwise stated)

(m) Translation of foreign currencies

Foreign currency transactions during the year are translated into Renminbi at the applicable exchange rates ruling at the transaction dates.

Monetary assets and liabilities denominated in foreign currencies are translated into Renminbi at rates quoted by the People s Bank of China at the balance sheet date. Non-monetary assets and liabilities denominated in foreign currencies, which are stated at historical cost, are translated into Renminbi at the foreign exchange rate ruling at the date of the transaction.

Foreign currency translation differences relating to funds borrowed to finance the construction of property, plant and equipment to the extent that they are regarded as an adjustment to interest costs are capitalized during the construction period. All other exchange gains and losses are recognized as net financial costs in profit or loss.

(n) Revenue recognition

Revenues associated with the sale of petroleum and chemical products are recognized in profit or loss when the significant risks and rewards of ownership have been transferred to the buyer. Revenue excludes value added tax and is after deduction of any trade discounts and returns. No revenue is recognized if there are significant uncertainties regarding recovery of the consideration due to the possible return of goods, or when the amount of revenue and the costs incurred or to be incurred in respect of the transaction cannot be measured reliably.

Revenue from services rendered is recognized in profit or loss upon performance of the services.

Dividend income is recognized as other operating income in profit or loss on the date the shareholder s right to receive payments is established.

Gains or losses arising from the retirement or disposal of unlisted investments are determined as the difference between the net disposal proceeds and the carrying amount of the investment and are recognized as other operating income or expenses in profit or loss on the date of retirement or disposal.

Rental income from investment property is recognized as other operating income in profit or loss on a straight-line basis over the term of the lease.

(o) Government grants

Government grants are recognized in the balance sheet initially when there is reasonable assurance that they will be received and that the Group will comply with the conditions attaching to them. Grants that compensate the Group for expenses incurred are recognized as revenue in profit or loss on a systematic basis in the same periods in which the expenses are incurred. Grants that compensate the Group for the cost of an asset are deducted in arriving at the carrying amount of the asset and consequently are recognized in profit or loss over the useful life of the asset.

(p) Net financing costs

Net financing costs comprise interest payable on borrowings calculated using the effective interest rate method, interest income on bank deposits, foreign exchange gains and losses and bank charges.

Interest income from bank deposits is recognized in profit or loss as it accrues using the effective interest method.

All interest and other costs incurred in connection with borrowings are expensed as incurred as part of net financing costs, except to the extent that they are capitalized as being directly attributable to the

SINOPEC SHANGHAI PETROCHEMICAL COMPANY LIMITED

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Notes to Consolidated Financial Statements (Continued)

(All Renminbi amounts in thousands, except per share data and except otherwise stated)

acquisition or construction of an asset which necessarily takes a substantial period of time to get ready for its intended use or sale.

(q) Repairs and maintenance expenses

Repairs and maintenance expenses are charged to cost of sales in the profit or loss as and when they are incurred.

(r) Research and development costs

Research and development costs comprise all costs that are directly attributable to research and development activities or that can be allocated on a reasonable basis to such activities. Because of the nature of the Group s research and development activities, no development costs satisfy the criteria for the recognition of such costs as an asset. Both research and development costs are therefore recognized as cost of sales in the period in which they are incurred.

(s) Employee benefits

The contributions payable under the Group s retirement plans are charged to the profit or loss on an accrual basis according to the contribution determined by the plans. Further information is set out in note 27.

Termination benefits, recorded as employee reduction expenses in the profit or loss, are recognized when, and only when, the Group demonstrably commits itself to terminate employment or to provide benefits as a result of voluntary redundancy by having a detailed formal plan which is without realistic possibility of withdrawal.

(t) Impairment loss

(i) Impairment of trade accounts receivable, bills and other receivables and investments in equity securities other than investments in associates and jointly controlled entities, that do not have a quoted market price in an active market (see note 2(t) (ii)) are accounted as follows:

Trade accounts receivable, bills and other receivables and investments in equity securities other than investments in associates and jointly controlled entities, that do not have a quoted market price in an active market are reviewed at each balance sheet date to determine whether there is objective evidence of impairment. If any such evidence exists, an impairment loss is determined and recognized as cost of sales or other operating expenses. The impairment loss is measured as the difference between the asset s carrying amount and the estimated future cash flows, discounted at the current market rate of return for a similar asset where the effect of discounting is material. Impairment losses for trade accounts receivable, bills and other receivables are reversed if in a subsequent period the amount of the impairment loss decreases. Impairment losses for investments in equity securities are not reversed.

(ii) Impairment of other long-lived assets is accounted as follows:

The carrying amounts of other long-lived assets, including property, plant and equipment, construction in progress, lease prepayment, other assets and investments in associates and jointly controlled entities, are reviewed periodically in order to assess whether the recoverable amounts have declined below the carrying amounts. These assets are tested for impairment whenever events or changes in circumstances indicate that their recorded carrying amounts may not be recoverable. When such a decline has occurred, the carrying amount is reduced to the recoverable amount. For goodwill, the recoverable amount is estimated at each balance sheet date.

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The recoverable amount is the greater of the fair value less costs to sell and the value in use. In determining the value in use, expected future cash flows generated by the asset are discounted to their present value using a pre-tax discount rate that reflects current market assessments of time value of money and the risks specific to the asset. Where an asset does not generate cash inflows largely independent of those from other assets, the recoverable amount is determined for the smallest group of assets that generates cash inflows independently (i.e. a cash-generating unit).

The amount of the reduction is recognized as other operating expenses in profit or loss unless the asset is carried at revalued amount for which an impairment loss is recognized directly against any related revaluation reserve to the extent that the impairment loss does not exceed the amount held in the revaluation reserve for that same asset. Impairment losses recognized in respect of cash-generating units are allocated first to reduce the carrying amount of any goodwill allocated to the cash-generating unit and then, to reduce the carrying amount of the other assets in the unit on a pro rata basis, except that the carrying value of an asset will not be reduced below its individual fair value less costs to sell, or value in use, if determinable.

The Group assesses at each balance sheet date whether there is any indication that an impairment loss recognized for an asset, except in the case of goodwill, in prior years may no longer exist. An impairment loss is reversed if there has been a favorable change in the estimates used to determine the recoverable amount. A subsequent increase in the recoverable amount of an asset, when the circumstances and events that led to the write-down or write-off cease to exist, is recognized as income unless the asset is carried at revalued amount. Reversal of an impairment loss on a revalued asset is credited to the revaluation reserve except for impairment loss which was previously recognized as an expense in the income statement; a reversal of such impairment loss is recognized as an income. The reversal is reduced by the amount that would have been recognized as depreciation had the write-down or write-off not occurred. An impairment loss in respect of goodwill is not reversed.

(u) Dividends payable

Dividends are recognized as a liability in the period in which they are declared.

(v) Income tax

Income tax expense comprises current and deferred tax. Income tax expense is recognized in profit or loss except to the extent that it relates to items recognized directly in equity, in which case it is recognized in equity.

Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantially enacted at the balance sheet date, and any adjustment to tax payable in respect of previous years.

Deferred tax is provided using the balance sheet liability method, providing for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes, except differences relating to goodwill not deductible for tax purposes and the initial recognition of assets or liabilities which affect neither accounting nor taxable income. The amount of deferred tax provided is based on the expected manner of realization or settlement of the carrying amount of assets and liabilities, using tax rates enacted or substantially enacted at the balance sheet date. The effect on deferred tax of any changes in tax rates is charged or credited to the profit or loss, except for the effect of a change in tax rate on the carrying amount of deferred tax assets and

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liabilities which were previously charged or credited directly to equity upon initial recognition, in such case the effect of a change in tax rate is also charged or credited to equity.

A deferred tax asset is recognized only to the extent that it is probable that future taxable income will be available against which the assets can be utilized. Deferred tax assets are reduced to the extent that it is no longer probable that the related tax benefit will be realized.

(w) Provisions and contingent liabilities

Provisions are recognized for liabilities of uncertain timing or amount when the Group has a legal or constructive obligation arising as a result of a past event, it is probable that an outflow of economic benefits will be required to settle the obligation and a reliable estimate can be made. Where the time value of money is material, provisions are stated at the present value of the expenditure expected to settle the obligation.

Where it is not probable that an outflow of economic benefits will be required, or the amount cannot be estimated reliably, the obligation is disclosed as a contingent liability, unless the probability of outflow of economic benefits is remote. Possible obligations, whose existence will only be confirmed by the occurrence or non-occurrence of one or more future events are also disclosed as contingent liabilities unless the probability of outflow of economic benefits is remote.

(x) Related parties

Parties are considered to be related to the Group if the Group has the ability, directly or indirectly, to control or jointly control the party or exercise significant influence over the party in making financial and operating decisions, or vice versa, or where the Group and the party are subject to common control or common significant influence. Related parties may be individuals (being members of key management personnel, significant shareholders and / or their close family members) or other entities and include entities which are under the significant influence of related parties of the Group where those parties are individuals, and post-employment benefit plans which are for the benefit of employees of the Group or of any entity that is a related party of the Group.

(y) Segment reporting

A segment is a distinguishable component of the Group that is engaged in providing products or services and is subject to risks and rewards that are different from those of other segments.

The Group evaluates performance based on operating profits before income tax and non-operating income and expenses. Certain administrative expenses are allocated based on the percentage of sales.

Inter-segment transfer pricing is based on cost plus an appropriate margin, as specified by Group policy.

Segment results, assets and liabilities include items directly attributable to a segment as well as those that can be allocated on a reasonable basis. Unallocated items mainly comprise income-earning assets and revenue, interest-bearing loans, borrowings and expenses, and corporate assets and expenses.

Segment capital expenditure is the total cost incurred during the year to acquire segment assets that are expected to be used for more than one period.

3. CHANGES IN ACCOUNTING POLICIES

The IASB has issued a number of new and revised IFRS and Interpretations that are first effective or available for early adoption for the current accounting period of the Group.

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There have been no significant changes to the accounting policies applied in these financial statements for the years presented as a result of these developments. However, as result of the adoption of IFRS 7, *Financial instruments: Disclosures* and the amendment to IAS 1, *Presentation of financial statements: Capital disclosures,* there have been some additional disclosures provide as follows:

As a result of the adoption of IFRS 7, the financial statements include expanded disclosure about the significance of the Group s financial instrument and the nature and extent of risks arising from those instruments, compared with the information previously required to be disclosed by IAS 32, *Financial instruments: Disclosure and presentation.*

These disclosures are provided throughout these financial statements, in particular in note 31.

The amendment to IAS 1 introduces additional disclosure requirements to provide information about the level of capital and the Group s objectives, policies and processes for managing capital. These new disclosures are set out in note 24.

Both IFRS 7 and the amendment to IAS 1 do not have any material impact on the classification, recognition and measurement of the amounts recognized in the financial instruments.

The Group has not applied any new standard or interpretation that is not yet effective for the current accounting period (see note 32).

4. OTHER INCOME

During the year ended December 31, 2007, the Group recognized a grant income of RMB94 million (2006: RMB282 million; 2005: RMB633 million). These grants were for compensation of losses incurred due to the distortion of the correlation of domestic refined petroleum product prices and the crude oil prices, and the measures taken by the Group to stabilize the supply in the PRC refined petroleum product market during the respective year. There are no unfilled conditions and other contingencies attached to the receipts of these grants. There is no assurance that the Group will continue to receive such grant in the future.

5. COST OF SALES

Cost of sales represents:

	Years ended December 31,		
	2005	**2006**	**2007**
Costs of raw materials			
crude oil	29,576,407	33,307,637	34,456,334
other ancillary materials	6,953,588	7,901,778	10,022,551
Depreciation	1,688,110	1,806,444	1,681,874
Repairs and maintenance	896,022	874,461	1,023,794
Research and development	54,451	51,610	53,548
Employer s pension costs			
municipal retirement scheme costs	165,046	207,071	197,191

supplementary retirement scheme costs	56,917	61,692	55,048
Staff costs	1,168,461	1,210,266	1,209,035
Amortization of lease prepayments	13,441	29,400	16,972
Others	2,315,299	3,731,873	3,930,169
	42,887,742	49,182,232	52,646,516

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6. OTHER OPERATING INCOME

Other operating income represents:

	Years ended December 31, 2005	2006	2007
Income from rendering of services	57,421	35,068	36,282
Gain on disposal of property, plant and equipment	42,233	83,386	7,745
Rental income from investment property	18,681	42,643	40,021
Amortization of deferred income	11,518	23,033	
Income from unlisted investments	101,350	97,179	122,709
Others	7,408	16,085	9,796
	238,611	297,394	216,553

7. OTHER OPERATING EXPENSES

Other operating expenses represent:

	Years ended December 31, 2005	2006	2007
Loss on disposal of property, plant and equipment	26,935	63,817	51,790
Employee reduction expenses (note 8)	109,410	83,603	208,013
Impairment losses on property, plant and equipment (note (i) and 17)		50,000	200,295
Donations	8,079	380	14,250
Others	57,070	42,730	46,910
	201,494	240,530	521,258

(i) Impairment loss recognized on property, plant and equipment, primarily relates to the assets of synthetic fibres segment, was RMB181,681 (2006: RMB50,000; 2005: RMB nil) for the year ended December 31, 2007. The impairment loss relates to certain synthetic fibres facilities that have reduced volume of production during the year. In measuring the amounts of impairment charges, the carrying amounts of these assets were compared to the present value of the expected future cash flows of the assets, as well as information about their fair values less costs to sell.

8. EMPLOYEE REDUCTION EXPENSES

In accordance with the Group s voluntary employee reduction plan, the Group recorded employee reduction expenses of RMB208,013 during the year ended December 31, 2007 (2006: RMB83,603; 2005: RMB109,410) payable in cash in respect of the voluntary resignation of approximately 2,622 employees (1,280 employees in 2006 and 1,645 employees in 2005).

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9. NET FINANCING COSTS

Net financing costs represent:

	Years ended December 31,		
	2005	2006	2007
Interest income	(39,631)	(56,827)	(46,421)
Net foreign exchange gain	(57,145)	(81,170)	(35,859)
Financial income	(96,776)	(137,997)	(82,280)
Interest on loans and borrowings	309,357	367,716	329,643
Less: borrowing costs capitalized as construction in progress	(33,183)	(64,330)	(69,437)
Financial expenses	276,174	303,386	260,206
Net financing costs	179,398	165,389	177,926

Interest costs capitalized as a component of the cost of construction in progress amounted to RMB33,183, RMB64,330 and RMB69,437 in 2005, 2006 and 2007 respectively. Interest costs have been capitalized at a rate of 5.27%-7.47% per annum (2006: 5.18%-5.85%; 2005: 2.98%-5.56%) for construction in progress.

10. INVESTMENT INCOME

Investment income represents the gain on disposal of available-for-sale securities transferred from equity during the year ended December 31, 2007 (2006: Nil; 2005: Nil).

11. TAXATION

(a) Taxation in the consolidated income statement represents:

	Years ended December 31,		
	2005	2006	2007
Current tax			
Provision for income tax for the year	340,532	71,183	557,078
(Over) / under-provision in respect of prior years		(6,911)	2,439
Deferred taxation	25,768	(11,034)	(91,301)

	366,300	53,238	468,216

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A reconciliation of the income tax calculated at the applicable tax rate with income tax expense is as follows:

	Years ended December 31,		
	2005	**2006**	**2007**
Income before income tax	2,287,594	964,200	2,151,352
Expected PRC income tax expense at a statutory tax rate of 33% (2006: 15%; 2005: 15%)	343,139	144,630	709,946
Tax effect of non-deductible expenses	7,679	7,361	47,056
Tax effect of non-taxable income	(4,438)	(5,414)	(32,201)
(Over) / under-provision in prior years		(6,911)	2,439
Effect of change in tax rate on deferred tax			(23,083)
Tax effect of share of losses / (profits) recognized under the equity method	9,145	(86,503)	(219,746)
Tax effect of unused tax losses not recognized for deferred tax	7,090	9,688	22,621
Tax effect of differential tax rate on subsidiaries income	3,685	(9,613)	(38,816)
Actual tax expense	366,300	53,238	468,216

The State Administration of Taxation (SAT) issued a tax circular Enterprise Income Tax Issues relating to Nine Companies Listed Overseas (Circular No. 664) in June 2007 which requested the relevant local tax authorities to rectify, immediately, the expired concessionary tax policy for the nine listed companies authorized by the State Council to issue shares in Hong Kong in 1993 which, at the time of writing, was still being applied. The notice stated that the difference in enterprise income tax (EIT) arising from the expired preferential rate and the applicable rate should be settled according to the provisions of Law on the Administration of Tax Collection .

The Company is one of the nine listed companies mentioned above and applied the preferential EIT rate of 15% in prior years. The Company communicated with the relevant tax authority to assess the situation and was informed that the EIT rate for the Company would be adjusted from the original 15% to 33% from 2007. The Company has not been requested to pay additional EIT in respect of any prior year.

In response to the SAT notice and communication with the relevant tax authority, the charge for PRC income tax for the year is calculated at the rate of 33% (2006: 15%; 2005: 15%) on the estimated assessable income of the period determined in accordance with relevant income tax rules and regulations. The directors of the Company consider that it is uncertain whether the relevant tax authorities will retrospectively claim additional EIT from the Company and that it is not possible to reliably estimate the eventual outcome of this matter. Consequently, no provision has been made in these financial statements in respect of the EIT differences arising from prior years.

The Company did not carry out business overseas and therefore does not incur overseas income taxes.

Pursuant to the PRC enterprise income tax law passed by the Tenth National People s Congress on March 16, 2007, the new enterprise income tax rates for domestic and foreign enterprises are unified at 25 per cent. and will be effective from January 1, 2008.

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As the EIT rate applicable to the Company will be changed from 33% in 2007 to 25% in 2008, deferred tax recognized as at December 31, 2007 is based on the 25% tax rate that is expected to apply to the period when the asset is realized or the liability is settled (2006: 15%; 2005: 15%).

(b) Deferred taxation:

(i) Deferred tax assets and deferred tax liabilities are attributable to the items detailed in the tables below:

	Assets December 31,		Liabilities December 31,		Net balance December 31,	
	2006	2007	2006	2007	2006	2007
Current						
Provisions	12,141	40,075			12,141	40,075
Non-current						
Provisions for impairment losses	16,342	77,310			16,342	77,310
Lease prepayments	18,880	30,592			18,880	30,592
Capitalization of borrowing costs			(20,799)	(32,070)	(20,799)	(32,070)
Fair value of available-for-sale securities			(3,873)	(115,855)	(3,873)	(115,855)
Others	7,619	11,822		(2,245)	7,619	9,577
Deferred tax assets / (liabilities)	54,982	159,799	(24,672)	(150,170)	30,310	9,629

As at December 31, 2007, a subsidiary of the Company provided valuation allowance against tax value of losses carried forward for PRC income tax purpose. The total deductible losses available to offset their future PRC taxation income are RMB112,444, if any. The deductible losses carried forward of RMB14,539, RMB29,357 and RMB68,548 will expire in 2010, 2011 and 2012, respectively.

(ii) Movements in deferred tax assets and liabilities are as follows:

	Balance at January 1, 2005	Recognized in consolidated statements of income	Balance at December 31, 2005
Current			
Provisions	32,600	(21,204)	11,396
Non-current			
Provision for impairment losses	8,842		8,842
Lease prepayments	19,928	(525)	19,403
Capitalization of borrowing costs	(12,453)	(4,039)	(16,492)

Net deferred tax assets	48,917	(25,768)	23,149

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	Balance at January 1, 2006	Recognized in consolidated statements of income	Recognized in reserve	Balance at December 31, 2006
Current				
Provisions	11,396	745		12,141
Non-current				
Provision for impairment losses	8,842	7,500		16,342
Lease prepayments	19,403	(523)		18,880
Capitalization of borrowing costs	(16,492)	(4,307)		(20,799)
Fair value of available-for-sale securities			(3,873)	(3,873)
Others		7,619		7,619
Net deferred tax assets	23,149	11,034	(3,873)	30,310

	Balance at January 1, 2007	Recognized in consolidated statements of income	Recognized in reserve	Balance at December 31, 2007
Current				
Provisions	12,141	27,934		40,075
Non-current				
Provision for impairment losses	16,342	60,968		77,310
Lease prepayments	18,880	11,712		30,592
Capitalization of borrowing costs	(20,799)	(11,271)		(32,070)
Fair value of available-for-sale securities	(3,873)		(111,982)	(115,855)
Others	7,619	1,958		9,577
Net deferred tax assets	30,310	91,301	(111,982)	9,629

12. BASIC EARNINGS PER SHARE

The calculation of basic earnings per share is based on the profit attributable to shareholders of RMB1,634,080 (2006: RMB844,407; 2005: RMB1,850,449) and 7,200,000 (2006: 7,200,000; 2005: 7,200,000) shares in issue during the year.

The amount of diluted earnings per share is not presented as there were no dilutive potential ordinary shares in existence for either year.

13. DIVIDENDS

(a) Dividends attributable to the year:

	Years ended December 31,		
	2005	2006	2007
Final dividend proposed after the balance sheet date of RMB0.09 per share (2006: RMB0.04 per share)	720,000	288,000	648,000

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Pursuant to a resolution passed at the directors meeting on April 7, 2008, a final dividend of RMB0.09 per share totaling RMB648,000 (2006: RMB288,000; 2005: RMB720,000) was proposed for shareholders approval at the Annual General Meeting. The final dividend proposed after the balance sheet date has not been recognized as a liability at the balance sheet date.

(b) Dividends attributable to the previous financial year, approved and paid during the year:

	Years ended December 31,		
	2005	2006	2007
Final dividend in respect of the previous financial year, approved and paid during the year, of RMB0.04 per share (2006: RMB0.10 per share; 2005: RMB0.20 per share)	1,440,000	720,000	288,000

14. INVENTORIES

Inventories in the balance sheet comprise:

	December 31,	
	2006	2007
Raw materials	873,130	1,669,945
Work in progress	1,661,487	1,871,324
Finished goods	1,014,225	986,782
Spare parts and consumables	614,414	669,798
	4,163,256	5,197,849

At December 31, 2007, the Group had inventories carried at net realizable value with carrying amount of RMB626,212 (2006: RMB208,157).

Allowance for diminution in value of inventories, primarily related to spare parts and consumables, is analyzed as follows:

At January 1, 2005	56,670
Provision for the year	1,636
Write-off	(8,236)
At December 31, 2005	50,070
Provision for the year	33,407
Write-off	(42,122)

At December 31, 2006	41,355
Provision for the year	35,753
Write-off	(3,316)
At December 31, 2007	73,792

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15. TRADE DEBTORS

Trade debtors comprise:

	December 31, 2006	December 31, 2007
Trade debtors	389,601	236,848
Less: Impairment losses for bad and doubtful debts	(30,911)	(24,591)
	358,690	212,257

Impairment losses for bad and doubtful debts are analyzed as follows:

At January 1, 2005	45,282
Provision for the year	13,683
Written-off	(33,120)
At December 31, 2006	25,845
Provision for the year	8,513
Written-off	(3,447)
At December 31, 2006	30,911
Provision for the year	3,687
Written-off	(10,007)
At December 31, 2007	24,591

16. OTHER DEBTORS AND PREPAYMENTS

Other debtors and prepayments comprise:

	December 31, 2006	December 31, 2007
Purchase deposits	68,661	47,939
Prepayments in connection with construction work and equipment purchases	2,884	
Sundry debtors	167,569	214,979
	239,114	262,918

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17. PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment comprise:

	Buildings	Plant and other fixed assets	Total
Cost or valuation:			
At January 1, 2006	5,501,887	26,702,532	32,204,419
Additions	41,376	147,671	189,047
Transferred from construction in progress (note 19)	128,200	502,704	630,904
Disposals	(47,923)	(812,917)	(860,840)
At December 31, 2006	5,623,540	26,539,990	32,163,530
At January 1, 2007	5,623,540	26,539,990	32,163,530
Additions	27,041	145,737	172,778
Transferred from construction in progress (note 19)	113,445	3,419,832	3,533,277
Disposals	(97,443)	(537,517)	(634,960)
At December 31, 2007	5,666,583	29,568,042	35,234,625
Accumulated depreciation and impairment losses:			
At January 1, 2006	2,953,509	14,599,743	17,553,252
Charge for the year	164,172	1,646,818	1,810,990
Impairment loss		50,000	50,000
Written back on disposals	(35,814)	(574,760)	(610,574)
At December 31, 2006	3,081,867	15,721,801	18,803,668
At January 1, 2007	3,081,867	15,721,801	18,803,668
Charge for the year	184,765	1,502,670	1,687,435
Impairment loss	48,335	151,960	200,295
Written back on disposals	(33,524)	(400,486)	(434,010)
At December 31, 2007	3,281,443	16,975,945	20,257,388
Net book value:			
At December 31, 2007	2,385,140	12,592,097	14,977,237
At December 31, 2006	2,541,673	10,818,189	13,359,862

All of the Group s buildings are located in the PRC (including Hong Kong).

Buildings in Hong Kong with a net book value of RMB32,944 (2006: RMB34,129) were held under medium-term leases.

The Company was established in the PRC on June 29, 1993 as a joint stock limited company as part of the restructuring of Shanghai Petrochemical Complex (SPC). On the same date, the principal business undertakings of SPC together with the relevant assets and liabilities were taken over by the Company. As required by the relevant PRC rules and regulations, a valuation of the assets and liabilities to be injected into the Company was carried out as at January 1, 1993 by the State-owned Assets Administration Bureau and the injected assets and liabilities were reflected in the financial statements on this basis.

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In accordance with IAS 16, subsequent to this revaluation, which was based on depreciated replacement costs, property, plant and equipment are carried at revalued amount, being the fair value at the date of the revaluation less any subsequent accumulated depreciation and impairment losses. Revaluation is performed periodically to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet date. Based on a revaluation performed as of February 5, 2005, which was based on depreciated replacement costs, the carrying value of property, plant and equipment did not differ materially from their fair value.

18. INVESTMENT PROPERTY

	2006	2007
Cost:		
At January 1	528,465	528,465
Additions		25,768
At December 31	528,465	554,233
Accumulated depreciation:		
At January 1	13,883	26,561
Charge for the year	12,678	14,879
At December 31	26,561	41,440
Net book value:		
At December 31	501,904	512,793

Investment property represents certain floors of an office building rented out under the terms of operating leases.

The fair value of the investment property of the Group as at December 31, 2007 was estimated by the directors to be approximately RMB715,779 by reference to market values of like properties in the relevant regions (2006: RMB622,098). The investment property has not been valued by an external independent valuer.

Rental income of RMB40,021 was received by the Group during the year ended December 31, 2007 (2006: RMB42,643).

19. CONSTRUCTION IN PROGRESS

Construction in progress comprises costs incurred on property, plant and equipment not yet commissioned. The movement of construction in progress is as follows:

	2006	2007
At January 1	787,376	2,008,447
Additions	1,851,975	2,487,143
Transferred to property, plant and equipment (note 17)	(630,904)	(3,533,277)
At December 31	2,008,447	962,313

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20. INTEREST IN ASSOCIATES AND JOINTLY CONTROLLED ENTITIES

	December 31, 2006	December 31, 2007
Interest in associates	2,708,323	2,967,944
Interest in jointly controlled entities	79,472	100,191
	2,787,795	3,068,135

The above amount represents the share of net assets of the Company s interest in its associates and jointly controlled entities.

The particulars of these associates and jointly controlled entities, which are limited companies established and operating in the PRC, which principally affected the results or assets of the Group at December 31, 2007 are as follows:

Company		Registered Capital	Percentage of equity held by the Company %	Percentage of equity held by subsidiaries %	Principal activities
Shanghai Chemical Industry Park Development Company Limited	RMB	2,372,439	38.26		Planning, development and operation of the Chemical Industry Park in Shanghai, PRC
Shanghai Secco Petrochemical Company Limited	US$	901,441	20		Manufacturing and distribution of chemical products
Shanghai Jinpu Plastics Packaging Material Company Limited	US$	20,204		50	Production of polypropylene film
Shanghai Jinsen Hydrocarbon Resins Company Limited	US$	23,395		40	Production of resins products
Shanghai Yamatake Automation Company Limited	US$	3,000		40	Service and maintenance of building automation systems and products
BOC-SPC Gases Company Limited	US$	32,000	50		Production and sales of industrial gases

Summary financial information on associates:

	Assets	Liabilities	Equity	Revenues	Profit
2007					
100 per cent	28,956,271	(15,016,047)	13,940,224	24,972,018	3,044,526
Group s effective interest	6,752,902	(3,784,958)	2,967,944	5,183,450	645,178

2006					
100 per cent	29,206,140	(16,392,029)	12,814,111	22,477,236	2,747,085
Group s effective interest	6,751,136	(4,042,813)	2,708,323	4,671,386	574,437

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21. OTHER INVESTMENTS

Other investments comprise:

	December 31,	
	2006	**2007**
Available-for-sale equity securities	105,185	478,793
Other unlisted investments	462,584	272,834
	567,769	751,627
Less provision for impairment losses	(38,838)	(37,200)
	528,931	714,427

Provision for impairment losses is analyzed as follows:

	2005	**2006**	**2007**
At January 1	61,750	56,228	38,838
Written back on disposals	(5,522)	(17,390)	(1,638)
At December 31	56,228	38,838	37,200

22. GOODWILL

Cost:	
At December 31, 2007 and 2006	22,415

Goodwill related to the Company s purchase of the entire equity in Shanghai Jinyang Acrylic Fibre Plant in 1996.

23. DEBT

Short-term debt consists of:

December 31,

	2006	2007
Short-term bank loans	1,853,692	2,317,642
Current portion of long-term bank loans	416,645	419,027
Corporate bonds	2,000,000	
Loans from related companies		1,355,300
	4,270,337	4,091,969

The Group s short-term debts are used primarily to finance working capital needs. At December 31, 2007, no bank loans and borrowings were secured by the way of pledge of property, plant and equipment (2006: RMB Nil). The Group s weighted average short-term interest rates were 5.87% and 5.34% at December 31, 2006 and 2007, respectively.

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The Group s long-term debt, which are for the addition of plant and equipment and working capital purposes, consists of:

	Interest rate at December 31, 2007	Interest type	December 31, 2006	2007
Arranged by Central Treasury of the Company:				
U.S. Dollar denominated:				
Due in 2007	5.70%	Floating	383,034	
Payable semi-annually through 2008 (note (a))	1.80%	Fixed	23,710	9,097
Renminbi denominated:				
Due in 2008	6.30% - 7.47%	Fixed	400,000	250,000
Due in 2009	6.30% - 7.47%	Fixed	450,000	450,000
Arranged by subsidiaries:				
U.S. Dollar denominated:				
Payable annually through 2011	Interest free		14,055	10,519
Renminbi denominated:				
Payable due in 2007	5.85%	Fixed	8,500	
Payable due in 2008	5.27% - 6.72%	Fixed	110,000	135,000
Payable due in 2009	5.27% - 6.48%	Fixed		35,000
Payable due in 2010	5.91%	Fixed		100,000
Payable annually through 2010	Interest free		82,000	61,500
Payable annually through 2011	Interest free		9,000	7,200
Total long-term bank loans outstanding			1,480,299	1,058,316
Less: Amounts due within one year			(416,645)	(419,027)
Amounts due after one year			1,063,654	639,289

Note (a) Guaranteed by China Petrochemical Corporation

The aggregate maturities of long-term loans subsequent to December 31, 2007 are as follows:

2008	419,027
2009	509,929
2010	124,930
2011	4,430
	1,058,316

Included in short-term and long-term debts are the following amounts denominated in currencies other than the functional currency of the entity to which they relate:

	December 31,	
	2006	2007
United States Dollars	USD261,901	USD86,556

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24. SHARE CAPITAL

Share capital represents:

	December 31,	
	2006	**2007**
Registered, issued and paid up capital:		
4,870,000,000 A shares of RMB1.00 each	4,870,000	4,870,000
2,330,000,000 H shares of RMB1.00 each	2,330,000	2,330,000
	7,200,000	7,200,000

All the A and H shares rank pari passu in all respects.

Capital management

The Group optimizes the structure of its capital, comprising equity and loans. In order to maintain or adjust the capital structure, the Group may issue new shares, adjust the capital expenditure plan, sell assets to reduce debt, or adjust the proportion of short-term and long-term loans. The Group monitors capital on the basis of debt-to-equity ratio, which is calculated by dividing current and non-current loans by the total of equity attributable to equity shareholders of the Company, and liability-to-asset ratio, which is calculated by dividing total liabilities by total assets. The Group s strategy is to make appropriate adjustments according to the operating and investment needs and the changes of market conditions, and has maintained the debt-to-equity ratio and the liability-to-asset ratio at a range considered as reasonable by management. As at December 31, 2007, the debt-to-equity ratio and the liability-to-asset ratio of the Group were 22.91% (2006: 28.11%) and 29.82% (2006: 29.53%), respectively.

The schedule of the contractual maturities of loans and commitments are disclosed in note 23 and note 26, respectively.

There were no changes in the Group s approach to capital management during the year. Neither the Company nor any of its subsidiaries are subject to externally imposed capital requirements.

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25. SHARE PREMIUM AND RESERVES

Movements on reserves comprise:

	2006	2007
Share premium *(note a)*		
Balance at January 1 and December 31	2,420,841	2,420,841
Statutory surplus reserve *(note b)*		
Balance at January 1	3,174,419	3,248,104
Appropriation	73,685	192,434
General surplus reserve transfer to statutory surplus reserve *(note c)*		82,089
Adjustment to statutory surplus reserve *(note b)*		(36,733)
Balance at December 31	3,248,104	3,485,894
General surplus reserve *(note c)*		
Balance at January 1	82,089	82,089
General surplus reserve transfer to statutory surplus reserve *(note c)*		(82,089)
Balance at December 31	82,089	
Capital reserve *(note d)*		
Balance at January 1 and December 31	4,180	4,180
Discretionary surplus reserve *(note e)*		
Balance at January 1 and December 31	1,280,514	1,280,514
Excess over share capital *(note f)*		
Balance at January 1 and December 31	(148,604)	(148,604)
Fair value reserve *(note g)*		
Balance at December 31	21,949	347,564
Retained profits *(note h)*	4,867,270	6,057,649
	11,776,343	13,448,038

Note a

The application of the share premium account is governed by Sections 178 and 179 of the PRC Company Law.

Note b

According to the Company s Articles of Association, the Company is required to transfer 10% of the Company s profit after taxation, as determined under China Accounting Standards for Business Enterprises, to a statutory surplus reserve until the reserve balance reaches 50% of the registered capital. The transfer to this reserve is made before distribution of a dividend to shareholders.

The statutory surplus reserve can be used to make good of previous years losses, if any, and may be converted into share capital by the issue of new shares to shareholders in proportion to their existing

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shareholdings or by increasing the par value of the shares currently held by them, provided that the balance after such issue is not less than 25% of the registered capital.

Commencing from January 1, 2007, the Group has adopted the China Accounting Standards for Business Enterprises issued by the Ministry of Finance of the PRC (the MOF) on February 15, 2006, certain PRC accounting policies have been changed and applied retrospectively. The net profits as determined in accordance with the China Accounting Standards for Business Enterprises for prior periods have been restated and the statutory surplus reserve has been adjusted based on 10% of the restated net profits. The adjustment to the statutory surplus reserve was reflected as a movement in the current year.

Note c

From January 1, 2007, general surplus reserve has been combined with statutory surplus reserve under the China Accounting Standards for Business Enterprises issued by the MOF on February 15, 2006.

Note d

This reserve represents gifts or grants received from China Petrochemical Corporation, the ultimate parent company and which are required to be included in this reserve fund by PRC regulations.

Note e

The transfer to this reserve from the retained profits is subject to the approval by shareholders at general meetings. Its usage is similar to that of statutory surplus reserve.

Note f

Effective from January 1, 2002, land use rights which are included in lease prepayments are carried at historical cost. Accordingly, the surplus on the revaluation of land use rights net of deferred tax is reversed to shareholders equity. Under China Accounting Standards for Business Enterprises, land use rights are carried at revalued amounts.

Note g

The fair value reserve comprises the cumulative net change in the fair value of available-for-sale securities, net of deferred tax, held at the balance sheet date, which is based on reliably measured fair values at year end.

Note h

According to the Company s Articles of Association, the reserve available for distribution is the lower of the amount determined under China Accounting Standards for Business Enterprises and the amount determined under IFRS. As of December 31, 2007, the retained earning available for distribution of the Company was RMB5,630,080 (2006: RMB4,186,180). Final dividend of RMB648,000 (2006: RMB288,000) in respect of the financial year 2007 was declared after the balance sheet date.

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26. COMMITMENTS AND CONTINGENCIES

(a) Capital commitments

The Group had capital commitments outstanding at December 31, 2007 not provided for in the financial statements as follows:

Property, plant and equipment	
Contracted but not provided for	311,991
Authorized by the Board but not contracted for	3,546,960
	3,858,951

(b) Contingent liabilities

(i) Financial guarantees issued

At December 31, 2007, the Group was contingently liable with respect to guarantees issued to banks in favor of associates and joint ventures of RMB30,747 (2006: RMB49,750).

Guarantees issued to banks in favor of associates and joint ventures are given to the extent of the Company s respective interest in these entities. The Group monitors the conditions that are subject to the guarantees to identify whether it is probable that a loss has occurred, and recognize any such losses under guarantees when those losses are estimable. At December 31, 2006 and 2007, it is not probable that the Group will be required to make payments under the guarantees. Thus no liability has been accrued for a loss related to the Group s obligation under the guarantee arrangements.

(ii) Income tax differences

As discussed in note 11, the Group has certain income tax exposures with regard to prior years. At present, the directors of the Company consider that it is not possible to reliably estimate the eventual outcome of this matter and therefore no provision has been made in the financial statements for additional taxes, penalties and interest, if any.

27. RETIREMENT SCHEMES

As stipulated by the regulations of the PRC, the Group participates in a defined contribution retirement plan organized by the Shanghai Municipal Government for its staff. The Group is required to make contributions to the retirement plan at a rate of 22% of the salaries, bonuses and certain allowances of its staff in 2007 (2006: 22%). A member of the plan is entitled to a pension equal to a fixed proportion of the salary prevailing at his retirement date. The Group has no other material obligation for the payment of pension benefits associated with this plan beyond the annual contributions described above.

Pursuant to a document Lao Bu Fa (1995) No. 464 dated December 29, 1995 issued by the Ministry of Labor of the PRC, the Company has set up a supplementary defined contribution retirement plan for the benefit of employees. Employees who have served the Company for five years or more may participate in this plan. The Company and participating employees make defined contributions to their pension saving accounts according to the plan. The assets of this plan are held separately from those of the Company in an independent fund administered by a committee consisting of representatives from the employees and the Company. In April 2003, the Company revised certain terms of the plan and increased the amounts of contributions. For the year ended December 31, 2007, the Group s contribution to this plan amounted to RMB55,048 (2006: RMB61,692; 2005: RMB65,685).

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28. RELATED PARTY TRANSACTIONS

(a) Most of the transactions undertaken by the Group during the year ended December 31, 2007 have been affected with such counterparties and on such terms as have been determined by China Petroleum & Chemical Corporation (Sinopec Corp), the immediate parent company, and relevant PRC authorities.

Sinopec Corp negotiates and agrees the terms of crude oil supply with suppliers on a group basis, which is then allocated among its subsidiaries, including the Group, on a discretionary basis. During the year ended December 31, 2007, the value of crude oil purchased in accordance with Sinopec Corp s allocation was as follows:

	Years ended December 31,		
	2005	2006	2007
Purchases of crude oil	27,180,740	31,223,530	33,334,157

(b) Other transactions between the Group and other related parties during the year ended December 31, 2007 were as follows:

	Years ended December 31,		
	2005	2006	2007
Sales of goods and service fee income	20,068,746	20,173,106	22,907,085
Purchases other than crude oil	2,318,351	2,579,394	5,400,022
Insurance premiums paid	95,521	98,643	106,000
Net withdrawal from deposits in a related party	(70,389)	(101,353)	(50,177)
Interest received and receivable	1,035	229	908
Loans borrowed	130,000	576,000	1,475,300
Loans repayment	130,000	626,000	40,000
Interest paid and payable	6,649	7,529	9,813
Transportation fees	415,497	344,928	254,128
Construction and installation fees	183,191	194,958	206,256
Proceeds from sales of property, plant & equipment	62,742	52,547	
Gains from disposal of investments	24,063	24,308	25,822
Sales commissions	70,752	182,840	194,645
Net decrease of guarantees	(33,586)	(18,550)	(19,003)

(c) Deposits with related parties

December 31

	2006	2007
Deposits, with maturity within 3 months	79,913	29,736

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(d) Loans with related parties

	December 31,	
	2006	**2007**
Short-term loans		1,355,300
Long-term loans		120,000
		1,475,300

(e) Key management personnel compensation and post-employment benefit plans

	Years Ended December 31,	
	2006	**2007**
Short-term employee benefits	4,529	5,301
Post-employment benefits	84	89
	4,613	5,390

Post-employment benefits are included in contributions to defined contribution retirement plans as disclosed in note 28(f).

(f) Contributions to defined contribution retirement plans

The Group participates in defined contribution retirement plans organized by municipal governments for its staff. The contributions to defined contribution retirement plans are as follows:

	2006	**2007**
	RMB 000	**RMB 000**
Municipal retirement scheme costs	207,071	197,191
Supplementary retirement scheme costs	61,692	55,048

At December 31, 2006 and 2007, there was no material outstanding contribution to post-employment benefit plans.

(g) Transactions with other state-owned entities in the PRC

The Group is a state-controlled enterprise and operates in an economic regime currently dominated by entities directly or indirectly controlled by the PRC government (collectively referred as state-controlled entities) through its government authorities, agencies, affiliations and other organizations.

Apart from transactions with related parties, the Group has transactions with other state-controlled entities include but are not limited to the following:

- sales and purchase of goods and ancillary materials;
- rendering and receiving services;
- lease of assets, purchase of property, plant and equipment;
- placing deposits and obtaining finance; and
- use of public utilities.

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These transactions are conducted in the ordinary course of the Group s business on terms comparable to those with other entities that are not state controlled. The Group has established its procurement policies, pricing strategy and approval process for purchases and sales of products and services which do not depend on whether the counterparties are state-controlled entities or not.

Having considered the transactions potentially affected by related party relationships, the entity s pricing strategy, procurement policies and approval processes, and the information that would be necessary for an understanding of the potential effect of the related party relationship on the financial statements, the directors are of the opinion that the following transactions require disclosure of numeric details.

(i) Transactions with other state-controlled energy and chemical companies

The Group s major domestic suppliers of crude oil are China National Offshore Oil Corporation and its subsidiaries (CNOOC Group), which are state-controlled entities.

During the year ended December 31, 2007, the aggregate amount of crude oil purchased by the Group s refining segment from CNOOC Group was RMB1,126,222 (2006: RMB1,682,519; 2005: RMB2,095,315).

The amounts due from / to CNOOC Group are nil as at December 31, 2007 (2006: Nil).

(ii) Transactions with state-controlled banks

The Group deposits its cash with several state-controlled banks in the PRC. The Group also obtains short-term and long-term loans from these banks in the ordinary course of business. The interest rates of the bank deposits and loans are regulated by the People s Bank of China. The Group s interest income from and interest expenses to these state-controlled banks in the PRC are as follows:

	2005	**2006**	**2007**
Interest income	39,315	56,597	45,992
Interest expenses	285,647	324,267	231,707

The amounts of cash deposited at and loans from state-controlled banks in the PRC are summarized as follows:

	2006	**2007**
Cash and cash equivalents at state-controlled banks in the PRC	731,971	745,401
Short-term loans and current portion of long-term loans	2,245,225	2,711,739
Long-term loans excluding current portion of long-term loans	983,710	465,000

Total loans from state-controlled banks in the PRC	3,228,935	3,176,739

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29. OPERATING SEGMENT DATA

Segment information is presented in respect of the Group s business segments. The format is based on the Group s management and internal reporting structure. In view of the fact that the Company and its subsidiaries operate mainly in the PRC, no geographical segment information is presented.

The Group principally operates in four operating segments: synthetic fibers, resins and plastics, intermediate petrochemicals and petroleum products. All of the Group s products are produced through intermediate steps from the principal raw material of crude oil. The specific products of each segment are as follows:

(a) The synthetic fibers segment produces primarily polyester and acrylic fibers mainly used in the textile and apparel industries.

(b) The resins and plastics segment produces primarily polyester chips, low density polyethylene resins and films, polypropylene resins and PVA granules. The polyester chips are used in the processing of polyester fibers and construction coating materials and containers. Low density polyethylene resins and plastics are used in cable jacketing, sheeting, the manufacture of moulded products, such as housewares and toys and for agricultural and packaging uses. Polypropylene resins are used in the manufacturing of extruded films or sheets and injection moulded products such as housewares, toys and household electric appliance and automobile parts.

(c) The intermediate petrochemicals segment primarily produces ethylene and benzene. Most of the intermediate petrochemicals produced by the Group are used by the Group as raw materials in the production of other petrochemicals, resins, plastics and synthetic fibers. A portion of the intermediate petrochemicals as well as certain by-products of the production process are sold to outside customers.

(d) The Group s petroleum products segment has crude oil distillation facilities used to produce vacuum and atmospheric gas oils used as feedstocks of the Group s downstream processing facilities. Residual oil and low octane gasoline fuels are produced primarily as a co-product of the crude oil distillation process. A proportion of the residual oil is further processed into qualified refined gasoline and diesel oil. In addition, the Group produces a variety of other transportation, industrial and household heating fuels, such as diesel oils, jet fuels, heavy oils and liquefied petroleum gases.

(e) All other operating segments represent the operating segments which do not meet the quantitative threshold for determining reportable segments. These include sales of consumer products, services and a variety of other commercial activities, which are not allocated to the above four operating segments.

Most of the Group s sales and concentrations of credit risk (see note 31) are with affiliates of Sinopec Corp or other state-owned enterprises. Export sales accounted for approximately 0.5% and 0.4% of total sales in 2006 and 2007 respectively.

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Reportable information on the Group s operating segments is as follows:

	Years ended December 31,		
Sales and other income	**2005**	**2006**	**2007**
Manufactured Products			
Synthetic Fibers			
External sales	4,781,787	4,727,261	4,342,215
Intersegment sales	79	71	85
Total	4,781,866	4,727,332	4,342,300
Resins and Plastics			
External sales	14,010,287	15,800,015	15,927,089
Intersegment sales	53,020	63,767	75,183
Total	14,063,307	15,863,782	16,002,272
Intermediate Petrochemicals			
External sales (note a)	6,586,556	6,800,577	9,406,507
Intersegment sales	13,848,105	14,536,675	16,966,433
Total	20,434,661	21,337,252	26,372,940
Petroleum Products			
External sales (note a)	18,616,544	19,977,755	21,997,362
Intersegment sales	1,064,616	1,187,744	1,336,695
Other income	632,820	282,142	93,900
Total	20,313,980	21,447,641	23,427,957
All others			
External sales	1,960,729	3,293,877	3,655,211
Intersegment sales	3,687,428	3,582,206	3,402,717
Total	5,648,157	6,876,083	7,057,928
Eliminations of intersegment sales	(18,653,248)	(19,370,463)	(21,781,113)
Consolidated sales and other income	46,588,723	50,881,627	55,422,284

Note (a): External sales include sales to Sinopec Corp Group companies as follows:

	Years ended December 31,		
	2005	**2006**	**2007**
Sales to Sinopec Corp Group companies			

Synthetic Fibers	489,240		
Intermediate Petrochemicals	1,931,950	2,335,250	2,968,753
Petroleum Products	15,855,347	15,842,808	17,884,389
Total	18,276,537	18,178,058	20,853,142

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	Years ended December 31,		
Profit from operations	**2005**	**2006**	**2007**
Synthetic Fibers	263,359	196,255	(82,083)
Resins and Plastics	1,490,740	1,162,103	656,475
Intermediate Petrochemicals	981,025	680,425	813,762
Petroleum Products	(446,867)	(1,697,730)	(644,234)
All others	239,703	211,854	148,736
Consolidated profit from operations	2,527,960	552,907	892,656
Net financing costs	(179,398)	(165,389)	(177,926)
Investment income			770,725
Share of (losses) / profits of associates and jointly controlled entities	(60,968)	576,682	665,897
	(240,366)	411,293	1,258,696
Profit from ordinary activities before taxation	2,287,594	964,200	2,151,352
Income tax	(366,300)	(53,238)	(468,216)
Net income	1,921,294	910,962	1,683,136
Attributable to:			
Equity shareholders of the Company	1,850,449	844,407	1,634,080
Minority interests	70,845	66,555	49,056
	1,921,294	910,962	1,683,136

	December 31,	
	2006	**2007**
Assets		
Segment assets		
Synthetic Fibers	2,877,473	2,756,536
Resins and Plastics	3,115,456	2,768,515
Intermediate Petrochemicals	5,876,117	7,440,853
Petroleum Products	8,507,134	8,929,073
All others	2,263,875	2,639,287
Total segment assets	22,640,055	24,534,264
Interest in associates and jointly controlled entities	2,787,795	3,068,135
Unallocated:		
(including Cash and cash equivalents, Deposits, Income tax recoverable, Investments, Deferred tax assets, Investment property and Goodwill)	1,978,210	2,250,651
Consolidated assets	27,406,060	29,853,050

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	December 31, 2006	December 31, 2007
Liabilities		
Segment liabilities		
Synthetic Fibers	254,614	325,867
Resins and Plastics	851,001	1,195,267
Intermediate Petrochemicals	366,284	705,922
Petroleum Products	1,076,017	1,650,818
All others	177,411	274,309
Total segment liabilities	2,725,327	4,152,183
Unallocated:		
(including Loans and borrowings, Income tax payable and Deferred income)	5,368,377	4,748,838
Consolidated liabilities	8,093,704	8,901,021

	Years ended December 31,		
Depreciation and amortization	**2005**	**2006**	**2007**
Synthetic Fibers	222,910	236,559	227,503
Resins and Plastics	350,625	353,321	351,273
Intermediate Petrochemicals	596,717	664,667	603,707
Petroleum Products	368,210	407,835	352,532
All others	167,192	178,008	169,392
Segment depreciation and amortization	1,705,654	1,840,390	1,704,407
Unallocated:	12,847	12,678	14,879
Consolidated depreciation and amortization	1,718,501	1,853,068	1,719,286

	Years ended December 31,		
Impairment losses	**2005**	**2006**	**2007**
Synthetic Fibers		50,000	180,681
All others			19,614
Consolidated impairment losses		50,000	200,295

	Years ended December 31,		
Total capital expenditures for segment long-lived assets	**2005**	**2006**	**2007**
Synthetic Fibers	172,106	145,513	130,392
Resins and Plastics	17,323	45,418	16,973
Intermediate Petrochemicals	497,787	1,083,542	773,720

Petroleum Products	335,586	586,570	1,098,320
All others	104,003	147,736	114,718
Total segment capital expenditures	1,126,805	2,008,779	2,134,123
Unallocated:	16,122		
Consolidated capital expenditures for segment long-lived assets	1,142,927	2,008,779	2,134,123

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SINOPEC SHANGHAI PETROCHEMICAL COMPANY LIMITED

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Notes to Consolidated Financial Statements (Continued)

(All Renminbi amounts in thousands, except per share data and except otherwise stated)

30. ACCOUNTING ESTIMATES AND JUDGEMENTS

The Group s financial condition and results of operations are sensitive to accounting methods, assumptions and estimates that underlie the preparation of the financial statements. The Group bases the assumptions and estimates on historical experience and on various other assumptions that the Group believes to be reasonable and which form the basis for making judgements about matters that are not readily apparent from other sources. On an on-going basis, management evaluates its estimates. Actual results may differ from those estimates as facts, circumstances and conditions change.

The selection of critical accounting policies, the judgements and other uncertainties affecting application of those policies and the sensitivity of reported results to changes in conditions and assumptions are factors to be considered when reviewing the financial statements. The principal accounting policies are set forth in note 2. The Group believes the following critical accounting policies involve the most significant judgements and estimates used in the preparation of the financial statements.

Impairments for long lived assets

If circumstances indicate that the net book value of a long-lived asset may not be recoverable, the asset may be considered impaired , and an impairment loss may be recognized in accordance with IAS 36 Impairment of Assets . The carrying amounts of long-lived assets are reviewed periodically in order to assess whether the recoverable amounts have declined below the carrying amounts. These assets are tested for impairment whenever events or changes in circumstances indicate that their recorded carrying amounts may not be recoverable. When such a decline has occurred, the carrying amount is reduced to recoverable amount. For goodwill, the recoverable amount is estimated annually. The recoverable amount is the greater of the net selling price and the value in use. It is difficult to precisely estimate selling price because quoted market prices for the Group s assets and cash generating units are not readily available. In determining the value in use, expected cash flows generated by the assets are discounted to their present value, which requires significant judgement relating to level of sale volume, selling price and amount of operating costs. The Group uses all readily available information in determining an amount that is a reasonable approximation of recoverable amount, including estimates based on reasonable and supportable assumptions and projections of sale volume, selling price and amount of operating costs.

Depreciation

Property, plant and equipment are depreciated on a straight-line basis over the estimated useful lives of the assets, after taking into account the estimated residual values. The Group reviews the estimated useful lives of the assets regularly in order to determine the amount of depreciation expense to be recorded during any reporting period. The useful lives are based on the Group s historical experience with similar assets and taking into account anticipated technological changes. The depreciation expense for future periods is adjusted if there are significant changes from previous estimates.

Impairment for bad and doubtful debts

The Group estimates impairment losses for bad and doubtful debts resulting from the inability of the customers to make the required payments. The Group bases the estimates on the ageing of the accounts receivable balance, customer credit-worthiness, and historical write-off experience. If the financial condition of the customers were to deteriorate, actual write-offs would be higher than estimated.

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SINOPEC SHANGHAI PETROCHEMICAL COMPANY LIMITED

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(All Renminbi amounts in thousands, except per share data and except otherwise stated)

Allowance for diminution in value of inventories

Any excess of the cost over the net realizable value of each item of inventories is recognized as a provision for diminution in the value of inventories. Net realizable value represents the estimated selling price in the ordinary course of business, less the estimated costs of completion and the estimated costs necessary to make the sale. The Group bases the estimates on all available information, including the current market prices of the finished goods and raw materials, and historical operating costs. If the actual selling prices were to be lower or the costs of completion were to be higher than estimated, the actual allowance for diminution in value of inventories could be higher than estimated.

Income tax

As discussed in note 26(b), the directors of the Company consider that it is uncertain whether the relevant tax authorities will retrospectively claim additional EIT from the Company and that it is not possible to reliably estimate the eventual outcome of this matter. Consequently, no provision has been made in these financial statements in respect of the EIT differences arising from prior years.

31. FINANCIAL INSTRUMENTS

Overview

Financial assets of the Group include cash and cash equivalents, other investments, trade debtors, bills receivable, other debtors and amounts due from related parties. Financial liabilities of the Group include loans and borrowings, trade creditors, bills payable, other creditors and amounts due to related parties. The Group has no derivative instruments that are designated and qualified as hedging instruments at December 31, 2007 and 2006.

The Group has exposure to the following risks from its use of financial instruments:

- credit risk;
- liquidity risk; and
- market risk

The Board of Directors has overall responsibility for the establishment, oversight of the Group s risk management framework, and developing and monitoring the Group s risk management policies.

The Group s risk management policies are established to identify and analyze the risks faced by the Group, to set appropriate risk limits and controls, and to monitor risks and adherence to limits. Risk management policies and systems are reviewed regularly to reflect changes in market conditions and the Group s activities. The Group, through its training and management standards and procedures, aims to develop a disciplined and constructive control environment in which all employees understand their roles and obligations. Internal audit department undertakes both regular and ad hoc reviews of risk management controls and procedures, the results of which are reported to the Group s audit committee.

Credit risk

Credit risk is the risk of financial loss to the Group if a customer or counterparty to a financial instrument fails to meet its contractual obligations, and arises principally from the Group s receivables from customers. The majority of the Group s trade debtors and amounts due from related parties relate to sales of petroleum and chemical products to third parties and related parties operating in the petroleum and chemical industries.

SINOPEC SHANGHAI PETROCHEMICAL COMPANY LIMITED

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Notes to Consolidated Financial Statements (Continued)

(All Renminbi amounts in thousands, except per share data and except otherwise stated)

The Group performs ongoing credit evaluations of its customers financial condition and generally does not require collateral on trade debtors and related parties. The Group maintains an impairment loss for doubtful accounts and actual losses have been within management s expectations. The details of the Group s credit policy for and quantitative disclosures in respect of the Group s exposure on credit risk relating to trade receivables are set out in Note 15.

The carrying amounts of trade debtors, bills receivables, other debtors, and amounts due from related parties, represent the Group s maximum exposure to credit risk in relation to financial assets.

Liquidity risk

Liquidity risk is the risk that the Group will not be able to meet its financial obligations as they fall due. The Group s approach in managing liquidity is to ensure, as far as possible, that it will always have sufficient liquidity to meet its liabilities when due, under both normal and stressed conditions, without incurring unacceptable losses or risking damage to the Group s reputation. The Group prepares monthly cash flow budget to ensure that they will always have sufficient liquidity to meet its financial obligation as they fall due. The Group arranges and negotiates financing with financial institutions and maintains a certain level of standby credit facilities to reduce the liquidity risk.

At December 31, 2007, the Group has standby credit facilities with several PRC financial institutions which allows the Group to borrow up to RMB2,900,000 (2006: RMB2,900,000) on an unsecured basis, at a weighted average interest rate of 6.29% (2006: 5.95%). At December 31, 2007, the Group s outstanding borrowings under these facilities were RMB1,812,642 (2006: RMB1,618,692) and were included in short-term bank loans.

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Notes to Consolidated Financial Statements (Continued)

(All Renminbi amounts in thousands, except per share data and except otherwise stated)

The following table sets out the remaining contractual maturities at the balance sheet date of the Group s financial liabilities, which are based on contractual undiscounted cash flows (including interest payments computed using contractual rates or, if floating, based on prevailing rates current at the balance sheet date) and the earliest date the Group would be required to repay:

The Group

	2006				
	Carrying amount RMB 000	Total contractual undiscounted cash flow RMB 000	Within 1 year or on demand RMB 000	More than 1 year but less than 2 years RMB 000	More than 2 years but less than 5 years RMB 000
Loans and borrowings (current)	4,270,337	4,405,610	4,405,610		
Loans and borrowings (non-current)	1,063,654	1,193,902	52,731	611,552	529,619
Trade creditors	1,385,577	1,385,577	1,385,577		
Bills payable	7,026	7,026	7,026		
Other creditors	732,951	732,951	732,951		
Amounts due to related parties	599,773	599,773	599,773		
	8,059,318	8,324,839	7,183,668	611,552	529,619

	2007				
	Carrying amount RMB 000	Total contractual undiscounted cash flow RMB 000	Within 1 year or on demand RMB 000	More than 1 year but less than 2 years RMB 000	More than 2 years but less than 5 years RMB 000
Loans and borrowings (current)	4,091,969	4,179,154	4,179,154		
Loans and borrowings (non-current)	639,289	723,741	39,271	549,201	135,269
Trade creditors	1,504,454	1,504,454	1,504,454		
Bills payable	300,575	300,575	300,575		
Other creditors	1,442,284	1,442,284	1,442,284		
Amounts due to related parties	904,870	904,870	904,870		
	8,883,441	9,055,078	8,370,608	549,201	135,269

SINOPEC SHANGHAI PETROCHEMICAL COMPANY LIMITED

AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

(All Renminbi amounts in thousands, except per share data and except otherwise stated)

Market risk

(a) Currency risk

Currency risk arises on financial instruments that are denominated in a currency other than the functional currency in which they are measured. The Group s currency risk exposure primarily relates to short-term and long-term debts denominated in US dollars.

The Group has no hedging policy on foreign currency balances, and principally reduces the currency risk by monitoring the level of foreign currency.

Included in loans and borrowings are the following amounts denominated in a currency other than the functional currency of the entity to which they relate:

	2006	**2007**
United States Dollars	USD261,901	USD86,556

A 5 percent strengthening of Renminbi against the USD at December 31 would have increased net profit for the year and retained earnings of the Group by approximately RMB21,181 (2006: RMB86,917). This analysis has been determined assuming that the change in foreign exchange rates had occurred at the balance sheet date and had been applied to the foreign currency balances to which the Group has significant exposure as stated above, and that all other variables, in particular interest rates, remain constant. The analysis is performed on the same basis for 2006.

Other than the amounts as disclosed above, the amounts of other financial assets and liabilities of the Group are substantially denominated in the functional currency of respective entity of the Group.

(b) Interest rate risk

The Group s interest rate risk exposure arises primarily from its short-term and long-term debts. Debts carrying interest at variable rates and at fixed rates expose the Group to cash flow interest rate risk and fair value interest rate risk respectively. The interest rates of loans and borrowings of the Group are disclosed in note 23.

As at December 31, 2007, it is estimated that a general increase / decrease of 100 basis points in variable interest rates, with all other variables held constant, would decrease / increase the Group s net profit for the year and retained earnings by approximately RMB12,146 (2006: RMB17,642). This sensitivity analysis has been determined assuming that the change in interest rates had occurred at the balance sheet date and the change was applied to the Group s debts in existence at that date with exposure to cash flow interest rate risk. The analysis is performed on the same basis for 2006.

Fair value

The disclosures of the fair value estimates, methods and assumptions, set forth below for the Group s financial instruments, are made to comply with the requirements of IFRS 7 and IAS 39 and should be read in conjunction with the Group s consolidated financial statements and related notes. The estimated fair value amounts have been determined by the Group using market information and valuation methodologies considered appropriate. However, considerable judgment is required to interpret market data to develop the estimates of fair value. Accordingly, the estimates presented herein are not necessarily indicative of the amounts the Group could realize in a current market exchange. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts.

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SINOPEC SHANGHAI PETROCHEMICAL COMPANY LIMITED

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(All Renminbi amounts in thousands, except per share data and except otherwise stated)

The fair value of long term loans is estimated by discounting future cash flows thereon using current market interest rates offered to the Group for debts with substantially the same characteristics and maturities ranging 7.17% to 7.74% (2006: 6.00% to 6.48%). The following table presents the carrying amounts and fair values of the Group s long term loans at December 31, 2006 and 2007.

	2006		2007	
	Carrying amount	Fair value	Carrying amount	Fair value
Liabilities				
Long-term loans	1,480,299	1,445,950	1,058,316	1,034,682

The fair value of available-for-sale equity securities was based on quoted market price on a PRC stock exchange. Unquoted equity investments are individually and in the aggregate not material to the Group s financial condition or results of operations. There are no listed market prices for such interests in the PRC and, accordingly, a reasonable estimate of fair value could not be made without incurring excessive costs. The Group intends to hold these unquoted equity investments for long term purpose.

The fair values of all other financial instruments approximate their carrying amounts due to the short-term maturity of these instruments.

32. POSSIBLE IMPACT OF AMENDMENTS, NEW STANDARDS AND INTERPRETATIONS ISSUED BUT NOT YET EFFECTIVE FOR THE ANNUAL ACCOUNTING PERIOD ENDED DECEMBER 31, 2007

Up to the date of issue of these financial statements, the IASB has issued the following amendments, new standards and interpretations which are not yet effective for the annual accounting period ended December 31, 2007 and which have not been adopted in these financial statements:

	Effective for accounting period beginning on or after
IFRS 8, Operating Segments	January 1, 2009
Revised IAS 1, Presentation of financial statements	January 1, 2009
Revised IAS 23, Borrowing costs	January 1, 2009
IFRIC 11, IFRS 2 Group and treasury share transactions	March 1, 2007
IFRIC 12, Service concession arrangements	January 1, 2008
IFRIC 13, Customer loyalty programmes	July 1, 2008
IFRIC 14, IAS 19 The limit on a defined benefit asset, minimum funding requirements and their interaction	January 1, 2008

The Group is in the process of making an assessment of what the impact of these amendments, new standards and new interpretations is expected to be in the period of initial application. Up to the date of issuance of these financial statements, the Group believes that the adoption of IFRIC 11, IFRS 2, IFRIC 12, IFRIC 13, IFRIC 14 and IAS 19 are not applicable to any of the Group s operations and that the adoption of IFRS 8, Revised IAS 1 and Revised IAS 23 are unlikely to have a significant impact on the Group s results of operations and financial position.

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33. NON-ADJUSTING POST BALANCE SHEET EVENTS

In March 2008, the Group received a grant income of RMB247,280 as a compensation of losses incurred due to the distortion of the correlation of domestic refined petroleum product prices and the crude oil prices, and the measures taken by the Group to stabilize the supply in the PRC refined petroleum product market during the first quarter of 2008.

34. PARENT COMPANIES

The Directors consider the immediate parent company and the ultimate parent company at December 31, 2007 to be China Petroleum & Chemical Corporation and China Petrochemical Corporation, respectively, which are incorporated in the PRC. China Petroleum & Chemical Corporation produces financial statements available for public use.

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SHANGHAI SECCO PETROCHEMICAL COMPANY LIMITED

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Years Ended December 31, 2005 (Unaudited), 2006 and 2007

Financial Statements of Shanghai Secco Petrochemical Company Limited (1)

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(1) The financial statements of Shanghai Secco Petrochemical Company Limited, an investee of Sinopec Shanghai Petrochemical Company Limited, are included in this Annual Report on Form 20-F of Sinopec Shanghai Petrochemical Company Limited to comply with Rule 3-09 of Regulation S-X of the U.S. Federal Securities Laws.

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Independent Auditors Report

The Board of Directors and Shareholders of

Shanghai Secco Petrochemical Company Limited:

We have audited the accompanying balance sheets of Shanghai Secco Petrochemical Company Limited (the Company) as of December 31, 2006 and 2007, and the related income statement, statement of changes in equity, and cash flow statement for the years then ended. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on the financial statements based on our audits.

We conducted our audits in accordance with the auditing standards generally accepted in United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company s internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, 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 above present fairly, in all material respects, the financial position of Shanghai Secco Petrochemical Company Limited as of December 31, 2006 and 2007, and the results of its operations and its cash flows for the years then ended in conformity with the requirements of China Accounting Standards for Business Enterprises (2006) issued by the Ministry of Finance of the People s Republic of China.

As more fully described in Notes 3 and 4 to the financial statements, commencing January 1, 2007, the Company has adopted the China Accounting Standards for Business Enterprises issued by the Ministry of Finance of the PRC (the MOF) on February 15, 2006 that have resulted in certain changes in PRC accounting policies.

China Accounting Standards for Business Enterprises (2006) vary in certain significant respects from accounting principles generally accepted in the United States of America. Information relating to the nature of such differences is presented in Note 38 to the financial statements.

KPMG

Certified Public Accountants

Hong Kong, China, April 1, 2008

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SHANGHAI SECCO PETROCHEMICAL COMPANY LIMITED

Balance Sheet as of December 31, 2006 and 2007

(Expressed in Renminbi)

	Note	2006 RMB 000	2007 RMB 000
Assets			
Current assets			
Cash at bank and on hand	6	1,654,819	1,566,397
Bills receivable	7	664,533	1,198,306
Accounts receivable	8	330,704	512,035
Prepayments	9	264,717	70,432
Other receivables	10	14,249	18,314
Inventories	11	1,790,351	2,002,500
Other current assets	12	1,454,000	1,455,309
Total current assets		6,173,373	6,823,293
Non-current assets			
Fixed assets	13	14,051,870	12,813,676
Construction in progress	14	28,027	148,821
Intangible assets	15	1,470,095	1,368,122
Long-term deferred expenses	16	37,273	12,053
Deferred tax assets	17	17,636	70,603
Total non-current assets		15,604,901	14,413,275
Total assets		21,778,274	21,236,568
Liabilities and investors equity			
Current liabilities			
Accounts payable		1,075,676	1,087,670
Advances from customers		372,383	243,215
Employee benefits payable	19	84,274	79,042
Taxes payable/(recoverable)	5(3)	75,471	(45,645)
Interest payable		49,020	17,921
Other payables		397,020	83,690
Long-term loans due within one year	20	477,769	556,397
Total current liabilities		2,531,613	2,022,290
Non-current liabilities			
Long-term loans	21	9,853,625	8,772,455
Total non-current liabilities		9,853,625	8,772,455
Total liabilities		12,385,238	10,794,745
Investors equity			
Paid-in capital	22	7,443,585	7,443,585
Capital reserve	23	(509)	(509)

Surplus reserve	24	39,393	39,393
Retained earnings		1,910,567	2,959,354
Total equity		9,393,036	10,441,823
Total liabilities and investors equity		21,778,274	21,236,568

These financial statements have been approved by the Board of Directors of the Company on April 1, 2008.

Didier Baudrand	**Zhang Zhiliang**	**Hua Xin**
Legal Representative	General Manager	Chief Financial Officer

The notes on pages F-71 to F-105 form part of these financial statements.

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SHANGHAI SECCO PETROCHEMICAL COMPANY LIMITED

Income Statement

For the Years Ended December 31, 2005 (Unaudited), 2006 and 2007

(Expressed in Renminbi)

	Note	2005 RMB 000 (Unaudited)	2006 RMB 000	2007 RMB 000
Operating income	26	12,705,140	21,790,806	24,218,596
Less: Operating costs	27	(12,132,306)	(18,038,293)	(20,357,771)
Business taxes and surcharges		(361)	(594)	(503)
Selling and distribution expenses		(267,743)	(352,307)	(321,285)
General and administrative expenses		(754,279)	(288,557)	(443,189)
Financial expenses	28	(284,218)	(423,960)	(238,032)
Impairment loss	29	(15,406)	9,980	(127)
Add: Investment income	30			39,238
Operating (loss)/profit		(749,173)	2,697,075	2,896,927
Add: Non-operating income		6,517	12,058	10,654
Less: Non-operating expenses		(1,074)	(799)	(1,194)
(Including: Loss from disposal of non-current assets)		(363)	(267)	(893)
(Loss)/profit before income tax		(743,730)	2,708,334	2,906,387
Add: Income tax benefit	31		17,636	52,967
Net (loss)/profit for the year		(743,730)	2,725,970	2,959,354

These financial statements have been approved by the Board of Directors of the Company on April 1, 2008.

Didier Baudrand	**Zhang Zhiliang**	**Hua Xin**
Legal Representative	General Manager	Chief Financial Officer

The notes on pages F-71 to F-105 form part of these financial statements.

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SHANGHAI SECCO PETROCHEMICAL COMPANY LIMITED

Cash Flow Statement

For the Years Ended December 31, 2005 (Unaudited), 2006 and 2007

(Expressed in Renminbi)

	Note	2005 RMB 000 (Unaudited)	2006 RMB 000	2007 RMB 000
Cash flows from operating activities:				
Cash received from sale of goods		14,466,263	24,861,800	27,458,031
Refund of taxes		1,450	154	230
Other cash received relating to operating activities		18,719	71,555	64,618
Sub-total of cash inflows		14,486,432	24,933,509	27,522,879
Cash paid for goods		(14,040,129)	(19,945,622)	(22,924,708)
Cash paid to and for employees		(170,901)	(198,586)	(218,791)
Cash paid for all types of taxes		(40,283)	(562,294)	(923,535)
Other cash paid relating to operating activities		(24,348)	(43,516)	(16,026)
Sub-total of cash outflows		(14,275,661)	(20,750,018)	(24,083,060)
Net cash inflow from operating activities	32	210,771	4,183,491	3,439,819
Cash flows from investing activities:				
Cash received from disposal of investments				2,572,000
Cash received from return on investments				37,929
Net cash received from disposal of fixed assets			257	
Sub-total of cash inflows			257	2,609,929
Cash paid for acquisition of fixed assets, intangible assets and other long-term assets		(2,683,935)	(851,533)	(311,201)
Cash paid for acquisition of investments			(1,454,145)	(2,572,000)
Other cash paid relating to investing activities		(74,373)	(1,586)	
Sub-total of cash outflows		(2,758,308)	(2,307,264)	(2,883,201)
Net cash outflow from investing activities		(2,758,308)	(2,307,007)	(273,272)

The notes on pages F-71 to F-105 form part of these financial statements.

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SHANGHAI SECCO PETROCHEMICAL COMPANY LIMITED

Cash Flow Statement

For the Years Ended December 31, 2005 (Unaudited), 2006 and 2007 (Continued)

(Expressed in Renminbi)

	Note	2005 RMB 000 (Unaudited)	2006 RMB 000	2007 RMB 000
Cash flows from financing activities:				
Cash received from investors		1,092,975	347,594	
Cash received from borrowings		3,071,667		9,366,238
Sub-total of cash inflows		4,164,642	347,594	9,366,238
Cash repayments of borrowings		(820,000)	(320,000)	(10,056,238)
Cash paid for profits distribution and interest		(492,190)	(613,779)	(2,563,383)
Other cash paid relating to financing activities		(6,905)	(4,575)	(429)
Sub-total of cash outflows		(1,319,095)	(938,354)	(12,620,050)
Net cash outflow from financing activities		2,845,547	(590,760)	(3,253,812)
Effect of foreign exchange rate changes on cash and cash equivalents		(1,244)	(6,858)	(1,157)
Net increase/(decrease) in cash and cash equivalents		296,766	1,278,866	(88,422)
Add: cash and cash equivalents at the beginning of the year		79,187	375,953	1,654,819
Cash and cash equivalents at the end of the year		375,953	1,654,819	1,566,397

These financial statements have been approved by the Board of Directors of the Company on April 1, 2008.

Didier Baudrand	**Zhang Zhiliang**	**Hua Xin**
Legal Representative	General Manager	Chief Financial Officer

The notes on pages F-71 to F-105 form part of these financial statements.

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SHANGHAI SECCO PETROCHEMICAL COMPANY LIMITED

Statement of Changes in Equity

For the Years Ended December 31, 2005 (Unaudited), 2006 and 2007

(Expressed in Renminbi)

	Note	Paid-in capital RMB 000	Capital reserve RMB 000	Surplus reserve RMB 000	(Accumulated losses)/ retained earnings RMB 000	Total RMB 000
Balance at January 1, 2005 (Unaudited)		6,002,521	(14)		(12,584)	5,989,923
Changes in equity for the year						
Net profit for the year					(743,730)	(743,730)
Contribution by investors		1,092,975				1,092,975
Balance at December 31, 2005 (Unaudited)		7,095,496	(14)		(756,314)	6,339,168
Balance at January 1, 2006		7,095,496	(14)		(756,314)	6,339,168
Changes in equity for the year						
Net profit for the year					2,725,970	2,725,970
Contribution by investors		348,089	(495)			347,594
Appropriation of profits						
- Appropriation for surplus reserve				39,393	(39,393)	
- Appropriation for staff and workers bonus and welfare fund					(19,696)	(19,696)
Balance at December 31, 2006		7,443,585	(509)	39,393	1,910,567	9,393,036
Balance at January 1, 2007		7,443,585	(509)	39,393	1,910,567	9,393,036
Changes in equity for the year						
Net profit for the year					2,959,354	2,959,354
Distributions to investors	25				(1,910,567)	(1,910,567)
Balance at December 31, 2007		7,443,585	(509)	39,393	2,959,354	10,441,823

These financial statements have been approved by the Board of Directors of the Company on April 1, 2008.

Didier Baudrand	**Zhang Zhiliang**	**Hua Xin**
Legal Representative	General Manager	Chief Financial Officer

The notes on pages F-71 to F-105 form part of these financial statements.

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SHANGHAI SECCO PETROCHEMICAL COMPANY LIMITED

Notes to the Financial Statements

(Expressed in Renminbi)

1 COMPANY STATUS

Shanghai Secco Petrochemical Co., Ltd. (the Company) is an equity joint venture established in Shanghai in the People s Republic of China (PRC) by China Petroleum and Chemical Corporation (Sinopec), Sinopec Shanghai Petrochemical Co., Ltd. (SPCL) and BP Chemicals East China Investments Ltd. (BPCECIL) (registered in the United Kingdom). The Company obtained an approval certificate [Wai Jing Mao Zi Shen Zi (2001) No. 0099] from the Ministry of Commerce (formerly Ministry of Foreign Trade and Economic Co-operation) on September 13, 2001, and a business license (Qi He Hu Zong Zi No. 029541 (Shi ju)) on October 29, 2001 issued by the State Administration of Industry and Commerce of the PRC. The registered capital is USD901,440,964.

According to the joint venture agreement and articles of association, the Company s period of operation is 50 years and its principal activities are to produce, market and sell ethylene, polyethylene, styrene, polystyrene, propylene, acrylonitrile, polypropylene, butadiene, aromatics and co-products; provide related after-sales services and technical advice with respect to such main petrochemical products and co-products; engage in polymers application development; and provide ancillary utilities services and other services to suppliers and processors. The Company commenced its manufacturing operations on March 31, 2005.

2 BASIS OF PREPARATION

(1) Statement of compliance

The financial statements have been prepared in accordance with the requirements of the China Accounting Standards for Business Enterprises (CAS (2006)) issued by the Ministry of Finance (MOF). These financial statements present truly and completely the financial position, the results of operations and the cash flows of the Company.

(2) Accounting year

The accounting year of the Company is from January 1 to December 31.

(3) Measurement basis

The measurement basis used in the preparation of the financial statements is historical cost basis.

(4) Functional currency and presentation currency

The Company s functional currency is Renminbi. These financial statements are presented in Renminbi.

3 SIGNIFICANT ACCOUNTING POLICIES AND ACCOUNTING ESTIMATES

(1) Translation of foreign currencies

When the Company receives capital in foreign currencies from investors, the capital is translated to Renminbi at the spot exchange rate on the date of the receipt. Other foreign currency transactions are, on initial recognition, translated to Renminbi at the spot exchange rates on the dates of the transactions.

A spot exchange rate is an exchange rate quoted by the People s Bank of China.

Monetary items denominated in foreign currencies are translated to Renminbi at the spot exchange rates at the balance sheet date. The resulting exchange differences are recognized in profit or loss, except those arising from the principals and interests on foreign currency borrowings specifically for the purpose of acquisition, construction of qualifying assets. Non-monetary items denominated in foreign currencies that are measured at historical cost are translated to Renminbi using the foreign exchange rate at the transaction date.

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SHANGHAI SECCO PETROCHEMICAL COMPANY LIMITED

Notes to the Financial Statements (Continued)

(Expressed in Renminbi)

(2) Cash and Cash equivalents

Cash and cash equivalents comprise cash on hand and demand deposits.

(3) Inventories

Inventories are carried at the lower of cost and net realizable value.

Cost of inventories comprises all costs of purchase, costs of conversion and other costs. Inventories are initially measured at their actual cost. Cost of inventories is calculated using the weighted average method. In addition to the purchasing cost of raw materials, work in progress and finished goods include direct labour costs and an appropriate allocation of production overheads.

Any excess of the cost over the net realizable value of each class of inventories is recognized as a provision for diminution in the value of inventories. Net realizable value is the estimated selling price in the normal course of business less the estimated costs to completion and the estimated expenses and related taxes necessary to make the sale.

The Company maintains a perpetual inventory system.

(4) Fixed assets and construction in progress

Fixed assets represent the tangible assets held by the Company for use in the production of goods, supply of services or for operation and administrative purposes with useful lives over one year.

Fixed assets are stated in the balance sheet at cost less accumulated depreciation and impairment losses (see Note 3(8)). Construction in progress is stated in the balance sheet at cost less impairment losses (see Note 3(8)).

The cost of a purchased fixed asset comprises the purchase price, related taxes, and any directly attributable expenditure for bringing the asset to working condition for its intended use. The cost of self-constructed assets includes the cost of materials, direct labour, capitalized borrowing costs (see Note 3(15)), and any other costs directly attributable to bringing the asset to working condition for its intended use.

Construction in progress is transferred to fixed assets when it is ready for its intended use. No depreciation is provided against construction in progress.

Where the individual component parts of an item of fixed asset have different useful lives or provide benefits to the Company in different patterns thus necessitating use of different depreciation rates or methods, they are recognized as a separate fixed asset.

The subsequent costs including the cost of replacing part of an item of fixed assets are recognized in the carrying amount of the item if the recognition criteria are satisfied, and the carrying amount of the replaced part is derecognized. The costs of the day-to-day servicing of fixed assets are recognized in profit or loss as incurred.

Gains or losses arising from the retirement or disposal of an item of fixed asset are determined as the difference between the net disposal proceeds and the carrying amount of the item and are recognized in profit or loss on the date of retirement or disposal.

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SHANGHAI SECCO PETROCHEMICAL COMPANY LIMITED

Notes to the Financial Statements (Continued)

(Expressed in Renminbi)

Fixed assets are depreciated using the straight-line method over their estimated useful lives. The estimated useful lives, residual values and depreciation rates of each class of fixed assets are as follows:

	Estimated useful life	Estimated residual value	Depreciation rate
Plants and buildings	10-40 years	3%	2.43%-9.70%
Machinery and equipment	10-28 years	3%	3.46%-9.70%
Office and other equipment	4-5 years	3%	19.40%-24.25%
Motor vehicles	8 years	3%	12.13%

Useful lives, residual values and depreciation methods are reviewed at least each year end.

(5) Operating lease charges

Rental payments under operating leases are recognized as costs or expenses on a straight-line basis over the lease term.

(6) Intangible assets

Intangible assets are stated in the balance sheet at cost less accumulated amortization (where the estimated useful life is finite) and impairment losses (see Note 3(8)). For an intangible asset with finite useful life, its cost less residual value and impairment loss is amortized on the straight-line method over its estimated useful life. The respective amortization periods for such intangible assets are as follows:

	Estimated useful lives
Land use right	47 years
Patent	10 years
Computer software	5 years

An intangible asset is regarded as having an indefinite useful life and is not amortized when there is no foreseeable limit to the period over which the asset is expected to generate economic benefits for the Company. At the balance date, the Company doesn t have any intangible assets with indefinite useful lives.

(7) Long-term deferred expenses

Long-term deferred expenses represent catalyst costs, which are amortized on a straight-line basis over their estimated useful lives.

(8) Impairment of non-financial long-term assets

The carrying amounts of the following assets are reviewed at each balance sheet date based on the internal and external sources of information to determine whether there is any indication of impairment:

- fixed assets
- construction in progress
- intangible assets

If any indication exists that an asset may be impaired, recoverable amount of the asset is estimated.

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SHANGHAI SECCO PETROCHEMICAL COMPANY LIMITED

Notes to the Financial Statements (Continued)

(Expressed in Renminbi)

An asset group is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or asset groups. An asset group is composed of assets directly relating to cash-generation. Identification of an asset group is based on whether major cash inflows generated by the asset group are largely independent of the cash inflows from other assets or asset groups. In identifying an asset group, the Company also considers how management monitors the Company s operations and how management makes decisions about continuing or disposing of the Company s assets.

The recoverable amount of an asset, asset group or set of asset groups is the higher of its fair value less costs to sell and its present value of expected future cash flows.

An asset s fair value less costs to sell is the amount determined by the price of a sale agreement in an arm s length transaction, less the costs that are directly attributable to the disposal of the asset. The present value of expected future cash flows of an asset is determined by discounting the future cash flows, estimated to be derived from continuing use of the asset and from its ultimate disposal, to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset.

An impairment loss is recognized if the carrying amount of an asset exceeds its recoverable amount. Impairment losses are recognized in profit or loss. A provision for impairment loss of the asset is recognized accordingly. Impairment losses related to an asset group or a set of asset groups allocated to the asset group or set of asset groups, and then reduce the carrying amount of the other assets in the asset group or set of asset groups on a pro rata basis. However, that the carrying amount of an impaired asset will not be reduced below the highest of its individual fair value less costs to sell (if determinable), the present value of expected future cash flows (if determinable) and zero.

An impairment loss is not reversed in subsequent periods.

(9) Financial instruments

Financial instruments comprise cash at bank and on hand, receivables, payables and loans and borrowings, etc.

(a) Recognition and measurement of financial assets and financial liabilities

A financial asset or financial liability is recognized in the balance sheet when the Company becomes a party to the contractual provisions of a financial instrument.

The Company classifies financial assets and liabilities into different categories at initial recognition based on the purpose of acquiring assets or assuming liabilities: loans and receivables, and other financial liabilities.

Financial assets and financial liabilities are measured initially at fair value. Any attributable transaction costs are included in their initial costs. Subsequent to initial recognition financial assets and liabilities are measured as follows:

- Receivables

  Receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market.

Subsequent to initial recognition, receivables are subsequently stated at amortized cost using the effective interest method.

SHANGHAI SECCO PETROCHEMICAL COMPANY LIMITED

Notes to the Financial Statements (Continued)

(Expressed in Renminbi)

- Other financial liabilities

Financial liabilities other than the financial liabilities at fair value through profit or loss are classified as other financial liabilities.

Subsequent to initial recognition, other financial liabilities are measured at amortized cost using the effective interest method.

(b) Impairment of financial assets

The carrying amounts of financial assets are reviewed at each balance sheet date to determine whether there is objective evidence of impairment. If any such evidence exists, impairment loss is provided.

- Receivables

Receivables are assessed for impairment both on an individual basis and on a collective group basis.

Where impairment is assessed on an individual basis, an impairment loss in respect of a receivable is calculated as the excess of its carrying amount over the present value of the estimated future cash flows (exclusive of future credit losses that have not been incurred) discounted at the original effective interest rate. All impairment losses are recognized in profit or loss.

The assessment is made collectively where receivables share similar credit risk characteristics (including those having not been individually assessed as impaired), based on their historical loss experiences, and adjusted by the observative figures reflecting present economic conditions.

If in a subsequent period the amount of an impairment loss decreases and the decrease can be linked objectively to an event occurring after the impairment loss was recognized, the impairment loss is reversed through profit or loss. A reversal of an impairment loss will not result in the asset s carrying amount exceeding that which would have been determined had no impairment loss been recognized in prior years.

(c) Derecognition of financial assets and financial liabilities

A financial asset is derecognized if the Company s contractual rights to the cash flows from the financial asset expire or if the Company transfers substantially all the risks and rewards of ownership of the financial asset to another party.

Where a transfer of a financial asset in its entirety meets the criteria of the derecognition, the difference between the two amounts below is recognized in profit or loss:

- carrying amount of the financial asset transferred
- the consideration received from the transfer.

The Company derecognizes a financial liability (or part of it) only when the underlying present obligation (or part of it) is discharged.

(10) Employee benefits

Employee benefits are all forms of considerations given and other related expenditures incurred in exchange for services rendered by employees. Employee benefits are recognized as a liability in the

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SHANGHAI SECCO PETROCHEMICAL COMPANY LIMITED

Notes to the Financial Statements (Continued)

(Expressed in Renminbi)

period in which the associated services are rendered by employees, with a corresponding increase in cost of relevant assets or expenses in the current period.

(a) Retirement benefits

Pursuant to the relevant laws and regulations of the PRC, the Company has joined a defined contribution basic retirement scheme for the employees arranged by local Labor and Social Security Bureaus. The Company makes contributions to the retirement scheme at the applicable rates based on the amounts stipulated by the government organization. The contributions are charged to profit or loss on an accrual basis. When employees retire, the local Labor and Social Security Bureaus are responsible for the payment of the basic retirement benefits to the retired employees. The Company does not have any other obligations in this respect.

(b) Housing fund and other social insurances

Besides the retirement benefits, pursuant to the relevant laws and regulations of the PRC, the Company has joined defined social security contributions for employees, such as a housing fund, basic medical insurance, unemployment insurance, injury insurance and maternity insurance. The Company makes contributions to the housing fund and other social insurances mentioned above at the applicable rate(s) based on the employees salaries. The contributions are recognized as cost of assets or charged to profit or loss on an accrual basis.

(11) Income tax

Current tax and deferred tax are recognized in profit or loss.

Current tax is the expected tax payable calculated at the applicable tax rate on taxable income for the year, and any adjustment to tax payable in respect of previous years.

Deferred tax assets arise from deductible temporary differences, being the differences between the carrying amounts of assets for financial reporting purposes and their tax bases, which include the deductible losses carry forward to subsequent periods. Deferred tax assets are recognized to the extent that it is probable that future taxable profits will be available against which deductible temporary differences can be utilized.

At the balance sheet date, the amount of deferred tax recognized is measured based on the expected manner of realization or settlement of the carrying amount of the assets, using tax rates that are expected to be applied in the period when the asset is realized in accordance with tax laws.

(12) Provisions and contingent liabilities

A provision is recognized if, as a result of a past event, the Company has a present obligation that can be estimated reliably, and it is probable that an outflow of economic benefits will be required to settle the obligation. Where the effect of time value of money is material, provisions are determined by discounting the expected future cash flows.

In terms of a possible obligation resulting from a past transaction or event, whose existence will only be confirmed by the occurrence or non-occurrence of uncertain future events or a present obligation resulting from a past transaction or event, where it is not probable that the settlement of the above obligation will cause an outflow of economic benefits, or the amount of the outflow cannot be estimated reliably, the possible or present obligation is disclosed as a contingent liability.

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SHANGHAI SECCO PETROCHEMICAL COMPANY LIMITED

Notes to the Financial Statements (Continued)

(Expressed in Renminbi)

(13) Revenue recognition

Revenue is the gross inflow of economic benefit in the periods arising in the course of the Company s ordinary activities when the inflows result in increase in investors equity, other than increase relating to contributions from investors. Revenue is recognized in profit or loss when it is probable that the economic benefits will flow to the Company, the revenue and costs can be measured reliably and the following respective conditions are met:

(a) Sale of goods

Revenue from sale of goods is recognized when all of the general conditions stated above and following conditions are satisfied:

- The significant risks and rewards of ownership of goods have been transferred to the buyer

- The Company retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold.

Revenue from the sale of goods is measured at the fair value of the considerations received or receivable under the sales contract or agreement.

(b) Rendering of services

When the outcome of a transaction involving the rendering of services can be estimated reliably, revenue from the rendering of services is recognized in the income statement by reference to the stage of completion of the transaction based on the proportion of services performed to date to the total services to be performed.

(c) Interest income

Interest income is recognized on a time proportion basis with reference to the principal outstanding and the applicable rate.

(14) Government grants

Government grants are transfers of monetary assets from the government to the Company at no consideration.

A government grant is recognized when there is reasonable assurance that the grant will be received and that the Company will comply with the conditions associated with the grant.

If a government grant is in the form of a transfer of a monetary asset, it is measured at the amount that is received or receivable.

A government grant related to that compensates the Company for expenses incurred is recognized in profit or loss immediately.

(15) Borrowing costs

Borrowing costs incurred directly attributable to the acquisition, construction of a qualifying asset are capitalized as part of the cost of the asset.

Except for the above, other borrowing costs are recognized as financial expenses in the income statement when incurred.

SHANGHAI SECCO PETROCHEMICAL COMPANY LIMITED

Notes to the Financial Statements (Continued)

(Expressed in Renminbi)

In the capitalization period, the amount of interest (including amortization of any discount or premium on borrowing) to be capitalized in each accounting period is determined as follows:

- Where funds are borrowed specifically for the acquisition, construction of a qualifying asset, the amount of interest to be capitalized is the interest expense calculated using effective interest rates during the period less any interest income earned from depositing the borrowed funds before being used on the asset.

- Where funds are borrowed generally and used for the acquisition, construction of a qualifying asset, the amount of interest to be capitalized on such borrowings is determined by applying a capitalization rate to the weighted average of the excess amounts of cumulative expenditures on the asset over the above amounts of specific borrowings. The capitalization rate is the weighted average of the interest rates applicable to the general-purpose borrowings.

The effective interest rate is determined as the rate that exactly discounts estimated future cash flow through the expected life of the borrowing or, when appropriate, a shorter period to the carrying amount of the borrowings.

The capitalization period is the period from the date of commencement of capitalization of borrowing costs to the date of cessation of capitalization, excluding any period over which capitalization is suspended. Capitalization of borrowing costs commences when expenditure for the asset is being incurred, borrowing costs are being incurred and activities of acquisition, construction that are necessary to prepare the asset for its intended use are in progress, and ceases when the assets become ready for their intended use. Capitalization of borrowing costs is suspended when the acquisition, construction activities are interrupted abnormally and the interruption lasts over three months.

(16) Related parties

If the Company has the power to control, jointly control or exercise significant influence over another party, or vice versa, or where the Company and one or more parties are subject to common control, jointly control, or significant influence from another party, they are considered to be related parties. Related parties may be individuals or enterprises. Enterprises with which the Company is under common control only from the State and that have no other related party relationships are not regarded as related parties of the Company. The Company s related parties include, but are not limited to:

(a) the Company s parent

(b) enterprises that are controlled by the Company s parent

(c) investors that have joint control over the Company

(d) investors that exercise significant influence over the Company

(e) principal individual investors and close family members of such individuals

(f) key management personnel of the Company and close family members of such individuals

(g) key management personnel of the Company s parent

(h) close family members of key management personnel of the Company s parent

(i) other enterprises that are controlled, jointly controlled or significantly influenced by principal individual investors, key management personnel of the Company, and close family members of such individuals.

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SHANGHAI SECCO PETROCHEMICAL COMPANY LIMITED

Notes to the Financial Statements (Continued)

(Expressed in Renminbi)

(17) Significant accounting estimates and judgments

The preparation of financial statements requires management to make estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from these estimates. Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognized in the period in which the estimate is revised and in any future periods affected.

Key sources of estimation uncertainty are as follows:

(a) Impairment of receivables

As described in Note 3(9)(b), receivables that are measured at amortization cost are reviewed at each balance sheet date to determine whether there is objective evidence of impairment. If any such evidence exists, impairment loss is provided. Objective evidence of impairment includes observable data that comes to the attention of the Company about loss events such as a significant decline in the estimated future cash flow of an individual debtor or the portfolio of debtors, and significant changes in the financial condition that have an adverse effect on the debtor. If there is an indication that there has been a change in the factors used to determine the provision for impairment, the impairment loss recognized in prior years is reversed.

(b) Impairment of non-financial long-term assets

As described in Note 3(8), non-financial long-term assets are reviewed at each balance sheet date to determine whether the carrying amount exceeds the recoverable amount of the assets. If any such indication exists, impairment loss is provided.

The recoverable amount of an asset (asset group) is the greater of its net selling price and its present value of expected future cash flows. Since a market price of the asset (the asset group) cannot be obtained reliably, the fair value of the asset cannot be estimated reliably. In assessing value in use, significant judgements are exercised over the asset s production, selling price, related operating expenses and discounting rate to calculate the present value. All relevant materials which can be obtained are used for estimation of the recoverable amount, including the estimation of the production, selling price and related operating expenses based on reasonable and supportable assumption.

(c) Depreciation and amortization

As described in Note 3(4) and (6), fixed assets and intangible assets are depreciated and amortized using the straight-line method over their estimated useful lives after taking into account residual value. The estimated useful lives are regularly reviewed to determine the depreciation and amortization costs charged in each reporting period. The estimated useful lives are determined based on historical experiences of similar assets and the estimated technical changes. If there is an indication that there has been a change in the factors used to determine the depreciation or amortization, the amount of depreciation or amortization is revised.

4 CHANGES IN ACCOUNTING POLICIES

(1) Changes in accounting policies and their effects

The Company adopted CAS (2006) on January 1, 2007. The significant accounting policies applicable to the Company under CAS (2006) are summarized in Note 3. Apart from the reclassification adjustments as set out below, there was no significant impact on the financial statements of the Company upon adoption of CAS(2006). Certain items in the comparative figures of 2005 and 2006 have been reclassified to conform with the requirements of CAS 38.

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SHANGHAI SECCO PETROCHEMICAL COMPANY LIMITED

Notes to the Financial Statements (Continued)

(Expressed in Renminbi)

Affected asset and liability items in the balance sheet as at December 31, 2006

	Before adjustment RMB 000	Adjustment RMB 000	After adjustment RMB 000
Short-term investments	1,454,000	(1,454,000)	
Other current assets		1,454,000	1,454,000
Fixed assets	14,566,444	(514,574)	14,051,870
Intangible assets	955,521	514,574	1,470,095
Other payables	457,153	(60,133)	397,020
Staff welfare payable	21,802	(21,802)	
Employee benefits payable		84,274	84,274
Other creditors	2,708	(2,708)	
Tax payable	75,102	369	75,471

Affected income and expense items in the income statement for the year ended December 31, 2005 (Unaudited)

	Before adjustment RMB 000	Adjustment RMB 000	After adjustment RMB 000
Sales from principal activities	12,690,197	(12,690,197)	
Other operating income	14,943	(14,943)	
Operating income		12,705,140	12,705,140
Cost of sales from principal activities	(12,117,727)	12,117,727	
Other operating costs	(14,579)	14,579	
Operating costs		(12,132,306)	(12,132,306)
Business taxes and surcharges		(361)	(361)
General and administrative expenses	(769,685)	15,406	(754,279)
Impairment loss		(15,406)	(15,406)
Subsidy income	6,457	(6,457)	
Non-operating income	60	6,457	6,517

Affected income and expense items in the income statement for the year ended December 31, 2006

	Before adjustment RMB 000	Adjustment RMB 000	After adjustment RMB 000
Sales from principal activities	21,777,397	(21,777,397)	
Other operating income	13,409	(13,409)	
Operating income		21,790,806	21,790,806
Cost of sales from principal activities	(18,025,664)	18,025,664	
Other operating costs	(13,223)	13,223	
Operating costs		(18,038,293)	(18,038,293)
Business taxes and surcharges		(594)	(594)

General and administrative expenses	(278,577)	(9,980)	(288,557)
Impairment loss		9,980	9,980
Subsidy income	11,515	(11,515)	
Non-operating income	543	11,515	12,058

SHANGHAI SECCO PETROCHEMICAL COMPANY LIMITED

Notes to the Financial Statements (Continued)

(Expressed in Renminbi)

5 TAXATION

(1) The types of taxes applicable to the Company s sale of goods and rendering of services include business tax and value added tax (VAT).

Their tax rates are as follows:

Business tax rate:	5%
VAT rate:	17%

(2) Income tax

In accordance with State Tax Bureau notices (Guo Shui Han [2003] 420), the income tax rate applicable to the Company for the year ended December 31, 2007 was 15% (2005:15%; 2006: 15%).

Pursuant to the Income Tax Law of PRC for Foreign Invested Enterprises and Foreign Enterprises, starting from the year in which a taxable profit is made after the offset of deductible losses incurred in prior years, the Company is entitled to a preferential tax treatment of a tax-free period for the first and second profit making years and a 50% reduction in the income tax rate for the third to fifth years.

2007 is the second year that the Company makes a taxable profit after the offset of deductible losses incurred in prior years. The applicable income tax rate was 0%.

On March 16, 2007, the Fifth Plenary Session of the Tenth National People s Congress passed the Corporate Income Tax Law of the PRC (the new tax law) which took effect on January 1, 2008, when the current tax law was abolished. The new tax law adopts an uniform tax rate of 25% for all enterprises including foreign investment enterprises and revokes the current tax exemption, reduction and protective treatments only applicable to foreign investment enterprises. The State Council of the PRC passed the implementation guidance (Implementation Guidance) on December 26, 2007, which set out the details of how the existing preferential income tax rate will be adjusted to the standard rate of 25%. According to the Implementation Guidance, the Company, which is eligible for a 100% or 50% relief from PRC Enterprise Income Tax, will continue to enjoy the preferential income tax rate up to the end of the derating period, after which, the 25% standard rate applies. The applicable new rates were considered to measure the Company s deferred tax assets as at December 31, 2007.

(3) Taxes payable/(recoverable)

	2006 **RMB 000**	**2007** **RMB 000**
VAT payable/(recoverable)	73,916	(47,177)
Others	1,555	1,532
Total	75,471	(45,645)

6 CASH AT BANK AND ON HAND

	2006 RMB 000	2007 RMB 000
Cash on hand	48	32
Demand deposits	1,654,771	1,566,365
Total	1,654,819	1,566,397

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SHANGHAI SECCO PETROCHEMICAL COMPANY LIMITED

Notes to the Financial Statements (Continued)

(Expressed in Renminbi)

7 BILLS RECEIVABLE

	2006 RMB 000	2007 RMB 000
Bank acceptance bills	664,533	1,198,306

All of the above bills held by the Company are due within one year.

8 ACCOUNTS RECEIVABLE

(1) Accounts receivable by customers type:

	Note	2006 RMB 000	2007 RMB 000
Amounts due from related parties	35(2) (ii)	183,082	283,160
Amounts due from others customers		147,622	228,875
Total		330,704	512,035

(2) The ageing analysis of the Company s accounts receivables is as follows:

	2006			2007		
	Amounts RMB 000	Percentage of total accounts receivables	Bad debt provision RMB 000	Amounts RMB 000	Percentage of total accounts receivables	Bad debt provision RMB 000
Within 1 year	330,704	100%		512,035	100%	

The ageing is counted starting from the date accounts receivable is recognized.

9 PREPAYMENTS

Prepayments are made for purchase. All the prepayments are due within one year.

10 OTHER RECEIVABLES

(1) Other receivables by customers type:

	Note	2006 RMB 000	2007 RMB 000
Amounts due from related parties	35(2) (ii)	537	
Amounts due from others parties		13,712	18,314
Total		14,249	18,314

SHANGHAI SECCO PETROCHEMICAL COMPANY LIMITED

Notes to the Financial Statements (Continued)

(Expressed in Renminbi)

(2) The ageing analysis of the Company s other receivables is as follows:

	2006 Amounts RMB 000	2006 Percentage of total other receivables	2006 Bad debt provision RMB 000	2007 Amounts RMB 000	2007 Percentage of total other receivables	2007 Bad debt provision RMB 000
Within 1 year (inclusive)	13,541	95%		17,021	93%	
1 and 2 years (inclusive)	708	5%		1,035	6%	
2 and 3 years (inclusive)				258	1%	
Total	14,249	100%		18,314	100%	

The ageing is counted starting from the date of recognition of other receivables.

11 INVENTORIES

	2006 RMB 000	2007 RMB 000
Raw materials	864,873	949,683
Work in progress	42,288	41,485
Semi-finished goods	387,594	397,696
Finished goods	501,022	619,189
Subtotal	1,795,777	2,008,053
Less: Provision for diminution in value of inventories	(5,426)	(5,553)
Total	1,790,351	2,002,500

An analysis of provision for diminution in value of inventories is as follows:

	2006 Semi-finished goods RMB 000	2006 Finished goods RMB 000	2006 Total RMB 000	2007 Semi-finished goods RMB 000	2007 Finished goods RMB 000	2007 Total RMB 000
Opening balance as at January 1	(6,979)	(8,427)	(15,406)	(3,279)	(2,147)	(5,426)
Add: Provision made during the year	(3,279)	(2,147)	(5,426)		(5,553)	(5,553)
Less: Reversal during the year	6,979	8,427	15,406	3,279	2,147	5,426

Closing balance as at December 31	(3,279)	(2,147)	(5,426)		(5,553)	(5,553)

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SHANGHAI SECCO PETROCHEMICAL COMPANY LIMITED

Notes to the Financial Statements (Continued)

(Expressed in Renminbi)

12 OTHER CURRENT ASSETS

	2006 RMB 000	2007 RMB 000
Designated loan		
- principal	1,454,000	1,454,000
- interest receivable		1,309
Less: Provision for diminution in value		
Total	1,454,000	1,455,309

The Company entrusted Bank of Communications Shanghai Branch to grant loans. Details of loan balances as at December 31, 2007 are as follows:

Borrower	Balance	Duration	Interest rate
SPCL	391,000	2007.10.09-2008.01.09	3.80%
SPCL	336,000	2007.12.26-2008.06.26	3.58%
BP (China) Holdings Ltd. (BP Holdings)	391,000	2007.10.09-2008.01.09	3.80%
BP Zhuhai Chemical Co., Ltd. (BP Zhuhai)	336,000	2007.12.26-2008.06.26	3.58%
Total	1,454,000		

13 FIXED ASSETS

	Plant and buildings RMB 000	Machinery and equipment RMB 000	Office and other equipment RMB 000	Motor vehicles RMB 000	Total RMB 000
Cost:					
As at January 1, 2006	1,247,955	14,869,101	78,372	2,340	16,197,768
Additions		3,973	10,228	1,510	15,711
Transfer from construction in progress		2,034			2,034
Disposals			(2,819)		(2,819)
As at December 31, 2006	1,247,955	14,875,108	85,781	3,850	16,212,694
Accumulated depreciation:					
As at January 1, 2006	(63,268)	(913,716)	(22,336)	(203)	(999,523)
Charge for the year	(73,289)	(1,073,364)	(16,583)	(360)	(1,163,596)
Written back on disposal			2,295		2,295

As at December 31, 2006	(136,557)	(1,987,080)	(36,624)	(563)	(2,160,824)
Carrying amount:					
As at December 31, 2006	1,111,398	12,888,028	49,157	3,287	14,051,870
As at January 1, 2006	1,184,687	13,955,385	56,036	2,137	15,198,245