ABOITIZ EQUITY VENTURES, INC. AND SUBSIDIARIES

Consolidated Financial Statements
As of December 31, 2004 and 2003 and
the Three Years Ended December 31, 2004

and

Report of Independent Auditors

SGVMC404218

Report of Independent Auditors

The Stockholders and the Board of Directors
Aboitiz Equity Ventures, Inc.

We have audited the accompanying consolidated balance sheets of Aboitiz Equity Ventures, Inc. and Subsidiaries as of December 31, 2004 and 2003, and the related consolidated statements of income, changes in stockholders' equity and cash flows for each of the three years in the period ended December 31, 2004. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the Philippines. 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 Aboitiz Equity Ventures, Inc. and Subsidiaries as of December 31, 2004 and 2003, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2004 in conformity with accounting principles generally accepted in the Philippines.

Ladislao Z. Avila, Jr.
Partner
CPA Certificate No. 69099
SEC Accreditation No. 0111-A
Tax Identification No. 109-247-891
PTR No. 1195827, January 3, 2005, Makati City

April 6, 2005

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Report of Independent Auditors

The Stockholders and the Board of Directors
Aboitiz Equity Ventures, Inc.
Aboitiz Corporate Center
Gov. Manuel A. Cuenco Avenue, Cebu City

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ABOITIZ EQUITY VENTURES, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(Amounts in Thousands)

	December 31	
	2004	2003 (As restated - Note 2)
ASSETS		
Current Assets		
Cash and cash equivalents (Notes 3 and 22)	**₱4,384,459**	₱3,286,213
Trade and other receivables - net (Notes 4 and 22)	**2,889,647**	2,149,415
Inventories (Note 5)	**1,439,175**	991,539
Other current assets - net (Notes 22 and 26)	**440,470**	167,344
Total Current Assets	**9,153,751**	6,594,511
Noncurrent Assets		
Property, plant and equipment - net (Notes 6, 12 and 14)	**11,903,366**	11,802,477
Investments in associates - net (Notes 2, 8 and 15)	**12,642,145**	11,838,025
Investments in shares of stock at cost	**50,986**	53,028
Noncurrent advances to associates - net of allowance for losses of ₱23,472 in 2003 (Note 22)	**264,398**	248,716
Other noncurrent assets - net (Notes 9, 20 and 21)	**782,185**	521,055
Total Noncurrent Assets	**25,643,080**	24,463,301
TOTAL ASSETS	**₱34,796,831**	₱31,057,812
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities		
Bank loans (Notes 10 and 22)	**₱1,629,663**	₱1,087,450
Trade and other payables (Notes 11, 13, 22 and 24)	**3,317,498**	2,483,010
Income tax payable	**199,707**	122,089
Current portion of long-term debt (Notes 12 and 22)	**1,573,482**	1,248,623
Current portion of obligations under finance lease (Notes 6 and 14)	**134,273**	115,338
Total Current Liabilities	**6,854,623**	5,056,510
Noncurrent Liabilities		
Long-term debt - net of current portion (Notes 12 and 22)	**7,102,238**	7,797,919
Obligations under finance lease - net of current portion (Notes 6 and 14)	**372,566**	504,081
Customers' deposits (Note 13)	**911,751**	828,968
Deferred income tax (Note 21)	**9,657**	–
Total Noncurrent Liabilities	**8,396,212**	9,130,968
Minority Interest	**352,455**	312,908
Stockholders' Equity		
Capital stock (Note 15)	**5,881,300**	5,794,600
Additional paid-in capital	**2,880,940**	2,100,640
Share in net unrealized loss on available-for-sale securities and underwriting accounts of an associate (Note 8)	**(383,473)**	(320,707)
Retained earnings (Note 15)	**12,524,858**	10,690,878
Treasury stock at cost	**(1,710,084)**	(1,707,985)
Total Stockholders' Equity	**19,193,541**	16,557,426
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	**₱34,796,831**	₱31,057,812

See accompanying Notes to Consolidated Financial Statements.

ABOITIZ EQUITY VENTURES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

(Amounts in Thousands, Except Per Share Amounts)

	Years Ended December 31		
	2004	2003 (As restated - Note 2)	2002 (As restated - Note 2)
NET REVENUE (Notes 16 and 22)	**₱21,064,982**	₱17,951,108	₱16,574,344
COSTS AND EXPENSES (Notes 5, 6, 17, 18, 22, 23, 24 and 26)	**19,465,725**	16,438,091	14,839,670
INCOME FROM OPERATIONS	**1,599,257**	1,513,017	1,734,674
OTHER INCOME (CHARGES)			
Share in net earnings of associates (Note 8)	**1,552,190**	1,562,544	1,871,829
Interest income (Note 22)	**217,041**	189,728	158,743
Interest expense (Notes 10, 12, 13, 14 and 22)	**(1,144,429)**	(1,030,100)	(730,091)
Others - net (Notes 6, 20 and 22)	**721,236**	226,224	(33,490)
	1,346,038	948,396	1,266,991
INCOME BEFORE INCOME TAX AND MINORITY INTEREST	**2,945,295**	2,461,413	3,001,665
PROVISION FOR INCOME TAX (Note 21)	**483,252**	403,894	465,897
INCOME BEFORE MINORITY INTEREST	**2,462,043**	2,057,519	2,535,768
MINORITY INTEREST	**40,269**	15,699	308,863
NET INCOME	**₱2,421,774**	₱2,041,820	₱2,226,905
Earnings Per Common Share (Note 27)	**₱0.48**	₱0.41	₱0.44

See accompanying Notes to Consolidated Financial Statements.

ABOITIZ EQUITY VENTURES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

(Amounts in Thousands, Except Par Value, Number of Shares and Per Share Amounts)

	Years Ended December 31					
	2004		2003		2002	
	Number of Shares	**Amount**	Number of Shares	Amount	Number of Shares	Amount
CAPITAL STOCK (Note 15)						
Authorized						
Preferred shares - ₱1 par value	400,000,000		400,000,000		400,000,000	
Common shares - ₱1 par value	9,600,000,000		9,600,000,000		9,600,000,000	
Issued						
Preferred shares	**186,700,000**	**186,700**	100,000,000	₱100,000	100,000,000	₱100,000
Common shares	**5,694,599,621**	**5,694,600**	5,694,599,621	5,694,600	5,694,599,621	5,694,600
	5,881,299,621	**5,881,300**		5,794,600		5,794,600
ADDITIONAL PAID-IN CAPITAL		**2,880,940**		2,100,640		2,100,640
SHARE IN NET UNREALIZED LOSS ON AVAILABLE-FOR-SALE SECURITIES AND UNDERWRITING ACCOUNTS OF AN ASSOCIATE (Note 8)						
Balance at beginning of year		**(320,707)**		(277,382)		–
Net change during the year		**(62,766)**		(43,325)		(277,382)
Balance at end of year		**(383,473)**		(320,707)		(277,382)
RETAINED EARNINGS (Note 15)						
Balance at beginning of year, as previously reported		**11,169,465**		9,642,286		7,941,767
Effect of change in accounting policies (Note 2)		**(478,587)**		(426,917)		(376,101)
Balance at beginning of year, as restated		**10,690,878**		9,215,369		7,565,666
Net income (Note 2)		**2,421,774**		2,041,820		2,226,905
Cash dividends						
Common - ₱0.10 per share in 2004, 2003 and 2002		**(497,280)**		(497,821)		(505,222)
Preferred - ₱0.73 per share in 2004, ₱0.68 per share in 2003 and ₱0.72 per share in 2002		**(90,514)**		(68,490)		(71,980)
Balance at end of year		**12,524,858**		10,690,878		9,215,369
TREASURY STOCK AT COST - Common shares						
Balance at beginning of year	**873,159,261**	**(1,707,985)**	858,559,966	(1,672,441)	529,338,840	(880,867)
Net change during the year	**102,176**	**(2,099)**	14,599,295	(35,544)	329,221,126	(791,574)
Balance at end of year	**873,261,437**	**(1,710,084)**	873,159,261	(1,707,985)	858,559,966	(1,672,441)
		₱19,193,541		₱16,557,426		₱15,160,786

See accompanying Notes to Consolidated Financial Statements.

ABOITIZ EQUITY VENTURES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Amounts in Thousands)

	Years Ended December 31		
	2004	2003 (As restated - Note 2)	2002 (As restated - Note 2)
CASH FLOWS FROM OPERATING ACTIVITIES			
Income before income tax and minority interest	**₱2,945,295**	₱2,461,413	₱3,001,665
Adjustments for:			
Depreciation	**1,702,633**	1,506,975	1,583,161
Interest expense	**1,144,429**	1,030,100	730,091
Franchise tax expense	**108,937**	76,063	84,281
Provisions for:			
Doubtful accounts and probable losses	**96,711**	87,717	66,714
Losses on project costs, investments in shares of stock and advances	**–**	–	109,810
Decline in value of marketable equity securities	**–**	–	13,769
Write-downs of tied up vessels and other accounts	**–**	–	10,870
Retirement benefits	**–**	–	617
Share in net earnings of associates	**(1,552,190)**	(1,562,544)	(1,871,829)
Loss (gain) on sale of:			
Property and equipment	**(420,653)**	(18,275)	28,238
Investments in shares of stock	**(15,696)**	(15)	–
Interest income	**(217,041)**	(189,728)	(158,743)
Unrealized foreign exchange gain	**(21,736)**	(18,421)	(69,462)
Unrealized gain on recovery in value of marketable equity securities	**(11,661)**	(13,777)	–
Write-off of project costs and others	**–**	–	9,727
Operating income before working capital changes	**3,759,028**	3,359,508	3,538,909
Increase in:			
Trade and other receivables	**(779,216)**	(284,360)	168,051
Inventories	**(447,636)**	–	–
Other current assets	**(261,523)**	(101,734)	(275,749)
Increase (decrease) in:			
Trade and other payables	**692,616**	494,684	134,571
Other current liabilities	**–**	(390,316)	54,205
Customers' deposits	**82,783**	103,467	57,439
Net cash generated from operations	**3,046,052**	3,181,249	3,677,426
Interest paid	**(1,073,308)**	(1,011,248)	(809,340)
Income and final taxes paid	**(369,418)**	(276,461)	(312,698)
Franchise taxes paid	**(98,058)**	(81,846)	(84,030)
Net cash flows from operating activities	**1,505,268**	1,811,694	2,471,358

(Forward)

	Years Ended December 31		
	2004	2003	2002 (As restated - Note 2)
CASH FLOWS FROM INVESTING ACTIVITIES			
Proceeds from sale of property and equipment	**₱1,470,427**	₱–	₱129,098
Dividends received	**680,132**	762,635	1,096,089
Interest received	**159,314**	193,254	164,092
Proceeds from sale of investments in shares of stock	**26,763**	–	–
Additions to:			
Property, plant and equipment	**(2,802,862)**	(2,581,826)	(2,765,047)
Investments and noncurrent advances to associates	**(19,535)**	(6,150)	(204,210)
Decrease (increase) in:			
Marketable securities	**58**	303,764	197,433
Other noncurrent assets	**(287,689)**	(104,656)	(421,364)
Acquisition of ATSC and FILAM, net of cash (Note 2)	**–**	–	(5,517,709)
Effect of deconsolidation of VECO, net of cash (Note 2)	**–**	–	1,808,679
Net cash flows used in investing activities	**(773,392)**	(1,432,979)	(5,512,939)
CASH FLOWS FROM FINANCING ACTIVITIES			
Proceeds from issuance of capital stock	**867,000**	–	–
Net proceeds from (payments of):			
Bank loans	**542,213**	(524,961)	836,000
Long-term debt	**(483,402)**	1,968,111	4,106,303
Cash dividends paid	**(578,356)**	(565,390)	(579,889)
Acquisition of treasury shares	**(2,099)**	(35,544)	(791,574)
Increase (decrease) in minority interest	**(722)**	(247,472)	174,441
Net cash flows from financing activities	**344,634**	594,744	3,745,281
EFFECT OF EXCHANGE RATE CHANGES ON CASH AND CASH EQUIVALENTS	**21,736**	18,421	69,462
NET INCREASE IN CASH AND CASH EQUIVALENTS	**1,076,510**	973,459	703,700
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	**3,286,213**	2,294,333	1,521,171
CASH AND CASH EQUIVALENTS AT END OF YEAR	**₱4,384,459**	₱3,286,213	₱2,294,333

See accompanying Notes to Consolidated Financial Statements.

1. Corporate Information

Aboitiz Equity Ventures, Inc. (the Parent Company) and its subsidiaries (collectively referred to as "the Group") were incorporated in the Republic of the Philippines. The Parent Company is the publicly-listed holding and management company of the Aboitiz Group. The Group is engaged in various business activities in the Philippines, including power generation and distribution, food manufacturing, banking and financial services, and transportation (see Note 28). The average number of employees in the Parent Company was 41 in 2004 and 2003 and 40 in 2002. On a consolidated basis, the average number of employees was 1,952 in 2004, 1,971 in 2003 and 2,037 in 2002. The registered office address of the Parent Company is Aboitiz Corporate Center, Gov. Manuel A. Cuenco Avenue, Cebu City.

The accompanying consolidated financial statements of the Group as of and for the year ended December 31, 2004 and 2003, and for the earn of the three years in the period end December 31, 2004 were authorized for issue by the Board of Directors (BOD) on April 6, 2005.

2. Summary of Significant Accounting Policies

Basis of Preparation
The consolidated financial statements of the Group have been prepared in accordance with accounting principles generally accepted in the Philippines using the historical cost basis.

Changes in Accounting Policies
On January 1, 2004, the Group adopted the following Statements of Financial Accounting Standards (SFAS)/International Accounting Standards (IAS):

?? SFAS 17/IAS 17, *Leases*, which resulted in the recognition of lease payments under operating leases on a straight-line basis. Previously, lease payments under operating leases were expensed on the basis of the terms of the lease agreements. The change in policy was reflected in the consolidated financial statements on a retroactive basis. Net income decreased by ₱575, ₱582 and ₱554 in 2004, 2003 and 2002, respectively. Retained earnings decreased by ₱2,727, ₱2,145 and ₱1,591 as of January 1, 2004, 2003 and 2002, respectively.

?? SFAS 12/IAS 12, *Income Taxes*, which resulted in the Group's recognition of its share in the deferred income tax liability of an associate arising from foreign exchange losses capitalized to the associate's power station which were realized for tax purposes. Previously this deferred tax liability was not recognized in the consolidated financial statements. The adoption of SFAS 12/IAS 12 also resulted in the Group's derecognition of its share in the deferred income tax assets of an associate that are not expected to reverse within a reasonable period of time. The change in policy was reflected in the consolidated financial statements on a retroactive basis. Net income decreased by ₱51,088 and ₱50,263 in 2003 and 2002, respectively. Retained earnings decreased by ₱475,860, ₱424,772 and ₱374,510 as of January 1, 2004, 2003 and 2002, respectively. Investments in associates decreased by ₱475,860 and ₱424,772 as of December 31, 2003 and 2002, respectively.

Basis of Consolidation
The consolidated financial statements include the financial statements of the Parent Company and its subsidiaries as of December 31 of each year.

Subsidiaries are consolidated from the date on which control is transferred to the Group and cease to be consolidated from the date on which control is transferred out of the Group.

Consolidated financial statements are prepared using uniform accounting policies for like transactions and other events in similar circumstances. All significant intercompany transactions and balances, including intercompany profits and unrealized profits and losses, are eliminated.

Minority interests represent the interests in the subsidiaries not held by the Group.

Cash and Cash Equivalents
Cash includes cash on hand and in banks. Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash with original maturities of three months or less and that are subject to an insignificant risk of change in value.

Trade and Other Receivables
Trade and other receivables are recognized and carried at original invoice amount or face value less an allowance for any uncollectible amounts. An estimate for doubtful accounts is made when collection of the full amount is no longer probable.

Inventories
Inventories are valued at the lower of cost and net realizable value (NRV). Cost is determined using the specific identification method for wheat grains; first-in, first-out method for finished goods, fuel and lubricants and other raw materials; and average method for livestock and parts and supplies. NRV for finished goods and livestock is the estimated selling price in the ordinary course of business less estimated costs necessary to make the sale. NRV for other inventories is the estimated current replacement cost.

Investments in Marketable Securities
Investments in marketable securities (included under "Other current assets" account in the consolidated balance sheets) are stated at the lower of aggregate cost or market value, determined at the balance sheet date. The amount by which aggregate cost exceeds aggregate market value is accounted for as a valuation allowance and changes in the valuation allowance are included in income. The cost of marketable securities sold is based on the average cost. Realized gains and losses from the sale of current marketable securities are included in income.

Property, Plant and Equipment
Property, plant and equipment, except for land, are stated at cost less accumulated depreciation and amortization and any impairment in value. Land is stated at cost less any impairment in value.

The initial cost of property, plant and equipment consists of its purchase price, including import duties, taxes and any directly attributable costs of bringing the asset to its working condition and location for its intended use. Expenditures incurred after the property, plant and equipment have been put into operation, such as repairs and maintenance and overhaul costs, are normally charged to income in the period in which the costs are incurred. In situations where it can be clearly demonstrated that the expenditures have resulted in an increase in the future economic benefits expected to be obtained from the use of an item of property, plant and equipment beyond its

originally assessed standard of performance, the expenditures are capitalized as an additional cost of property, plant and equipment.

Drydocking costs, consisting mainly of steel plate replacement of the ships' hull and related expenditures, are capitalized as part of ships in operation and amortized generally over 30 months or 2 1/2 years.

Depreciation and amortization are computed using the straight-line method over the estimated useful lives of the assets, or the terms of the lease in case of leasehold improvements, whichever is shorter, except for power plant equipment of certain subsidiaries, as follows:

Category	Number of Years
Buildings, warehouses and improvements	10 - 30
Power plant equipment	10 - 25
Transmission and distribution equipment	11 - 20
Distribution transformers and substation equipment	12 - 20
Machinery and equipment	10 - 20
Transportation equipment	3 - 10
Ships in operation and improvements, excluding drydocking costs	10 - 15
Drydocking costs	2 1/2
Containers	5 - 7
Handling equipment	5 - 7
Office furniture, fixtures and equipment	3 - 10
Leasehold improvements	3 - 10
Miscellaneous	3 - 10

The useful lives and the depreciation and amortization methods are reviewed periodically to ensure that the periods and methods of depreciation and amortization are consistent with the expected pattern of economic benefits from items of property, plant and equipment.

Ships under refurbishment include the acquisition cost of the ships, the cost of on-going refurbishments and other direct costs. Construction in progress represents structures under construction and is stated at cost. This includes cost of construction and other direct costs. Borrowing costs that are directly attributable to the refurbishment of ships and construction of other property and equipment are capitalized during the refurbishment and construction period. Ships under refurbishment and construction in progress are not depreciated until such time that the relevant assets are completed and put into operational use.

Tied up vessels, which represent excess vessels identified in the rationalization of Aboitiz Transport System Corporation (ATSC) routing schedules, are offered for sale and presented as part of "Other noncurrent assets" account in the consolidated balance sheets, are stated at their carrying amounts (cost less accumulated depreciation) at the date when the vessels were retired from active use less allowance for any impairment in value.

Investments

Associates

The Group's investments in its associates are accounted for under the equity method of accounting. An associate is an entity in which the Group has significant influence and which is neither a subsidiary nor a joint venture of the Group. The investments in associates are carried in the consolidated balance sheets at cost plus post-acquisition changes in the Group's share of net assets of the associate, less any impairment in value. The consolidated statements of income reflect the Group's share of the results of operations of the associates. The Group's investments in associates include goodwill (net of accumulated amortization and impairment loss) on acquisition, which is treated in accordance with the policy for goodwill. Dividends received are deducted from the carrying value of the investment. Share in the associates' net earnings or losses is adjusted for the amortization and impairment of the related goodwill.

Other investments

Other investments in shares of stock are valued at cost, net of allowance for any substantial and presumably permanent decline in value.

Goodwill

Goodwill represents the excess of the cost of acquisition over the fair value of identifiable net assets of subsidiaries or associates at the date of acquisition. With respect to an investment in associate, goodwill is included in the carrying amount of the investment. Goodwill is stated at cost less accumulated amortization and any impairment in value. Goodwill is amortized on a straight-line basis over its useful economic life up to a presumed maximum of 20 years. Goodwill is reviewed for impairment when events or changes in circumstances indicate that the carrying value may not be recoverable.

Noncurrent Advances to Associates

Noncurrent advances to associates are stated at face value less any allowance for probable losses. An estimate for doubtful accounts is made when collection of the full amount is no longer probable.

Software Development Costs

Costs incurred in the development of computer software are capitalized. Software development costs, included under "Other noncurrent assets" account in the consolidated balance sheets, are amortized using the straight-line method over a period of two to three years.

The carrying value of software development costs is reviewed for impairment annually when the asset is not yet in use, and otherwise when events or changes in circumstances indicate that the carrying value may not be recoverable.

Impairment of Assets

The carrying values of investments, property, plant and equipment and other long-lived assets are reviewed for impairment when events or changes in circumstances indicate the carrying values may not be recoverable. If any such indication exists and where the carrying values exceed the estimated recoverable amount, the assets or cash-generating units are written down to their recoverable amounts. The recoverable amount of the assets is the greater of net selling price and

value in use. In assessing value in use, the estimated future cash flows are discounted 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. For an asset that does not generate largely independent cash inflows, the recoverable amount is determined for the cash-generating unit to which the asset belongs. Impairment losses are recognized in the consolidated statements of income.

Provisions

Provisions are recognized when the Group has a present obligation (legal or constructive) as a result of a past event, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and a reliable estimate can be made of the amount of the obligation. If the effect of the time value of money is material, provisions are determined by discounting the expected future cash flows at a pre-tax rate that reflects current market assessments of the time value of money and, where appropriate, the risks specific to the liability. Where discounting is used, the increase in the provisions due to the passage of time is recognized as interest expense.

Revenue

Revenue is recognized to the extent that it is probable that the economic benefits will flow to the Group and the amount of the revenue can be measured reliably. The following specific recognition criteria must also be met before revenue is recognized:

Sales

Revenue from sale of power and electricity is recognized in the period in which actual capacity is generated and earned, and upon distribution of power to customers. Revenue from the sale of goods is recognized upon delivery to customers and transfer of risks and rewards of ownership of the goods is completed.

Rendering of services

Freight and passage revenues are recognized when the related services are rendered, net of rebates and percentage taxes.

Rental income

Rental income is accounted for on a straight-line basis over the lease term.

Dividend income

Dividend income is recognized when the shareholders' right to receive payment is established.

Interest income

Interest is recognized as it accrues.

Foreign Currency Transactions

Transactions denominated in foreign currencies are recorded in Philippine peso using the exchange rate at the date of the transaction. Foreign currency-denominated monetary assets and liabilities are restated using the closing exchange rate at balance sheet dates. Foreign exchange differences on foreign currency liabilities, net of amounts regarded as adjustment of interest cost, incurred in connection with the acquisition or construction of property, plant and equipment are capitalized as part of the asset, provided that the adjusted carrying amounts of the asset does not exceed the estimated recoverable amount.

The Parent Company uses long-term forward foreign exchange agreements to manage its foreign currency exposure on US dollar denominated loans. Gains and losses on these agreements, computed based on changes on spot exchange rates, are recognized in the same period as the underlying loans.

Borrowing Costs

Borrowing costs generally are expensed as incurred. Borrowing costs, including foreign exchange differences arising from foreign currency borrowings that are regarded as an adjustment of interest costs, are capitalized if they are directly attributable to the acquisition or construction of a qualifying asset. Capitalization of borrowing costs commences when the activities to prepare the asset are in progress and expenditures and borrowing costs are being incurred. Borrowing costs are capitalized until the assets are substantially ready for their intended use. If the carrying amount of the asset exceeds its recoverable amount, an impairment loss is recorded.

Retirement Cost

Retirement cost is computed based on the projected unit credit method which includes current service cost plus amortization of past service cost, experience adjustments and changes in actuarial assumptions over the expected remaining average working lives of the covered employees.

Income Taxes

Deferred income tax is provided, using the balance sheet liability method, on all temporary differences at the balance sheet date between the tax bases of assets and liabilities and their carrying amounts for financial reporting purposes.

Deferred income tax liabilities are recognized for all taxable temporary differences, including asset revaluations. Deferred income tax assets are recognized for all deductible temporary differences, carryforward of unused tax credits from excess minimum corporate income tax and unused tax losses, to the extent that it is probable that taxable profit will be available against which the deductible temporary differences and carryforward of unused tax credits and unused tax losses can be utilized. Deferred income tax, however, is not recognized when it arises from the initial recognition of an asset or liability in a transaction that is not a business combination and, at the time of the transaction, affects neither the accounting profit nor taxable profit or loss.

Deferred tax liabilities are not provided on non-taxable temporary differences associated with investments in domestic subsidiaries, associates and interests in joint ventures. With respect to investments in other subsidiaries, associates and interests in joint ventures, deferred tax liabilities are recognized except where the timing of the reversal of the temporary difference can be controlled and it is probable that the temporary difference will not reverse in the foreseeable future.

The carrying amount of deferred income tax assets is reviewed at each balance sheet date and reduced to the extent that it is no longer probable that sufficient taxable profit will be available to allow all or part of the deferred income tax asset to be utilized.

Deferred income tax assets and liabilities are measured at the tax rates that are expected to apply to the period when the asset is realized or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted at the balance sheet date.

Leases
Finance leases, which transfer to the Group substantially all the risks and benefits incidental to ownership of the leased item, are capitalized at the inception of the lease at the fair value of the leased property or, if lower, at the present value of the minimum lease payments. Lease payments are apportioned between the finance charges and reduction of the lease liability so as to achieve a constant rate of interest on the remaining balance of the liability. Finance charges are charged directly against income.

Capitalized leased assets are depreciated over the shorter of the estimated useful lives of the assets or the respective lease terms.

Leases where the lessor retains substantially all the risks and benefits of ownership of the asset are classified as operating leases. Operating lease payments are recognized as an expense in the consolidated statements of income on a straight-line basis over the lease term.

Business Segments
For management purposes, the Group is organized into four major operating entities (power, food manufacturing, transportation and parent company/others) according to the nature of the products and the services provided, with each segment representing a strategic business unit that offers different products and serves different markets. The entities are the basis upon which the Group reports its primary segment information. Financial information on business segments is presented in Note 28.

Contingencies
Contingent liabilities are not recognized in the consolidated financial statements. These are disclosed unless the possibility of an outflow of resources embodying economic benefits is remote. Contingent assets are not recognized in the consolidated financial statements but disclosed when an inflow of economic benefits is probable.

Subsequent Events
Post year-end events that provide additional information about the Group's position at balance sheet date (adjusting events) are reflected in the consolidated financial statements. Post year-end events that are not adjusting events are disclosed when material.

Earnings Per Common Share
Earnings per common share are computed by dividing net income for the year attributable to common shares by the weighted average number of common shares issued and outstanding during the year, after retroactive adjustments for any stock dividends declared.

New Accounting Standards Effective in 2005
New accounting standards based on IAS and International Financial Reporting Standards, referred to as Philippine Accounting Standards (PAS) and Philippine Financial Reporting Standards (PFRS), respectively, will become effective in 2005. The Group will adopt the following new accounting standards that are relevant to the Group effective January 1, 2005:

?? PAS 19, *Employee Benefits*, will result in the use of the projected unit credit method in measuring retirement benefit expense and a change in the manner of computing benefit expense relating to past service cost and actuarial gains and losses. It requires the Group to determine the present value of defined benefit obligations and the fair value of any plan assets with sufficient regularity that the amounts recognized in the financial statements do not differ materially from the amounts that would be determined at the balance sheet date. The Group

will update their respective actuarial valuations in 2005 to determine the impact of adopting PAS 19. Adoption of this standard is expected to result in the recognition of liability and charge against beginning retained earnings representing the difference between the deferred benefit obligation and the fair value of the plan assets, among others.

?? PAS 21, *The Effects of Changes in Foreign Exchange Rates*, will result in the elimination of the capitalization of foreign exchange losses. The standard provides that, upon adoption in 2005, any undepreciated capitalized foreign exchange losses (net of amount regarded as an adjustment of interest cost) will be adjusted against beginning retained earnings and prior years' consolidated financial statements presented will be restated. PAS 21 further requires the Group to determine its functional currency and measure its results and financial position in that currency. Translation procedures are specified when the presentation currency used for reporting differs from the Group's functional currency.

The Group's practice has been to capitalize foreign exchange adjustments arising from foreign currency denominated obligations incurred to finance the construction of power plants. Foreign exchange adjustments incurred during the construction period that are regarded as adjustments to borrowing costs may qualify for capitalization as part of the power plant cost under SFAS No. 23, *Borrowing Costs,* and accordingly, will not be affected by the adjustments required under PAS 21 in 2005. As of December 31, 2004, undepreciated capitalized foreign exchange losses included in property, plant, and equipment account, excluding the amount regarded as an adjustment of interest cost and eligible for capitalization under SFAS No. 23, amounted to ₱541,567.

?? PAS 32, *Financial Instruments: Disclosure and Presentation,* covers the disclosure and presentation of all financial instruments. The standard requires more comprehensive disclosures about a company's financial instruments, whether recognized or unrecognized in the financial statements. New disclosure requirements include terms and conditions of financial instruments used by the Group, types of risks associated with both recognized and unrecognized financial instruments (price risk, credit risk, liquidity risk, and cash flow risk), fair value information of both recognized and unrecognized financial assets and financial liabilities, and the Group's financial risk management policies and objectives. The standard also requires financial instruments to be classified as liabilities or equity in accordance with their substance and not their legal form. Required disclosures and presentation, as applicable, will be included in the 2005 consolidated financial statements.

?? PAS 39, *Financial Instruments: Recognition and Measurement,* establishes the accounting and reporting standards for recognizing, measuring, and disclosing information about the Group's financial assets and financial liabilities. The standard requires a financial asset or financial liability to be recognized initially at fair value. Subsequent to initial recognition, the Group should continue to measure financial assets at their fair values, except for loans and receivables and held-to-maturity investments, which are to be measured at cost or amortized cost using the effective interest rate method. Financial liabilities are subsequently measured at cost or amortized cost, except for liabilities classified as "at fair value through profit and loss" and derivatives, which are subsequently to be measured at fair value.

PAS 39 also covers the accounting for derivative instruments. This standard has expanded the definition of a derivative instrument to include derivatives (and derivative-like provisions) embedded in non-derivative contracts. Under the standard, every derivative instrument is recorded in the balance sheet as either an asset or liability measured at its fair value.

Derivatives that do not qualify as hedges are adjusted to fair value through income. If a derivative is designated and qualify as a hedge, depending on the nature of the hedging relationship, changes in the fair value of the derivative are either offset against the changes in fair value of the hedged assets, liabilities, and firm commitments through earnings, or recognized in stockholders' equity until the hedged item is recognized in earnings. The Group must formally document, designate and assess the hedge effectiveness of derivative transactions that receive hedge accounting treatment.

Adoption of PAS 39 is expected to have operational and financial statement impact to the Group which is not presently quantifiable. Volatility in the consolidated financial statements is anticipated because of the requirement to fair value most financial instruments, including derivative financial statements. The Group plans to undertake certain detailed activities in 2005, which include, among others, the following:

1. Review of contracts for the purpose of identifying and, where required, bifurcating derivatives that are embedded in both financial and non-financial contracts;

2. Development of a financial instruments policy that will cover accounting for financial instruments, to include in the preparation of hedge accounting guidelines and requirements for derivatives that are designated and qualify as hedges;

3. Evaluation of the proper classification of financial instruments, including determining whether a financial instrument should be accounted for as debt or equity; and

4. Assessment of required process and systems changes.

In 2005, the impact of adoption of PAS 39 will be retroactively computed, as applicable, and adjusted to January 1, 2005 retained earnings. Prior years' consolidated financial statements, as allowed by the Securities and Exchange Commission (SEC), will not be restated.

?? PAS 40, *Investment Property*, prescribes the accounting treatment for investment property and related disclosure requirements. This standard permits the company to choose either the fair value model or cost model in accounting for investment property. Fair value model requires an investment property to be measured at fair value with fair value changes recognized directly in the consolidated statements of income. Cost model requires that an investment property should be measured at depreciated cost less any accumulated impairment losses. Upon effectivity of PAS 40, the Group will adopt the cost model and will continue to carry its investment property at depreciated cost less any accumulated impairment losses. Adoption of this standard is not expected to have significant impact to the Group.

?? PFRS 3*, Business Combination,* which will result in the cessation of the amortization of goodwill and a requirement for an annual test for goodwill impairment. Any resulting negative goodwill after performing reassessment will be credited to income. Moreover, pooling of interests in accounting for business combination will no longer be permitted. Upon adoption of PFRS 3 in 2005, annual amortization of goodwill of ₱170,244 under the current standards will no longer be charged to operations. Unamortized goodwill as of December 31, 2004 amounted to about ₱1,849,910.

The Group will also adopt in 2005 the following revised standards*:*

?? PAS 1, *Presentation of Financial Statements*, provides a framework within which an entity assesses how to present fairly the effects of transactions and other events; provides the base criteria for classifying liabilities as current or noncurrent; prohibits the presentation of income from operating activities and extraordinary items as separate line items in the consolidated statements of income; and specifies the disclosures about key sources of estimation, uncertainty and judgments management has made in the process of applying the entity's accounting policies. It also requires changes in the presentation of minority interest in the consolidated balance sheets and consolidated statements of income.

?? PAS 2, *Inventories*, reduces the alternatives for measurement of inventories. It does not permit the use of the last in, first out formula to measure the cost of inventories.

?? PAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, removes the concept of fundamental error and the allowed alternative to retrospective application of voluntary changes in accounting policies and retrospective restatement to correct prior period errors. It defines material omission or misstatements, and describes how to apply the concept of materiality when applying accounting policies and correcting errors.

?? PAS 10, *Events After the Balance Sheet Date*, provides a limited clarification of the accounting for dividends declared after the balance sheet date.

?? PAS 16, *Property, Plant and Equipment*, provides additional guidance and clarification on recognition and measurement of items of property, plant and equipment. It also provides that each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item shall be depreciated separately. It also requires that the cost of an item of property, plant and equipment should include the costs of its dismantlement, removal or restoration, the obligation for which the Group incurs as a consequence of installing the item or of using the item during a particular period for purposes other than to produce inventories during that period. The Group has yet to determine the impact of these new requirements as quantification will require detailed evaluation of the significant property, plant and equipment as well as determination of the existence of any constructive and/or legal obligation related to the dismantlement, removal or restoration of certain of its property, plant and equipment. If it is eventually determined that the Group is liable for such costs, adoption of the new standard would result in an increase in the net book value of property, plant and equipment and in the recognition of the related dismantlement or restoration liability. The difference between the increase in the net book value of property, plant and equipment and the amount of dismantlement or restoration liability would be adjusted to beginning retained earnings. Subsequent annual depreciation expense would increase and an accretion expense recognized to bring the dismantlement or restoration liability to the required cash outflows at the time of decommissioning or dismantlement.

?? PAS 17, *Leases*, provides a limited revision to clarify the classification of a lease of land and buildings and prohibits expensing of initial direct costs in the financial statements of the lessors.

?? PAS 24, *Related Party Disclosures*, provides additional guidance and clarity in the scope of the standard including the definitions and disclosures for related parties. It also requires disclosure of the compensation of key management personnel by benefit type.

?? PAS 27, *Consolidated and Separate Financial Statements*, reduces alternatives in accounting for subsidiaries in consolidated financial statements and in accounting for investments in the separate financial statements of a parent, venturer or investor. Investments in subsidiaries will be accounted for either at cost or in accordance with PAS 39 in the separate financial statements. The equity method of accounting will no longer be allowed in the separate financial statements. This standard also requires strict compliance with adoption of uniform accounting policies and requires the parent to make appropriate adjustments to the subsidiary's financial statements to conform them to the parent's accounting policies for reporting like transactions and other events in similar circumstances.

?? PAS 28, *Investments in Associates,* reduces alternatives in accounting for associates in consolidated financial statements and in accounting for investments in the separate financial statements of an investor. Investments in associates will be accounted for either at cost or in accordance with PAS 39 in the separate financial statements. The equity method of accounting will no longer be allowed in the separate financial statements. This standard also requires strict compliance with adoption of uniform accounting policies and requires the investor to make appropriate adjustments to the associate's financial statements to conform them to the investor's accounting policies for reporting like transactions and other events in similar circumstances.

The Group does not expect any significant changes in the accounting policies when it adopts the above revised standards in 2005, except for PAS 27 and PAS 28 with respect to the separate parent company financial statements. The changes in the financial statement presentation as well as the required disclosure as prescribed by the above standard will be included in the 2005 consolidated financial statements, as applicable.

3. Cash and Cash Equivalents

	2004	2003
Cash on hand and in banks	**₱861,246**	₱627,520
Short-term investments (see Note 22)	**3,523,213**	2,658,693
	₱4,384,459	₱3,286,213

Cash in banks earn interest at the respective bank deposit rates. Short-term investments are made for varying periods of between one day and ninety days depending on the immediate cash requirements of the Group, and earn interest at the respective short-term investment rates.

4. Trade and Other Receivables

	2004	2003
Trade - net of allowance for doubtful accounts of ₱195,104 in 2004 and ₱152,308 in 2003 (see Note 22)	**₱2,219,812**	₱1,680,609
Receivables from insurance and other claims	**91,038**	38,817
Notes receivable	**11,946**	13,725
Others (see Note 22)	**566,851**	416,264
	₱2,889,647	₱2,149,415

Insurance and other claims pertain to ATSC's claims for reimbursement of losses against insurance coverage for hull and machinery, cargo and personal accidents.

Notes receivable consist of interest-bearing notes received by ATSC from various customers for the conversion of the latters' past due trade accounts. These bear interest at rates ranging from 15% to 18% per annum in 2004 and 2003 and have maturity of 12 months.

5. Inventories

	2004	2003
At cost:		
Finished goods (see Note 18)	**₱58,661**	₱47,741
Livestock	**142,851**	83,057
Wheat grains and other raw materials	**992,203**	455,502
Fuel and lubricants	**106,480**	87,712
Purchases in transit	**95,474**	102,268
At NRV:		
Parts and supplies	**43,506**	215,259
	₱1,439,175	₱991,539

The cost of inventories recognized as part of costs of goods sold in the consolidated statements of income amounted to ₱4,952,801 and ₱4,502,572 in 2004 and 2003, respectively.

6. Property, Plant and Equipment

	2003	Additions	Disposals	Transfers/ Reclassifications	2004
Cost:					
Land	₱119,819	₱37,964	₱–	₱–	**₱157,783**
Buildings, warehouses and improvements	1,370,174	68,191	2,947	–	**1,435,418**
Power plant equipment	1,888,969	18,470	–	–	**1,907,439**
Transmission and distribution equipment	1,538,128	185,664	–	–	**1,723,792**
Distribution transformers and substation equipment	805,949	137,584	–	–	**943,533**
Machinery and equipment	1,134,495	63,102	2,590	160,603	**1,355,610**
Transportation equipment	464,270	65,630	26,955	–	**502,945**
Ships in operation and improvements	7,412,218	1,961,358	1,377,593	1,474,576	**9,470,559**
Containers	2,081,327	8,267	97,693	–	**1,991,901**
Handling equipment	956,025	142,791	12,345	–	**1,086,471**
Office furniture, fixtures and equipment	526,551	82,259	5,125	(3)	**603,682**

(Forward)

	2003	Additions	Disposals	Transfers/ Reclassifi cations	**2004**
Leasehold improvements	166,565	35,806	1,540	–	**200,831**
Ships under refurbishment and construction in progress	1,703,545	14,963	–	(1,639,352)	**79,156**
Others	118,789	31,247	65,209	2,001	**86,828**
	20,286,824	2,853,296	1,591,997	(2,175)	**21,545,948**
Accumulated depreciation and amortization:					
Buildings, warehouses and improvements	351,964	57,546	461	–	**409,049**
Power plant equipment	740,483	73,474	–	–	**813,957**
Transmission and distribution equipment	752,942	135,727	–	–	**888,669**
Distribution transformers and substation equipment	450,060	70,418	–	–	**520,478**
Machinery and equipment	477,264	61,168	1,621	–	**536,811**
Transportation equipment	216,605	59,534	17,000	–	**259,139**
Ships in operation and improvements	2,760,112	501,446	290,636	–	**2,970,922**
Containers	1,412,553	150,663	88,439	–	**1,474,777**
Handling equipment	815,592	57,278	8,543	–	**864,327**
Office furniture, fixtures and equipment	389,131	83,398	4,670	(4)	**467,855**
Leasehold improvements	55,612	25,364	1,540	–	**79,436**
Others	62,029	297,157	50	(1,974)	**357,162**
	8,484,347	1,573,173	412,960	(1,978)	**9,642,582**
Net book value	₱11,802,477	₱1,280,123	₱1,179,037	(₱197)	**₱11,903,366**

Containers include units acquired under finance lease arrangements (see Note 14). The related depreciation of the leased containers, amounting to ₱140,584, ₱137,368 and ₱117,920 in 2004, 2003 and 2002, respectively, was computed on the basis of the Group's depreciation policy for owned assets.

The balance of undepreciated capitalized foreign exchange losses arising from acquisition of containers amounting to ₱4,933 was fully depreciated in 2004.

Borrowing costs on loans obtained for the ship refurbishment and capitalized to property and equipment amounted to ₱50,434 and ₱22,617 in 2004 and 2003, respectively, at the average capitalization rate of 9.55% and 9.59% in 2004 and 2003, respectively.

In 2004, ATSC received the proceeds from insurance claim for the loss of MV SuperFerry 14 due to fire which took place on February 27, 2004. ATSC recognized a net gain of ₱208,659 in 2004.

7. Investments in Subsidiaries

The consolidated financial statements include the financial statements of Aboitiz Equity Ventures, Inc. and the subsidiaries listed in the following table.

		Percentage of Ownership					
	Nature of Business	**2004**		2003		2002	
		Direct	**Indirect**	Direct	Indirect	Direct	Indirect
Aboitiz Power Corporation (APC)	Power	**100.00**	–	**100.00**	–	100.00	–
Aboitiz Powersolutions, Inc. (APSI)***	Power	**100.00**	–	**100.00**	–	–	100.00
DLP	Power	**99.91**	–	**99.91**	–	–	99.91
CLP	Power	**99.91**	–	**99.91**	–	–	99.91
Subic Enerzone Corporation (SEZC)	Power	**20.00**	**40.00**	**20.00**	**40.00**	–	–
NMHC***	Power	–	**100.00**	–	**100.00**	–	100.00
Hydro Specialists, Inc.***	Power	–	**100.00**	–	**100.00**	–	100.00
Philippine Hydropower Corporation ***	Power	–	**100.00**	–	**100.00**	–	100.00
Benguet Hydropower Corporation ***	Power	–	**100.00**	–	**100.00**	–	100.00
Cordillera Hydro Corporation (formerly Sinacbat Hydro Power Corporation) **,***	Power	–	–	–	**100.00**	–	100.00
HEDCOR***	Power	–	**99.96**	–	**99.96**	–	99.96

(Forward)

	Nature of Business	Percentage of Ownership					
		2004		2003		2002	
		Direct	**Indirect**	Direct	Indirect	Direct	Indirect
Pilmico Foods Corporation (PILMICO)	FoodManufacturing	**100.00**	**–**	**100.00**	**–**	100.00	–
Fil-am Foods, Inc. (FILAM)	Food Manufacturing	**–**	**100.00**	**–**	**100.00**	–	100.00
ATSC	Transportation	**92.72**	**–**	**92.72**	**–**	90.05	–
Cebu Ferries Corporation (CFC)	Transportation	**–**	**100.00**	**–**	**100.00**	–	100.00
WG & A Supercommerce, Inc. (WSI)	Transportation	**–**	**100.00**	**–**	**100.00**	–	100.00
AEV Aviation, Inc. (AEV Aviation)***	Service	**100.00**	**–**	**100.00**	**–**	100.00	–
AEV Properties, Inc.*	Real Estate	**100.00**	**–**	**100.00**	**–**	100.00	–
Cebu Praedia Development Corporation (CPDC) ***	Real Estate	**88.27**	**11.72**	**88.27**	**11.72**	88.27	11.72
Cotabato Ice Plant, Inc. ***	Manufacturing	**–**	**100.00**	**–**	**100.00**	–	100.00
Fil-Agri Holdings, Inc.	Holding company	**–**	**100.00**	**–**	**100.00**	–	100.00

**Still in the preoperating stage*

***No commercial operations*

***The 2004, 2003 and 2002 financial statements of these subsidiaries were audited by other independent auditors. All other subsidiaries were audited by the principal auditors.

On June 13, 2003, APC declared property dividends to the Parent Company in the form of investments in shares of stock of APSI, DLP, CLP, Visayan Electric Company, Inc. (VECO), Hijos de F. Escaño, Inc. (Hijos), San Fernando Electric Light and Power Co., Inc. (SFELAPCO) and Pampanga Energy Ventures, Inc. (PEVI) amounting to ₱3,176,309. Thus, APSI, DLP and CLP became direct subsidiaries and VECO, Hijos, SFELAPCO and PEVI became direct associates of the Parent Company in 2003. The property dividend declaration was approved by the SEC on June 17, 2003.

Investment in SEZC in 2003

On June 3, 2003, the Group, together with SFELAPCO, an associate, Mirant Philippines II Corp., OKEELANTA Corporation and Pampanga Sugar and Development Corp., established SEZC, a company incorporated to do and perform all acts and activities, whether direct or indirect, in connection with the Distribution Management Service Agreement (DMSA) for the Subic Bay Metropolitan Authority (SBMA) Power Distribution System (PDS) on a rehabilitate-operate-transfer arrangement. SEZC is 60% owned by the Group and started commercial operations on October 25, 2003 when SBMA transferred to SEZC the administration, rehabilitation, operation and maintenance of the PDS. Accordingly, the accounts of SEZC were included starting in the 2003 consolidated financial statements.

From the date of its establishment, SEZC has contributed ₱25,471 net income and ₱17,638 net loss to the 2004 and 2003 consolidated net income, respectively. SEZC contributed ₱141,424 and ₱144,153 to the 2004 and 2003 consolidated net assets and net liabilities, respectively.

Acquisition of ATSC (formerly WG & A) in 2002

On September 23, 2002, the Parent Company acquired the combined 59% holdings of the Chiongbian Group and Carlos Gothong Group in ATSC.

On December 6, 2002, the Parent Company then acquired the 31% holdings of Accuria, Inc. and the holdings of minority stockholders in ATSC allowing the Parent Company to own 90% of ATSC, giving the Parent Company direct control over the financial and operating policies of ATSC. The fair values of the identifiable acquired assets and liabilities of ATSC at the dates of acquisition are as follows:

Assets:	
Cash and cash equivalents	₱1,049,658
Receivables - net	1,020,778
Materials, parts and supplies - net	138,865
Deferred income tax - net	212,566
Prepaid expenses and other current assets - net	171,825
Property and equipment - net	5,412,311
Other noncurrent assets - net	321,982
	8,327,985
Liabilities:	
Accounts payable and accrued expenses	1,196,553
Loans payable	360,000
Long-term debt	919,131
Obligations under capital lease	556,345
	3,032,029
Minority interest	526,948
Parent Company's share in fair value of net assets	₱4,769,008
Goodwill	₱622,554

Consideration:

Purchase price	₱5,370,156
Costs associated with the acquisition	21,406
Total consideration	₱5,391,562

The cash outflow on acquisition is as follows:

Cash paid	₱2,707,139
Debt	2,684,423
	₱5,391,562

On October 17, 2003, the Parent Company also acquired the 40,000,000 common shares initially subscribed by Aboitiz & Company, Inc. (ACO), resulting in a 92.72% direct holdings in ATSC.

Acquisition of FILAM in 2002

Also, on October 15, 2002, the Group acquired the 50% ownership in FILAM held by PMI Nutrition, allowing the Group to own 100% of FILAM.

The fair values of the identifiable acquired assets and liabilities of FILAM at the date of acquisition are as follows:

Assets:	
Cash and cash equivalents	₱4,469
Receivables - net	95,671
Inventories - net	204,861
Prepaid expenses and other current assets	2,524
Property, plant and equipment - net	733,991
Other noncurrent assets	105,430
	1,146,946
Liabilities:	
Loans payable	179,912
Accounts payable and accrued expenses	121,435
Due to a stockholder	400,000
	701,347
Net assets	₱445,599
50% additional acquisition	₱222,800
Negative goodwill	₱12,660

Consideration and cash outflow:

Purchase price	₱200,000
Costs associated with the acquisition	10,140
Total consideration and cash outflow	₱210,140

Accordingly, the accounts of ATSC and FILAM were included in the consolidated financial statements beginning in 2002. ATSC and FILAM have contributed the following to the 2002 consolidated financial statements:

	Assets	Liabilities	Net Revenue	Costs and Expenses	Net Income
ATSC	₱8,472,299	₱2,898,900	₱7,024,224	₱6,366,679	₱106,128
FILAM	988,377	551,176	1,338,163	1,111,509	33,465
	₱9,460,676	₱3,450,076	₱8,362,387	₱7,478,188	₱139,593

8. Investments in Associates

	2004	2003
Acquisition cost:		
Balance at beginning of year	**₱8,350,528**	₱8,350,528
Additions during the year	**5,895**	–
Disposals during the year	**(10,067)**	–
Balance at end of year	**8,346,356**	8,350,528

(Forward)

	2004	2003
Accumulated share in net earnings:		
Balance at beginning of year, as previously reported	**₱4,313,059**	₱3,462,062
Effect of change in accounting for income taxes (see Note 2)	**(475,860)**	(424,772)
Balance at beginning of year, as restated	**3,837,199**	3,037,290
Share in net earnings for the year, as previously reported (net of goodwill amortization of ₱129,460 in 2004 and ₱128,026 in 2003)	**1,552,190**	1,613,632
Effect of change in accounting for income taxes (see Note 2)	**–**	(51,088)
Share in net earnings for the year, as restated	**1,552,190**	1,562,544
Cash dividends received	**(680,132)**	(762,635)
Investment sold	**(1,000)**	–
Balance at end of year	**4,708,257**	3,837,199
Share in net unrealized loss on available-for-sale securities and underwriting accounts of an associate	**(383,473)**	(320,707)
	12,671,140	11,867,020
Less allowance for decline in value of investments	**28,995**	28,995
	₱12,642,145	₱11,838,025

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	Nature of Business	Percentage of Ownership		
		2004	2003	2002
VECO*	Power	**54.58**	54.57	54.45
PILMICO - Mauri Foods Corporation (Pilmico Mauri)*	Food manufacturing	**50.00**	50.00	50.00
Luzon Hydro Corporation (LHC)	Power	**50.00**	50.00	50.00
Accuria, Inc.	Holding company	**49.54**	49.54	49.54
JAIB, Inc.*,**		**49.00**	49.00	49.00
Hijos*	Holding company	**46.66**	46.66	46.66
SFELAPCO	Power	**43.78**	43.78	43.78
PEVI*	Holding company	**42.84**	42.84	42.84
Union Bank of the Philippines (UBP)	Banking	**42.02**	42.02	42.02
Cordillera Hydro Corporation *,**	Power	**35.00**	–	–
City Savings Bank (CSB)*	Banking	**34.38**	34.38	34.38
Western Mindanao Power Corporation (WMPC)	Power	**20.00**	20.00	20.00
Cebu International Container Terminal, Inc. (CICTI)**	Transportation	**20.00**	20.00	20.00
Southern Philippines Power Corporation (SPPC)	Power	**20.00**	20.00	20.00
South Western Cement Corporation*	Cement	**20.00**	20.00	20.00
Mindanao Container Corporation (MINCON)	Manufacturing	**–**	35.00	35.00

** The 2004, 2003 and 2002 financial statements of these associates were audited by other auditors. All other associates were audited by the principal auditors.*
***No commercial operations*

On January 2, 2004, the Parent Company sold its 35% investment in MINCON with a carrying value of ₱11,067 to MMM Holdings, Inc. The sale resulted in a gain amounting to ₱15,883.

Investment in VECO
As of December 31, 2002, VECO is 54.45% directly and indirectly owned by the Parent Company. However, following the definition of control under SFAS 27/IAS 27, *Consolidated Financial Statements and Accounting for Investments in Subsidiaries,* the accounts of VECO were deconsolidated in 2002 as a result of the other shareholders group of VECO being able to exercise the power to govern the financial and operating policies of VECO in 2002 (see Note 30).

Accordingly, effective in 2002, the investment in VECO is accounted for under the equity method.

The detailed carrying values of investments in associates which are accounted for under the equity method follow:

	2004	2003
UBP	**₱7,843,438**	₱7,204,580
LHC	**1,984,725**	1,546,527
VECO	**1,636,477**	1,760,234
WMPC	**410,096**	377,963
SPPC	**251,769**	238,025
CICTI	**240,125**	240,125
PEVI/SFELAPCO	**335,966**	352,292
Others	**(60,451)**	118,279
	₱12,642,145	₱11,838,025

The investments in associates include goodwill of ₱1,849,410 in 2004 and ₱1,969,419 in 2003. Goodwill is being amortized over their estimated economic useful life of 20 years.

Following is the summarized financial information of significant associates:

	2004	2003 (As restated - Note 2)
UBP		
Total current assets	**₱51,920,212**	₱23,602,155
Total noncurrent assets	**49,877,896**	53,852,778
Total current liabilities	**78,525,500**	62,936,928
Total noncurrent liabilities	**7,042,625**	–
Gross revenue	**4,974,937**	3,809,072
Gross profit	**3,054,765**	2,192,256
Net income	**2,275,134**	2,028,599
LHC		
Total current assets	**₱818,919**	₱746,531
Total noncurrent assets	**7,243,311**	7,192,311
Total current liabilities	**1,043,637**	984,687
Total noncurrent liabilities	**1,686,004**	2,562,267
Gross revenue	**2,306,257**	2,379,899
Gross profit	**1,883,272**	1,931,795
Net income	**1,515,665**	1,458,905

(Forward)

	2004	2003 (As restated - Note 2)
VECO*		
Total current assets	**₱1,883,009**	₱1,563,620
Total noncurrent assets	**3,157,220**	3,247,662
Total current liabilities	**1,189,549**	788,781
Total noncurrent liabilities	**1,496,032**	1,510,229
Gross revenue	**7,542,059**	6,339,466
Gross profit (loss)	**(159,726)**	126,125
Net income (loss)	**(31,078)**	31,722

*Amounts are based on appraised values which are adjusted to historical amounts upon equity take-up of the Parent Company.

9. Other Noncurrent Assets

	2004	2003
Software development costs - net of accumulated amortization of ₱92,257 in 2004 and ₱65,877 in 2003	**₱358,112**	₱217,996
Deferred income tax assets - net (see Note 21)	**158,658**	185,217
Others - net	**265,415**	117,842
	₱782,185	₱521,055

Software development costs comprise all expenditures that can be directly attributed to the development and acquisition of financial and revenue application software. The additions to software development costs amounted to ₱166,496 and ₱191,563 in 2004 and 2003, respectively. The related amortization amounted to ₱26,380, ₱23,707 and ₱30,455 in 2004, 2003 and 2002, respectively.

Provision for decline in value of tied up vessels (included in "Others") amounted to ₱10,870 in 2002 (see Note 20)

ATSC sold all tied up vessels at a gain of ₱10,006 in 2003.

10. Bank Loans

These represent short-term, peso-denominated, unsecured loans obtained from local banks. The loans bear interest at rates ranging from 8.35% to 9.45% and 6.03% to 8.78% in 2004 and 2003, respectively.

11. **Trade and Other Payables**

	2004	2003
Trade payables (see Note 24)	**₱1,550,644**	₱1,236,187
Accrued expenses (see Note 22)	**1,074,383**	790,218
Nontrade payables and others (see Note 22)	**692,471**	456,605
	₱3,317,498	₱2,483,010

12. **Long-term Debt**

	2004	2003
Parent Company:		
Financial institutions - unsecured loans		
Peso denominated	**₱3,856,000**	₱3,000,000
Dollar denominated	–	270,000
Non-financial institutions	**932,027**	1,206,176
	4,788,027	4,476,176
Subsidiaries:		
ATSC		
Financial institutions		
Secured	**2,169,318**	1,749,333
Unsecured	–	970,000
Installments payable	**25,823**	65,277
	2,195,141	2,784,610
DLP		
Financial institutions - secured	**654,616**	626,923
PILMICO		
Financial institutions - secured	**357,436**	478,333
HEDCOR		
Financial institution - secured	**450,000**	450,000
FILAM		
Financial institution - secured	**200,000**	200,000
CLP		
Financial institution - secured	**30,500**	30,500
Total	**8,675,720**	9,046,542
Less current portion	**1,573,482**	1,248,623
	₱7,102,238	₱7,797,919

Parent Company

The loans availed by the Parent Company from financial institutions include:

a. Unsecured loans totaling to ₱1,800,000 payable in five years up to 2007, with two years grace period, on a quarterly basis to commence at the end of the eighth quarter with 4% of the principal due on the 8th to 12th quarters, 7.5% due on the 13th to 16th quarters and 12.5% due on the 17th to 20th quarters, with interest rates ranging from 8.27% to 10.2% in 2004 and 2003.

b. An unsecured loan amounting to ₱1,000,000 payable in 12 equal consecutive quarterly installments up to 2008 to commence at the end of the eighth quarter with interest rates ranging from 8.32% to 10.20% in 2004 and 2003.

c. An unsecured loan amounting to ₱1,000,000 obtained in 2004 payable on the last day of the 60th month from the date of the first drawdown with interest rate of 9.77% in 2004, to be repriced on a quarterly basis.

d. An unsecured loan amounting to ₱200,000 obtained in 2003 and payable in five years up to 2008 to commence at the end of the third year with 25% of the principal due on the third and fourth years, and a bullet payment of the remaining principal balance upon maturity, with interest rates ranging from 8.21% to 9.94% in 2004 and 2003

e. US dollar denominated loans amounting to $4,857 (₱270,000) which are unsecured and bear interest rates ranging from 7.50% to 9.42% in 2004 and 2003. The ₱150,000 and ₱120,000 loans were paid in lump sum amounts on March 26, 2004 and May 7, 2004, respectively.

   Forward foreign exchange agreements, with the same terms as the underlying obligations, were entered into to cover foreign currency exposure on the loans. The agreements effectively fixed the principal repayments of the loans at the original spot exchange rate, which was determined using the Philippine Dealing System weighted average at the close of business on the second business day prior to date of drawdown (spot rate). The forward foreign exchange agreements also provide forward covers for all quarterly interest payments. The loan amounts shown are based on the fixed dollar rates of ₱55.586 to $1 in 2003.

The loans availed by the Parent Company from non-financial institutions include loans from the Chiongbian Group and the Carlos Gothong Group, ACO, Aboitiz Foundation, Inc. and other ATSC stockholders amounting to ₱937,027 and ₱1,207,176 in 2004 and 2003, respectively. The loans from the Chiongbian Group are payable in 48 equal consecutive monthly installments commencing on the last day of the 13th month, with interest of 12% per annum up to October 1, 2007. These loans arose mainly from the acquisition by the Parent Company in 2002 of the combined 59% holdings of the Chiongbian Group and the Carlos Gothong Group in ATSC.

In 2004 and 2003, the BOD unanimously approved the acceleration of the payment of the loans to the Chiongbian Group and Carlos Gothong Group, ACO and other ATSC stockholders. Accordingly, principal payments originally due in 2004 and 2005 for the Chiongbian Group and Carlos Gothong Group were paid in 2003 and 2004, respectively. On the other hand, loans with ACO and other ATSC stockholders were fully paid in 2003.

ATSC
Loans availed by ATSC from financial institutions are denominated in Philippine pesos with average interest rates ranging from 6.7% to 10.89% in 2004 and 2003 and are collateralized by certain parcels of land and vessels of ATSC with net book value of ₱4,557,732 and ₱5,197,515 as of December 31, 2004 and 2003, respectively. The pledged assets have an aggregate appraised value of ₱6,888,650 and ₱8,509,538 as of December 31, 2004 and 2003, respectively.

Some agreements covering bank loans provide for certain restrictions and requirements that include, among others, maintenance of favorable financial ratios such as current ratio, debt to tangible net worth ratio and debt service coverage ratio. As of December 31, 2004 and 2003, ATSC was not able to meet the required current ratio of 1:1. However, ATSC obtained waivers from the creditor banks.

Unsecured short-term loans are shown as part of "Long-term debt" account in the consolidated balance sheets in 2003 because ATSC has obtained on March 25, 2004 an approved long-term loan facility from a syndicate of banks to refinance these loans.

Installments payable, which are denominated in US dollars at an average interest rate of 8.27% in 2004 and 2003, have outstanding balances amounting to US$458 as of December 31, 2004 and US$1,174 as of December 31, 2003 and have been restated to Philippine pesos at the rates prevailing as of those dates of ₱56.341 to US$1 and ₱55.586 to US$1, respectively.

DLP
Loans availed by DLP from financial institutions include:

a. Loan amounting to ₱320,000 which bears interest at 11.2% per annum and is payable in 12 quarterly installments of ₱26,767 starting January 2007. The loan is secured by a mortgage trust indenture on property, plant and equipment with a carrying value of ₱1,301,902 as of December 31, 2004.

b. Loan amounting to ₱300,000 which is funded under the Countryside Loan Fund Program of the Land Bank of the Philippines (LBP) and bears a fixed interest rate of 10.53%. The loan is payable in 13 equal quarterly payments up to December 2006.

c. Loan amounting to ₱500,000 which bears interest at 10.89% per annum and is payable in five years up to 2005 in equal quarterly payments to commence at the end of the two years grace period with 20% of the principal due on the third year and the remaining 80% due equally on the fourth and fifth years. The loan is secured by a mortgage trust indenture participation via Mortgage Participation Certificate on property, plant and equipment with a carrying value of ₱1,301,902 as of December 31, 2004.

PILMICO
The loans availed by PILMICO include:

a. Two (2) loans with UBP of ₱250,000 and ₱100,000 which bear fixed interest rate of 9.17% and 8.82%, respectively. The first loan is payable in 13 quarterly installments of ₱19,231 starting October 2004 and the second loan is payable in 12 quarterly installments of ₱8,333 starting February 12, 2006. The loans are secured by MTI which requires Pilmico among others, to maintain and preserve the collateral values as well as seek prior approval for any merger, consolidation, change in ownership, suspension of business operation, disposal of assets, maintenance of financial ratios and others.

b. Two (2) loans with a local bank of ₱100,000 and ₱300,000. The first loan bears a fixed interest rate of 11.10% and is payable in 15 quarterly installments of ₱6,667 up to December 2005. The second loan bears a fixed interest rate of 13.88% and is payable in 12 quarterly installments of ₱25,000. The loans are secured by MTI which prohibits Pilmico to incur major capital expenditures and/or investments, and to pay out dividends or make any distributions to its stockholders, purchase, redeem, retire or otherwise acquire for value any of its capital stock now or hereafter outstanding (other than as a result of conversion of any shares of capital stock into shares of any other class of capital stock), return any capital to its stockholders (other that distributions payable in shares of its capital stock), or make any capital asset distribution to its stockholders without prior approval from the bank. The bank may waive and/or reconsider the prohibition on the payment of dividends by Pilmico commencing in the year 2003.

Carrying values of property and equipment of Pilmico used as collaterals to these loans amounted to ₱505,327 as of December 31, 2004.

HEDCOR
The loan availed by HEDCOR is a five year loan payable on December 9, 2009, and bears interest rates ranging from 6.75% to 9.27% in 2004 and 2003. The loan is secured by a chattel mortgage over the machineries and improvements of the Benguet and Davao hydro plants with a carrying value of ₱505,408 as of December 31, 2004.

FILAM
The loans availed by FILAM consist of term loans to finance the construction of a second feedmill plant and working capital requirements. The first loan is payable in seven years (inclusive of a three year grace period) in 12 quarterly installments of ₱12,500 starting May 2, 2005 and bears interest at a fixed rate of 9.41%. The second loan is payable in five years (inclusive of a two year grace period) in 12 quarterly installments of ₱4,200 starting March 10, 2006 and bears interest at a fixed rate of 10.04%.

The above loans are secured by a mortgage trust indenture in favor of the designated trustee, for the pari-passu and pro rata benefit of the creditor banks, covering FILAM's assets which at all times must cover 100% of FILAM's outstanding loan balance. Such assets had a net book value of ₱741,316 as of December 31, 2004.

<u>CLP</u>
The loan availed by CLP pertains to a term loan to partially finance capital and regular expenditures for the rehabilitation and modernization of its distribution system. The loan is payable in five years (inclusive of a two year grace period) in 13 quarterly installments of ₱2,300 starting September 26, 2005 and bears interest at a fixed rate of 8.78%. The loan is secured by a mortgage trust indenture in favor of the designated trustee, for the pari-passu and pro rata benefit of the creditor banks, covering CLP's land and building improvements and transmission and distribution equipment with a carrying value of ₱176,735 as of December 31, 2004.

13. Customers' Deposits

Customers' deposits consist of load and contract deposits received from customers. These deposits are refundable, together with accrued interest, only upon termination of the contract at the customers' request, provided that the metering equipment is returned in good condition and all accounts in the name of the customer have been paid. Customers' deposits earned interest at 6% per annum prior to 1995. In 1995, the then Energy Regulatory Board (ERB) amended the provisions of the standard rules and regulations governing electric utilities, which include, among others, increasing the interest rate of these deposits from 6% to 10%.

On June 9, 2004, the Energy Regulatory Board (ERC) issued a Resolution authorizing the promulgation of the Magna Carta for Residential Electricity Consumers. This Magna Carta took effect on July 19, 2004, fifteen days after its publication in a newspaper of general circulation. Under the Magna Carta, all residential consumers shall be exempt from payment of meter deposits since private distribution utilities have incorporated the cost of these electric watthour meters in their rate base. With regard to bill deposits, the Magna Carta provides that a customer who has paid his electric bills on or before its due date for three consecutive years, may now demand for the full refund of the deposit even prior to the termination of his service; otherwise, bill deposits shall be refunded within one month from termination of service provided all bills have been paid.

Under the Magna Carta, bill deposits of residential customers shall earn interest equivalent to the interest incorporated in the calculation of the Distribution Utilities' Weighted Average Cost of Capital (WACC), otherwise, the prevailing interest rate for savings deposit as approved by the Bangko Sentral ng Pilipinas shall apply and the same shall be credited yearly to the bills of the registered customer.

On November 11, 2004, the ERC issued the Guidelines implementing the Magna Carta. The Guidelines provided, among others, for the schedule of refund of the meter deposits, together with accrued interest, to the residential customers. DLP, CLP and SEZC do not impose meter deposits to its residential customers except when the customer does not own or is a lessee of the residential premises.

The accrued interest related to meter and service deposits amounting to ₱9,800 in 2004 and ₱18,244 in 2003 are shown as part of "Customers' deposits" account in the consolidated balance sheets.

14. Finance Leases

ATSC acquired certain containers under finance lease arrangements denominated in US dollars. Containers as of December 31, 2004 and 2003, shown under "Property, plant and equipment" account in the consolidated balance sheets, include the following amounts:

	2004	2003
Cost	**₱1,137,613**	₱1,144,204
Less accumulated depreciation	**630,019**	489,435
	₱507,594	₱654,769

The aggregate future minimum payments under the leases are as follows:

	2004	2003
2004	**₱–**	₱176,918
2005	**178,739**	180,270
2006 to 2009	**434,526**	427,936
Total minimum lease obligation	**613,265**	785,124
Less amount representing interest	**106,426**	165,705
Present value of minimum lease payments	**506,839**	619,419
Less current portion	**134,273**	115,338
	₱372,566	₱504,081

The outstanding balance of the US dollar denominated finance lease obligation of US$8,996 as of December 31, 2004 and US$11,143 as of December 31, 2003 have been restated at the rates prevailing as of those dates of ₱56.341 to US$1 and ₱55.586 to US$1, respectively.

15. Stockholders' Equity

a. Capital Stock

The preferred shares are non-voting, non-participating, non-convertible, redeemable, cumulative, reissuable and may be issued from time to time by the BOD in one or more series and fixed before issuance thereof, the number of shares in each series, and all designations, relative rights, preferences and limitations of the shares in each series. Preferred shares that are redeemed by the Parent Company may be re-issued.

Holders thereof are entitled to receive dividends payable out of the earned surplus profit of the Parent Company as the BOD may, by resolution, determine. In the event of any liquidation or dissolution or winding up of the Parent Company, the holders of the preferred shares shall be entitled to be paid in full the offer price of their shares before any payment in liquidation is made to the holders of the common shares.

b. Retained Earnings

The portion of the Parent Company's retained earnings corresponding to the equity in the undistributed net earnings of subsidiaries and associates amounting to ₱4,592,155, ₱3,525,427 and ₱6,505,390 as of December 31, 2004, 2003 and 2002, respectively, is not currently available for dividend distribution unless declared by the subsidiaries and associates.

16. Revenue

	2004	2003	2002
Sale of:			
Power and electricity	**₱6,526,494**	₱4,808,973	₱4,668,786
Goods	**6,168,828**	5,389,536	4,826,543
Freight - net	**4,343,981**	4,021,218	3,679,917
Passage	**3,815,646**	3,626,945	3,379,303
Others	**324,501**	214,039	122,278
	21,179,450	18,060,711	16,676,827
Less percentage taxes	**114,468**	109,603	102,483
	₱21,064,982	₱17,951,108	₱16,574,344

The Uniform Rate Filing Requirements (UFR) on the rate unbundling released by the ERC on October 30, 2001, specified that the billing for sale and distribution of power and electricity will have the following components: Generation Charge, Transmission Charge, System Loss Charge, Distribution Charge, Supply Charge, Metering Charge, the CERA and Interclass and Lifeline Subsidies. National and local franchise taxes, the Power Act Reduction (for residential customers) and the Universal Charge are also separately indicated in the customer's billing statements.

17. Costs and Expenses

	2004	2003	2002
Operating expenses (see Notes 6, 18, 22, 23 and 26)	**₱7,125,137**	₱6,021,149	₱5,440,933
Cost of goods sold (see Notes 5 and 18)	**5,292,806**	4,771,587	4,099,903
Cost of purchased power (see Note 25)	**4,093,411**	2,630,563	2,801,723
Overhead expenses (see Notes 18, 22, 23 and 26)	**1,047,470**	1,105,876	836,146
Terminal expenses (see Notes 18, 22, 23 and 26)	**1,046,848**	1,087,120	903,672
Depreciation of ships (see Note 6)	**860,053**	821,796	757,293
	₱19,465,725	₱16,438,091	₱14,839,670

18. Cost of Goods Sold and Operating Expenses

Cost of goods sold consists of:

	2004	2003	2002
Raw materials used	**₱4,963,721**	₱4,502,147	₱3,844,073
Direct labor	**21,407**	19,620	15,495
Manufacturing overhead			
Depreciation	**66,946**	67,387	63,348
Power	**52,241**	48,496	51,853
Repairs and maintenance	**38,934**	37,132	40,849
Utilities and supplies	**32,960**	29,382	29,865
Insurance	**27,378**	3,613	2,293
Indirect labor	**19,795**	10,705	12,350
Taxes and licenses	**13,818**	11,634	11,435
Freight and handling	**3,821**	4,245	4,748
Fuel and lubricants	**3,516**	3,271	2,982
Employees' benefits	**2,679**	2,497	2,518
Pest control	**2,220**	1,669	1,996
Others	**54,290**	29,364	21,706
	318,598	249,395	245,943
Cost of goods manufactured	**5,303,726**	4,771,162	4,105,511
Finished goods inventory (see Note 5)			
Beginning of year	**47,741**	48,166	42,558
End of year	**(58,661)**	(47,741)	(48,166)
	₱5,292,806	₱4,771,587	₱4,099,903

Operating expenses consist of:

	2004	2003	2002
Fuel and lubricants	**₱2,621,226**	₱2,031,682	₱1,690,350
Repairs and maintenance	**662,458**	467,847	520,188
Personnel (see Notes 22 and 26)	**449,667**	454,216	380,731
Depreciation	**421,530**	452,703	350,658
Insurance	**366,638**	267,957	274,488
Freight and handling	**215,468**	190,565	85,087
Outside services	**202,888**	892,464	816,432
Commissions	**186,461**	186,438	183,924
Taxes and licenses	**157,786**	163,279	155,942
Transportation and travel	**132,205**	64,818	56,274
Management fees (see Note 22)	**123,305**	176,304	166,076
Advertising	**27,458**	28,478	21,049
Charter hire (see Note 22)	**7,014**	80,476	284,639
Training and development	**5,589**	43,991	53,156
Others	**1,545,444**	519,931	401,939
	₱7,125,137	₱6,021,149	₱5,440,933

Terminal expenses consist of:

	2004	2003	2002
Management fees (see Note 22)	**₱305,834**	₱191,588	₱96,693
Depreciation	**237,189**	236,527	315,050
Repairs and maintenance	**124,028**	100,144	131,393
Outside services	**85,033**	107,000	116,571
Hustling and shifting	**71,834**	84,063	73,868
Transshipment cost	**48,925**	200,048	35,000
Personnel (see Notes 22 and 23)	**36,356**	30,518	31,175
Rent (see Notes 22 and 26)	**34,217**	37,282	27,943
Fuel and lubricants	**27,866**	20,453	17,321
Insurance	**16,176**	13,895	15,512
Others	**59,390**	65,602	43,146
	₱1,046,848	₱1,087,120	₱903,672

Overhead expenses consist of:

	2004	2003	2002
Personnel (see Notes 22 and 23)	**₱446,294**	₱473,607	₱330,388
Advertising	**108,953**	120,351	82,270
Depreciation and amortization	**116,915**	93,841	96,812
Provision for doubtful accounts	**90,711**	82,117	43,152
Outside services	**90,039**	78,796	88,094
Communication, light and water	**77,181**	95,887	71,974
Rent (see Notes 22 and 26)	**47,081**	43,581	40,075
Entertainment, amusement and recreation (EAR)	**17,105**	20,251	21,530
Others	**53,191**	97,445	61,851
	₱1,047,470	₱1,105,876	₱836,146

Under the Bureau of Internal Revenue (BIR) Regulation No. 10-2002 dated July 24, 2002, effective September 1, 2002, the maximum amount of EAR expenses allowable as deduction from gross income for purposes of income tax computation shall not exceed 1% and 0.05% of the gross revenue of company engaged in the sale of services and goods, respectively. EAR expenses charged to operations amounted to ₱17,105 in 2004, ₱20,251 in 2003 and ₱21,530 in 2002.

19. **Personnel Expenses**

	2004	2003	2002
Salaries and wages	**₱637,014**	₱582,292	₱534,769
Employee benefits	**270,505**	339,193	213,553
	₱907,519	₱921,485	₱748,322

20. Other Income (Charges) - Others

	2004	2003	2002
Gain (loss) on sale of:			
Property and equipment	**₱211,994**	₱18,275	(₱28,238)
Investments in shares of stock	**15,696**	15	–
Gain from insurance claims	**208,659**	–	–
Foreign exchange gains - net	**12,305**	17,820	12,354
Dividend income	**11,811**	3,547	55,983
Rent income (see Note 22)	**11,260**	56,729	15,657
Provisions for:			
Decline in value of current marketable equity securities	**–**	–	(13,769)
Losses on project costs, investments in shares of stock and advances	**–**	–	(109,810)
Write-downs of tied up vessels and other accounts (see Note 9)	**–**	–	(10,870)
Write-off of project costs and others	**–**	–	(9,727)
Unrealized gain on recovery in value of marketable equity securities	**11,661**	13,777	–
Others - net	**237,850**	116,061	54,930
	₱721,236	₱226,224	(₱33,490)

21. Income Taxes

The provision for income tax consists of:

	2004	2003	2002
Current			
Corporate income tax	**₱437,749**	₱289,301	₱303,807
Final tax	**9,287**	8,512	4,382
	447,036	297,813	308,189
Deferred	**36,216**	106,081	157,708
	₱483,252	₱403,894	₱465,897

A reconciliation between the statutory income tax rate and the Group's effective income tax rates follows:

	2004	2003	2002
Statutory income tax rate	**32.00%**	32.00%	32.00%
Tax effects of:			
Nontaxable equity in net earnings of associates	**(16.86)**	(20.31)	(19.96)
Interest income subjected to final tax at lower rates – net	**(1.00)**	(1.64)	(0.47)
Others	**2.27**	6.36	3.95
	16.41%	16.41%	15.52%

Deferred income tax at December 31 relates to the following:

	2004	2003
Deferred income tax assets (liabilities)		
Allowances for:		
Doubtful accounts and probable losses	**₱71,631**	₱53,099
Inventory obsolescence	**38,776**	35,900
MCIT	**42,169**	76,841
NOLCO	**26,589**	54,513
Unamortized preoperating expenses and software and project development costs	**15,437**	–
Unamortized past service cost	**2,742**	2,225
Accrued retirement benefits	**1,282**	5,737
Unrealized foreign exchange gains	**(16,723)**	(17,854)
Others	**(23,245)**	(25,244)
Net deferred income tax assets	**₱158,658**	₱185,217
Deferred income tax liabilities		
Unamortized customs duties and taxes capitalized	**₱8,175**	₱–
Unamortized streetlight donations capitalized	**1,749**	–
Unrealized foreign exchange gains	**(267)**	–
Net deferred income tax liabilities	**₱9,657**	₱–

The net deferred income tax assets is included under "Other noncurrent assets" account in the consolidated balance sheets.

In computing for deferred tax assets and liabilities, the rate used was 32%, which is the rate expected to apply to taxable income in the years in which the deferred tax assets and liabilities are expected to be recovered or settled. In addition, the effect of ATSC's availment of income tax holiday incentive for its registration with the Board of Investments (BOI) (see Note 25) on certain temporary differences has likewise been considered in the above computation.

The Group has net operating loss carryover (NOLCO) amounting to ₱466,899 as of December 31, 2004 that is available for offset over three years against future taxable profits of the companies that incurred the losses. The Group also has tax assets from the excess minimum corporate income tax (MCIT) amounting to ₱43,535 as of December 31, 2004 that may be credited in the next three years against income tax liabilities of the respective companies. Deferred tax assets have not been recognized on these items as they have arisen in subsidiaries that have been incurring losses for some time and may not be used to offset taxable profits or tax liabilities of other subsidiaries of the Group.

As of December 31, 2004, carryover NOLCO and MCIT (incurred in 2002 to 2004 and expires in 2005 to 2007) that can be claimed as deductions from future taxable income or used as deductions against income tax liabilities are as follows:

Year incurred	Expiry date	NOLCO	MCIT
2002	2005	₱251,096	₱10,332
2003	2006	660,386	32,272
2004	2007	547,578	931

	₱1,459,060	₱43,535

At December 31, 2004 and 2003, deferred income tax liabilities have not been recognized on the undistributed earnings of subsidiaries and associates since such amounts are not taxable. Such undistributed earnings amounted to ₱4,592,155 and ₱3,860,843 in 2004 and 2003, respectively (see Note 15).

There are no income tax consequences attaching to the payment of dividends by the Group to its shareholders.

22. Related Party Disclosures

ACO, the holding company of the Group, owns 49.80% of the Parent Company's common shares.

In the normal course of business, the Group enters into transactions with related parties, principally consisting of the following:

a. Management and other service contracts of certain subsidiaries and associates with ACO at fees based on agreed rates. Management and other service fees paid by the Group to ACO amounted to ₱87,806, ₱124,009 and ₱101,930 in 2004, 2003 and 2002, respectively.

b. Temporary cash advances from and to ACO for working capital requirements. The advances are interest bearing at an average rate of 3.26% in 2004, 5.12% in 2003 and 11.82% in 2002. Net interest expense (income) on temporary cash advances from (to) ACO amounted to (₱1,914), (₱13,006) and ₱43,440 in 2004, 2003 and 2002, respectively.

c. PILMICO's investment in preferred shares of stock of ACO amounting to ₱300,000 as of December 31, 2002. Dividend income on such investment amounted to ₱4,845 and ₱35,773 in 2003 and 2002, respectively. These investments are short-term in nature, intended to be available for working capital requirements, and redeemable any time at the option of PILMICO. PILMICO redeemed its investment in preferred shares of stock of ACO in 2003.

d. Short-term investments with UBP, an associate, amounting to ₱2,206,344 and ₱1,598,634 as of December 31, 2004 and 2003, respectively. These placements bear average interest rates ranging from 1.60% to 7.325% in 2004, 1.25% to 4.5% and 2.8% to 4% in 2003 and 2002, respectively. Interest income earned by the Group is mainly derived from short-term investments (see Note 3).

e. Aviation services rendered by AEV Aviation. Total aviation services income from associates amounted to ₱4,892, ₱2,527 and ₱1,137 in 2004, 2003 and 2002, respectively.

f. Lease of commercial office units by ACO and certain associates from CPDC for a period of three years. Rental income amounted to ₱6,453, ₱6,354 and ₱6,392 in 2004, 2003 and 2002, respectively.

g. Shipping services, charter hire and ship management services to ATSC as follows:

	2004	2003	2002
Starlite Express, Inc.	**₱129,911**	₱73,378	₱–
Reefer Van Specialist, Inc.	**125,607**	130,072	104,096
Aboitiz One, Inc.	**7,180**	6,647	84,396
Aboitiz Jebsen Group	**344**	278	–
Other related parties	**49,074**	35,923	35,900
	₱312,116	₱246,298	₱224,392

h. Purchases of steward supplies, availment of stevedoring, arrastre, trucking, and repair services from ATSC as follows:

	2004	2003	2002
Aboitiz Jebsen Group	**₱347,660**	**₱80,531**	₱287,858
Cox Trucking Corporation	**121,391**	**110,773**	100,951
Total Distribution Logistics Systems, Inc.	**60,786**	**71,542**	72,240
Aboitiz One, Inc.	**44,291**	**16,959**	22,004
Reefer Van Specialist, Inc.	**1,265**	**1,770**	835
Starlite Express, Inc.	**3,946**	**–**	–
Other related parties	**82,915**	**182,135**	127,213
	₱662,254	**₱463,710**	₱611,101

i. Long-term loan from ACO, which bears interest at 12% in 2002. Interest expense amounted to ₱3,568 in 2002 (see Note 12). This loan was fully paid in 2003.

The consolidated balance sheets include the following amounts resulting from the above transactions with related parties:

	2004						
	Cash and Cash Equivalents	**Receivables**	**Other Current Assets**	**Noncurrent Advances to Associates**	**Bank Loans**	**Accounts Payable and Accrued Expenses**	**Long-term Debt**
UBP	**₱2,206,344**	**₱–**	**₱–**	**₱–**	**₱–**	**₱**	**₱545,884**
Accuria, Inc.	**–**	**–**	**–**	**243,552**	**–**	**–**	**–**
CSB	**–**	**–**	**–**	**–**	**–**	**–**	**–**
ACO	**–**	**22,990**	**–**	**–**	**–**	**–**	**–**
Others	**–**	**–**	**–**	**–**	**–**	**–**	**–**
	₱2,206,344	**₱22,990**	**₱–**	**₱243,552**	**₱–**	**₱–**	**₱545,884**

	2003						
	Cash and Cash Equivalents	Receivables	Other Current Assets	Noncurrent Advances to Associates	Bank Loans	Accounts Payable and Accrued Expenses	Long-term Debt
UBP	₱1,598,634	₱–	₱–	₱–	₱–	₱–	₱710,756
Accuria, Inc.	–	–	–	248,234	–	–	–
CSB	–	–	–	–	9,000	–	–
ACO	–	2,794	–	–	–	11,450	–
Others	–	90,562	482	–	–	60,801	–
	₱1,598,634	₱93,356	₱482	₱248,234	₱9,000	₱72,251	₱710,756

23. Retirement Plan

The Group has funded, noncontributory retirement plans covering all regular and full-time employees. The benefits are based on years of service and final monthly salary at date of retirement. The plans provide for normal, early retirement, death and disability benefits. Retirement cost charged to operations amounted to ₱87,140 in 2004, ₱63,455 in 2003 and ₱33,343 in 2002. The funds are administered by a duly appointed Board of Trustees. As of the latest actuarial valuation, the actuarial present value of accrued retirement benefits amounted to ₱237,910. The fair value of the plan assets amounted to ₱75,444. The principal actuarial assumptions used to determine retirement cost were a discount rate of 12%, salary increase of 10% per year and interest rates ranging from 10% to 12% per year. The Group's annual contribution to the retirement plans consist of a payment covering current service cost for the year plus a payment toward funding the actuarial accrued liability.

24. Rate Regulation, Power Supply and Other Agreements

a. Prior to the approval of the Power Bill on June 8, 2001 (see Note 30), certain subsidiaries are subject to the ratemaking regulations and regulatory policies by the then ERB and gives recognition to the ratemaking policies of the ERB. The ERB has been replaced by a new regulating body, ERC.

b. Certain subsidiaries entered into a contract for the purchase of electricity from National Power Corporation (NPC). Under the contract, the parties have agreed, among others, on the contract demand (1,560 kilowatts, 216 kilowatts and 28 kilowatts for DLP, CLP and SEZC, respectively) and contract energy (504,367 kilowatt hours, 104,400 kilowatt hours and 13,286 kilowatt hours for DLP, CLP and SEZC, respectively per year at varying monthly rates per kilowatt hour), allocated by NPC to the subsidiaries for each year during the effectivity of the agreements.

b. HEDCOR has an Electric Power Supply Agreement with various corporations to supply or sell power and energy produced by the mini hydro electric power plants. The maturity of these agreements vary from one off-taker to another with the nearest to mature on calendar year 2007 and the farthest on 2018. All agreements provide for renewals or extensions subject to mutually agreed terms and conditions by both parties. HEDCOR is committed to supply 130,000 kilowatt hours per year based on 88% of the Luzon grid rate per kilowatt hour.

c. HEDCOR signed an Operating and Maintenance Agreement with LHC to provide administration services and operate the 70 MW hydro electric power plant of LHC located in Alilem, Ilocos Sur starting on October 27, 2000 until December 31, 2006 unless extended by mutual written agreement by the parties.

25. Registration with the Department of Energy and Board of Investments

a. HEDCOR and NMHC are registered as mini hydro electric power developers with the Department of Energy under Republic Act (RA) 7156, entitled "Mini Hydro Electric Power Incentive Act". By virtue of such registration, these companies are entitled to certain incentives, among which are the special privilege tax at the rate of 2% on power sales, tax and duty free importation of machinery, equipment and materials, tax credit on domestic capital equipment and income tax holiday. Income tax holiday on these companies, tax and duty free importation and tax credit on domestic capital equipment expired in 2000.

   With the effectivity of RA 9136 known as "Electric Power Industry Reform Act of 2001", sales of generated power by generation companies shall be value added tax zero-rated. HEDCOR and NMHC has updated their registration with the BIR from VAT Exempt to VAT Zero Rated effective April 10, 2003.

b. ATSC is registered with the BOI under the Omnibus Investment Code of 1987 as a new operator of inter-island shipping through its SuperFerry 15, 16, 17 and 18 vessels on a pioneer status starting February 13, 2003 and SuperFerry 19 starting December 29, 2004. Such registration entitles ATSC to income holiday for a period of six years from the date of registration. Income tax holiday incentive availed amounted to ₱43,584 and ₱21,086 in 2004 and 2003, respectively.

26. Other Commitments

a. Operating Lease Commitments
   Certain subsidiaries lease their office space for a period of one to three years. Total rent charged to operations amounted to ₱96,828, ₱1,700 and ₱831 in 2004, 2003 and 2002, respectively.

   Future minimum rental payable under non-cancelable operating leases is as follows as of December 31, 2004:

Within one year	₱30,247
After one year but not more than five years	144,956
	₱175,203

b. Memorandum of Agreement
   In 2002, ATSC entered into a Memorandum of Agreement (Agreement) with Asian Terminals, Inc. (ATI) for the use of the latter's facilities and services at the South Harbor for the embarkation and disembarkation of ATSC's domestic passengers, as well as loading, unloading and storage of the cargoes. The agreement shall be for a period of five years, which term commenced effective May 1, 2003, the first scheduled service of ATSC at the South Harbor. The agreement is renewable for another five years under such terms as may be mutually agreed by the parties in writing. If the total term of the Agreement is less than ten years, then ATSC shall pay the penalty equivalent to unamortized reimbursement of capital expenditures and other related costs incurred by ATI in the development of South Harbor.

Under the terms and conditions of the Agreement, ATSC shall avail of the terminal services of ATI, which include among others, stevedoring, arrastre, storage, warehousing and passenger terminal. Domestic tariff for such services shall be subject to an escalation of 5% every year. The agreement became effective on January 14, 2003. Total service fees charged to operations amounted to ₱222,230 in 2004 and ₱95,027 in 2003.

c. Agreement with SBMA
On May 15, 2003, the SBMA, the Parent Company and DLP entered into a DMSA for the privatization of the SBMA PDS on a rehabilitate-operate-and-transfer arrangement. Under the terms of the DMSA, SEZC was created to undertake the administration, rehabilitation, operation and maintenance of the PDS, including the provision of electric power service to the consumers within the Subic Bay Freeport Secured Areas of the Subic Bay Freeport Zone as well as the collection of the relevant fees from them for its services and the payment by SBMA of the service fees throughout the service period pursuant to the terms of the DMSA.

The DMSA shall be effective for a 25-year period commencing on the turnover date and consisting of two phases: (a) the five-year rehabilitation period and (b) 20-year operation, management and maintenance period. Total estimated rehabilitation costs committed by SEZC under the DMSA amounted to ₱368,600.

For and in consideration of the services and expenditures of SEZC for it to undertake the rehabilitation, operation, management and maintenance of the PDS, it shall be paid by the SBMA the service fees in such amount equivalent to all the earnings of the PDS, provided, however, that SEZC shall remit the amount of ₱40,000 to the SBMA at the start of every 12-month period throughout the service period regardless of the total amount of all earnings of the PDS. The said remittance may be reduced by the outstanding power receivables from SBMA, including streetlights power consumption and maintenance, for the immediately preceding year.

The unamortized portion of the remittance to SBMA as of December 31, 2004 and 2003 amounting to ₱33,300 is presented as part of "Other current assets" account in the consolidated balance sheets.

In connection with the implementation of the DMSA, SEZC streamlined the operations of the PDS through employee right-sizing by way of a two-pronged approach: one, an Early Disengagement Program (EDP); and two, a "secondment" scheme for all others who did not avail of the EDP whereby employees are employed by SEZC on a four-month probationary period until given regular status.

Total cost of severance amounted to ₱25,000 in 2003 (see Note 18).

27. Earnings Per Common Share and Dividends Per Preferred Share

Earnings per common share amounts were computed as follows:

	2004	2003 (As restated- Note 2)	2002 (As restated- Note 2)
a. Net income (after dividends on preferred shares of ₱90,514 in 2004, ₱68,490 in 2003 and ₱71,980 in 2002)	**₱2,331,260**	₱1,973,330	₱2,154,925
b. Weighted average number of common shares issued and outstanding	**4,821,494,988**	4,820,310,110	4,943,294,910
c. Earnings per common share (a/b)	**₱0.48**	₱0.41	₱0.44

Dividends per preferred share amounts were computed as follows:

	2004	2003	2002
a. Preferred dividends paid	**₱90,514**	₱68,490	₱71,980
b. Average number of outstanding preferred shares	**124,131,764**	100,000,000	100,000,000
c. Preferred dividends per share (a/b)	**₱0.73**	₱0.68	₱0.72

28. Business Segment Information

The Group's operating businesses are organized and managed separately according to the nature of the products and services provided, with each segment representing a strategic business unit that offers different products and serves different markets.

The power segment is engaged in power generation and sale of electricity.

The food manufacturing segment is engaged in the production of flour and feeds and swine breeding.

The transportation segment provides domestic sea transportation services.

Financial information on the operations of the business segment is summarized as follows:

	Power			Food Manufacturing			Transportation			Parent Company and Others			Eliminations			Consolidated		
	2004	2003	2002	2004	2003	2002	2004	2003	2002	2004	2003	2002	2004	2003	2002	2004	2003	2002
REVENUE	₱6,579,117	₱4,808,973	₱4,672,938	₱6,168,828	₱5,472,031	₱4,826,543	₱8,249,457	₱7,692,261	₱7,090,066	₱67,580	₱60,338	₱54,791	₱–	(₱82,495)	(₱69,994)	₱21,064,982	₱17,951,108	₱16,574,344
RESULTS																		
Segment results	₱1,041,178	₱816,407	₱806,282	₱470,941	₱196,776	₱414,433	₱280,611	₱669,417	656,992	(₱193,473)	(₱169,583)	(₱143,033)	₱–	₱–	₱–	₱1,599,257	₱1,513,017	₱1,734,674
Unallocated corporate income (expenses)	₱213,013	₱55,036	₱6,827	₱21,471	₱37,756	₱52,489	₱410,974	₱64,009	(₱1,646)	₱66,284	₱66,069	(₱82,311)	₱9,495	₱3,353	(₱8,849)	₱721,237	₱226,223	(₱33,490)
INCOME FROM OPERATIONS																1,599,257	1,513,017	1,734,674
Interest expense	(231,628)	(230,753)	(255,789)	(64,126)	(56,726)	(98,853)	(368,705)	(254,984)	(179,591)	(479,970)	(487,637)	(195,858)				(1,144,429)	(1,030,100)	(730,091)
Interest income	31,361	37,237	44,847	4,806	3,509	2,784	20,999	8,356	56,758	159,875	140,626	54,354				217,041	189,728	158,743
Share in net earnings of associates	862,529	1,807,011	1,257,892	184,579	195,900	6,642	–	–	–	2,880,681	2,501,101	2,640,334	(2,375,599)	(2,941,468)	(2,033,039)	1,552,190	1,562,544	1,871,829
Provision for income tax	(323,561)	(221,724)	(191,666)	(81,736)	(17,651)	(72,828)	(64,740)	(158,463)	(185,740)	(13,215)	(6,056)	(15,663)				(483,252)	(403,894)	(465,897)
Income before minority interest																2,462,043	2,057,519	2,535,768
OTHER INFORMATION																		
Segment assets	₱2,921,750	₱1,451,855	₱1,556,509	₱1,803,194	₱1,424,843	₱1,371,905	₱2,269,640	₱2,419,113	₱2,266,283	₱3,976,329	₱1,586,058	₱1,007,177	(₱1,817,162)	(₱287,358)	(₱524,317)	₱9,153,751	₱6,594,511	₱5,677,557
Investments in shares of stock at equity method	1,988,081	5,058,249	4,808,803	1,215,951	39,587	45,366	–	–	–	20,041,867	6,775,896	18,671,088	(10,603,754)	(35,707)	(12,450,676)	12,642,145	11,838,025	11,074,581
Unallocated corporate assets	3,903,338	554,754	2,981,121	1,248,740	1,280,837	1,051,353	7,611,908	7,685,717	6,090,885	1,248,740	2,924,582	1,312,627	(1,011,790)	179,386	(151,477)	13,000,936	12,625,276	11,284,509
Consolidated total assets																34,796,831	31,057,812	28,036,647
Segment liabilities	602,476	497,029	780,968	242,365	178,890	552,871	2,358,880	1,724,594	1,167,353	113,777	82,497	482,472	–	–	(621,159)	3,317,498	2,483,010	2,362,505
Unallocated corporate liabilities	2,357,976	2,086,160	2,737,299	1,450,696	1,377,422	914,412	3,336,638	3,764,029	1,731,547	4,788,027	4,476,858	4,659,902	–	–	93,340	11,933,337	11,704,469	10,136,500
Consolidated total liabilities																15,250,835	14,187,478	12,499,005
Capital expenditure	482,323	439,618	4,807,261	26,872	282,307	115,682	2,235,926	1,967,521	1,438,302	57,741	13,799	10,929				2,802,862	2,703,245	6,372,174
Depreciation and amortization	361,363	272,890	303,812	76,982	76,314	69,693	1,199,460	1,121,491	1,169,155	64,828	36,280	28,472				1,702,633	1,506,975	1,583,161
Non-cash expenses other than depreciation and amortization	9,298	16,305	29,381	42,482	5,903	–	93,489	82,117	57,206	1,785	221	130,739				147,054	104,546	217,326

The Group generally accounts for inter-segment sales and transfers as if the sales or transfers were to third parties at current market prices.

The Group operates principally in one geographical segment which is the Philippines.

29. Contingencies

There are legal cases filed against certain subsidiaries in the normal course of business. Management and its legal counsel believe that the subsidiaries have substantial legal and factual bases for their position and are of the opinion that losses arising from these cases, if any, will not have a material adverse impact on the consolidated financial statements.

30. Other Matters

a. Impact of the Recent Supreme Court Decision

On November 15, 2002, the Third Division of the Supreme Court (SC) rendered a decision ordering Manila Electric Company (Meralco), the largest power distribution company in the Philippines, to refund to its customers ₱0.167 per kilowatt hour starting with Meralco's billing cycles beginning February 1994 or correspondingly credit this in their favor for future consumption. The SC sustained the ERB disallowance of income tax as an operating expense, which resulted in Meralco's rate of return exceeding 12%, the maximum allowed. Meralco filed a Motion for Consideration but the SC denied it with finality on April 10, 2003.

The resolution of the Meralco case may affect other electric companies. Management, however, believes that the final decision of the SC on Meralco's case has no immediate impact on DLP, CLP, VECO and SFELAPCO's operations since the rates used by these subsidiaries and associates did not exceed 12%. Thus, whatever is the outcome of the final decision, management is confident that there will be no impact on the consolidated financial statements.

b. Electric Power Industry Reform Act (Act) of 2001

RA 9136 was signed in to law on June 8, 2001 and took effect on June 26, 2001. RA 9136 provides for the privatization of the National Power Corporation (NPC) and the restructuring of the electric power industry. The Implementing Rules and Regulations (IRR) were approved by the Joint Congressional Power Commission on February 27, 2002.

RA 9136 and the IRR impact the industry as a whole. Other provisions of RA 9136 and the IRR are: (a) distribution utilities will provide open and nondiscriminatory access to its distribution systems within three years from the effectivity of the Act, subject to certain conditions precedent; (b) distributors shall be allowed to recover stranded contract costs, subject to review and verification by the ERC for fairness and reasonableness; (c) NPC and distributors shall have filed their proposed unbundled charges within six months from the Act's effectivity; (d) distributors shall file a Business Separation Unbundling Plan (BSUP) with the ERC by December 26, 2002; (e) residential users shall get a ₱0.30 per kwh reduction in power rates to be provided by NPC and passed on by distributors starting August 2001; (f) the power to grant electric distribution franchises shall be vested solely in Congress, thereby repealing or amending Section 43 of Presidential Decree 269 (The National Electrification Decree); (g) NPC shall segregate its subtransmission assets for disposal to qualified distributors within two years from the effectivity of the Act; (h) NPC shall file with the ERC within six months from the effectivity of the Act the Transition Supply Contracts negotiated with distributors; and (i) distribution companies may engage in related business, provided up to 50% of the income from the related business shall be used to lower wheeling charges. The law also empowers the ERC to enforce rules to encourage competition and penalize anti-competitive behavior.

The ERC has published its Guidelines on the classification of TransCo's subtransmission assets on November 5, 2003. This document identifies which subtransmission assets may be transferred by TransCo to qualified distribution utility companies.

Also in accordance with RA No. 9136, the DOE promulgated the Wholesale Electric Spot Market (WESM) Rules on June 28, 2002 after being endorsed by the industry participants. In accordance with the Rules, a Technical Working Group (TWG), was constituted on July 27, 2002 to ensure smooth transition from the promulgation of the Rules to the actual operation of the WESM. On August 2003, the TWG endorsed the incorporation of the Philippine Electricity Market Corporation, the entity that will be in charge of the day-to-day operations of the WESM. Meanwhile, on December 5, 2003, the ERC released the draft Price Determination Methodology (PDM) for the WESM for comment. A public consultation on the PDM was conducted by ERC on February 12, 2004.

Electric Power industry participants, including distribution utility companies, are mandated to file by the end of 2002 a BSUP for approval by the ERC, pursuant to Section 36 of RA No. 9136 requiring structural and functional unbundling of business activities of electric industry participants. The ERC, however, has extended this deadline. On January 29, 2003, the ERC released for comments the Business Separation Guidelines which provides the framework for the plans to be filed by the industry participants. The Guidelines were finalized and published by the Commission on November 20, 2003 and took effect on December 5, 2003. According to the Guidelines, distribution utility companies are required to file their proposed BSUPs on or before June 5, 2004. DLP, CLP and VECO filed their BSUP in December 2004. In 2004, the ERC approved applications for unbundled rates of VECO and CLP. DLP's application was approved on December 22, 2003.

On February 24, 2003, the ERC issued an Order approving the IRR for the new Generation Rate Adjustment Mechanism (GRAM) and the Incremental Currency Exchange Rate Adjustment (ICERA). The GRAM and ICERA are the mechanisms by which the Company can reflect changes in the levels of the Generation Charge and the Currency Exchange Rate Adjustment (CERA). The levels of the Generation Charge and the CERA are fixed until such time that the Commission approves new levels for these following a filing by the Company under the GRAM and ICERA. These rate adjustment mechanisms still allow the Company to pass on to its customers changes in purchased power costs and some of the effects of the peso depreciation. The cost recovery process, however, is no longer automatic, as the ERC's approval is required on a quarterly basis resulting in a lag between the time the costs are incurred and when they may be recovered.

On November 26, 2004, the ERC approved the Company's application for recovery of its purchased power cost under the GRAM at a rate of ₱0.3318 per kwh for a period of 12 months or until such time that the full amount shall have been recovered, effective on the next billing cycle.

The ERC in a resolution dated December 20, 2004 approved the Distribution Wheeling Rates Guidelines (DWRG). The promulgation of the guidelines is in accordance with RA 9136 which allows ERC to adopt an alternative form of internationally accepted rate setting methodology to replace the current RORB rate-setting. The DWRG is a "performance-based rate (PBR) setting" methodology which establishes the maximum distribution wheeling rates that may be charged by distribution utilities for a four-year regulatory period after which it goes through a reset process. According to the ERC's December 20, 2004 resolution,

distribution utilities have the option on when to be subject to the DWRG, which can start from mid-2007 to as late as mid-2011. Distributors that opt to start in the later periods will continue to be under RORB-regulation in the interim.

c. DLP's Case

On December 7, 1990, certain customers of DLP filed a letter-petition for recovery before the ERB claiming that with the SC's decision reducing the sound appraisal value of DLP's properties, that DLP exceeded the 12% return on rate base. ERB's order dated June 4, 1998, limited the computation coverage of the refund from January 19, 1984 to December 14, 1984. No amount was indicated in the ERB order as this has yet to be recomputed.

The Court of Appeals (CA), in Court of Appeals General Register (CAGR) No. Special Proceeding (SP) No. 50771, promulgated a decision dated February 23, 2001 which reversed the order of the ERB, expanding the computation coverage period from January 19, 1984 to September 18, 1989.

DLP strongly disputes the decision. However, whatever is the outcome of the final decision, management is confident that there are no excess profits for the period 1984-1989 and therefore, there will be no refund.

d. VECO Dispute

On March 17, 2004, the Parent Company and Vivant, of which the Garcia family is the majority owner, signed a Memorandum of Agreement (MOA) for the purpose of amicably settling all existing litigation among the parties and to cooperate with respect to the management and preservation of VECO's assets, franchise and business for the benefit of all stakeholders.

The dispute arose when Hijos de F. Escaño (Hijos), a holding company owning 51% of the outstanding shares in VECO swapped 30% of its controlling block of shares in exchange for shares in the Garcia's publicly listed company, Vivant. VECO is the second largest private electric distribution utility in the county with a franchise in Cebu. Hijos is owned 46.7% by the Parent Company and 50.9% by the Garcia family. The Parent Company beneficially owns a total of 54.58% of the outstanding shares of VECO.

The MOA also aims to restore Hijoas' VECO shares transferred under the share swap transaction and redistribute prorata the excess of Hijos' 25% shareholdings in VECO to its shareholders to comply with the Electric Power Industry Reform Act of 2001. The agreed redistribution under the MOA will result in the increase of the Aboitizes' direct ownership of VECO to 43%. Under the MOA, the Garcias and the Aboitizes will share in the management of VECO. The Garcias will retain control of the VECO Board. The chairmanship and the vice-chairmanship will be rotated every year. Initially, the Garcias will nominate the chairman, while the Aboitizes will nominate the vice-chairman. The Garcias will also nominate the President. On the other hand, the Aboitizes will nominate the Executive Vice-President/Chief Operating Officer who will be responsible for the operations and performance of VECO. Moreover, the BOD shall create an Executive Committee that will be composed of five members. Such committee will have two co-chairmen, with the Garcias and the Aboitizes nominating their co-chairman.

Effectivity of the MOA is subject to compliance on or before April 2, 2004 of specific conditions, which include the finalization of Shareholders Cooperation Agreements and the setting up of an escrow account that will serve to enforce certain conditions of the MOA and mutual settlement of the cases at the CA.

On April 2, 2004, after complying with the specific conditions, the MOA was completed and related closing documents were signed.

On July 7, 2004, the Court of Appeals upheld the MOA in its Notice of Judgment with respect to the appeals filed by the Garcia and Aboitiz groups on the Decision dated January 8, 2004 in civil case No. SRC-045-CEB of the Regional Trial Branch 12, Cebu City.

e. <u>LHC Arbitration</u>

LHC is a party to a dispute with a contractor regarding the delay in the completion of LHC's Power Station. Under the Turnkey Contract, the contractor shall pay liquidated damages for each day of delay on the following day without the need of demand from LHC. LHC may, without prejudice to any other method of recovery, deduct the amount of such damages from any monies due or to become due to the contractor and/or by drawing on the irrevocable and confirmed standby letters of credit amounting to US$18 million (the Security).

Due to the delay, LHC had drawn from the Security, liquidated damages for delay equivalent to US$18 million in 2000 and 2001. However, such drawdown was not recognized by the Parent Company as part of its share in equity in net earnings of LHC in 2000 and 2001.

In November 2000, the contractor elevated the dispute to an Arbitration Court operating under the Rules of the International Chamber of Commerce sitting in Australia. The court addressed certain broad issues including the design and construction of headrace tunnel, extension of time, liquidated damages, and misleading and deceptive conduct.

On February 18, 2004, the Tribunal delivered its partial award (first liability award) on major liability issues. LHC was successful in certain claims concerning the design and construction of the lined and unlined tunnel. However, the Tribunal also found that the contractor is entitled to certain money claims and refund of the abovementioned liquidated damages. The Tribunal did not quantify the amounts that LHC is entitled to as well as the amounts for the other money claims of the contractor. These amounts and all other issues, including any issues as to quantum and costs arising from the findings in the partial award, were reserved to future proceedings and future award by the Tribunal. LHC did not recognize the potential financial impact of the partial award by the Tribunal, because: (a) as stated above, the Tribunal has not quantified the amounts that the parties are entitled to in respect of all their claims; (b) the partial award is still subject to application for clarification, interpretation and correction by both LHC and the contractor; and (c) LHC has substantial counter claims against the contractor arising from, among others, the design and construction defects in the lined and unlined tunnel which under Philippine laws can be set-off against any amount due to the contractor. In addition, the arbitration is unfinished and will continue for the purpose of further awards on the quantum of money claims between the parties.

The contractor has also brought proceedings against LHC and Pacific Hydro Ltd. concerning their alleged involvement in the negotiation, administration and assignment of LHC's construction contract. Management believes that the legal position of the contractor is not sustainable.

In the opinion of management, however, the final settlement of the dispute will not have a material impact on the consolidated financial statements of the Group.

f. Use of Tax Credit Certificates (TCC)

PILMICO, Pilmico-Mauri and VECO were assessed by the Bureau of Internal Revenue to pay the total amount of ₱57,618, including fines and penalties for value added taxes for the first quarter of 2003 and April 2003. The assessment arises from the use of alleged invalid TCC purchased by the companies and subsequently applied to taxes due.

Management and legal counsel believe that the companies acquired and applied the TCC in good faith and that the assessments have no legal basis.