

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

Basis of Financial Statement Presentation

The Company maintains its official accounting records in Korean won and prepares statutory financial statements in the Korean language (Hangul) in conformity with the accounting principles generally accepted in the Republic of Korea. Certain accounting principles applied by the Company that conform with financial accounting standards and accounting principles in the Republic of Korea may not conform with generally accepted accounting principles in other countries. Accordingly, these financial statements are intended for use by those who are informed about Korean accounting principles and practices. The accompanying financial statements have been condensed, restructured and translated into English (with certain expanded descriptions) from the Korean language financial statements. Certain information included in the Korean language financial statements, but not required for a fair presentation of the Company's financial position, results of operations or cash flows, is not presented in the accompanying financial statements.

The Company prepared its financial statements as of December 31, 2005 in accordance with the additional Statements of Korea Accounting Standards ("SKAS") No. 15, No. 16 and No. 17, effective from January 1, 2005.

Major changes compared with the standards applied in preparing the financial statements as of December 31, 2004 are as follows:

<u>Statements of Korea Accounting Standards</u>	<u>Major changes</u>
No.15 - Investments in Associates	- To distinguish investees from subsidiaries in using the equity method - Elimination of unrealized profits and losses on inter-company transactions (downward) - Explanatory notes
No.16 - Income Taxes	- Deferred income taxes credited or charged directly to equity - Classification into current and non-current - Explanatory notes
No.17 - Provision, Contingent Liabilities and Contingent Assets	- To separate provision for estimated liabilities into provision and contingent liabilities

The Company did not restate the non-consolidated balance sheet as of December 31, 2004 and non-consolidated statements of income and cash flows for the year ended December 31, 2004, which are presented for comparative purposes, in accordance with SKAS No.15, No.16 and No.17.

Except for the accounting changes above and the written accounting reporting opinion (2005-3) issued by the Financial Supervisory Service, the significant accounting policies followed by the Company in the preparation of its non-consolidated financial statements are summarized below.

Revenue Recognition

Revenues from long-term contracts, including shipbuilding contracts, are recognized using the percentage-of-completion method, measured by the units of work performed. Revenues from other sales are recognized upon delivery of goods.

Under the percentage-of-completion method, revenues are recognized based on the percentage of costs incurred (including man hours and raw material costs) over total estimated costs for each contract. As a result, the timing of revenue recognition of which the Company reports may differ materially from the timing of actual contract payments received. The Company's estimates reflect information during construction activities. In addition, since most contracts are completed over several months, the timing of the recognition of related revenues could have a significant impact on quarterly operating results. The revenue recognized in excess of the payment received by the Company is reflected as accounts receivable, while the payments received in excess of the revenue recognized by the Company are reflected as advances from customers. The expenditures incurred before the construction contract is entered into are recognized as prepaid construction costs, if they are directly related to making a contract, separately identifiable and reliably measurable, and an agreement to construction is probable. The prepaid construction costs are transferred to construction cost at the commencement of the construction. The Company adopted the written accounting reporting opinion (2005-3), which was issued by the Financial Supervisory Service, on the brokerage commission upon receipt of construction contracts in preparing its financial statements as of December 31, 2005. As a result, the total amount of expected brokerage commission is recorded as current liabilities when construction contracts are received, and the related amount of ₩185,570 million is recorded as prepaid expenses and accrued expenses, respectively. As the financial statement items in 2004 were restated for comparability, prepaid expenses and accrued expenses increased by ₩132,699 million.

The Company adopted early the written accounting reporting opinion (2005-1), which was issued by the Financial Supervisory Service, on the currency hedging account of the foreign currency long-term contracts in preparing its financial statements as of December 31, 2004, and it was applied prospectively from 2004 because the retrospective effect of this new accounting policy cannot reasonably be determined.

Cash and Cash Equivalents

Cash and cash equivalents include cash on hand and in banks and short-term investments with original maturities of less than ninety days, which can be converted into cash and whose risk of value fluctuation arising from changes of interest rates is not material.

Allowance for Doubtful Accounts

The Company provides an allowance for doubtful accounts based on management's estimate of the collectibility of receivables and prior years' collection experience.

Inventories

Inventories are stated at the lower of cost or net realized value. Cost is determined using the moving average method, except for materials in-transit for which cost is determined using the specific identification method. The physical count of inventories is performed at the end of the year.

Investments in Securities Other than those Accounted for Using the Equity Method

Classification of Securities

At acquisition, the Company classifies securities into one of the three categories; trading, held-to-maturity or available-for-sale. Trading securities are those that were acquired principally to generate profits from short-term fluctuations in prices. Held-to-maturity securities are those with fixed or determinable payments and fixed maturity that the Company has the positive intent and ability to hold to maturity. Available-for-sale securities are those not classified as either held-to-maturity or trading securities. Trading securities are classified as current assets, whereas available-for-sale and held-to-maturity securities are classified as non-current assets, except for those whose maturity dates or whose likelihood of being disposed of are within one year from balance sheet date, which are classified as current assets.

Valuation of Securities

Securities are recognized initially at cost, which includes the market price of the consideration given to acquire them and incidental expenses. If the market price of the consideration is not reliably determinable, the market prices of the securities purchased are used as the basis for measurement. If neither the market prices of the consideration given nor those of the acquired securities are available, the acquisition cost is measured at the best estimates of its fair value.

After initial recognition, held-to-maturity securities are stated at amortized cost. The difference between their acquisition costs and face values of held-to-maturity securities is amortized over the remaining term of the securities by applying the effective interest method and added to or subtracted from the acquisition costs and interest income of the remaining period. Trading securities are valued at fair value, with unrealized gains or losses included in current operations. Available-for-sales securities are also valued at fair value, with unrealized gains or losses included in capital adjustments, until the securities are sold or if the securities are determined to be impaired and the lump-sum cumulative amount of capital adjustments are included in current operations. However, available-for-sales securities that are not traded in an active market and whose fair values cannot be reliably estimated are accounted for at their acquisition costs. For those securities that are traded in an active market, fair values refer to those quoted market prices, which are measured as the closing price at the balance sheet date. The fair value of non-marketable securities are measured at the discounted future cash flows by using the discount rate that appropriately reflects the credit rating of issuing entity assessed by a publicly reliable independent credit rating agency. If application of such measurement method is not feasible, estimates of the fair values may be made using a reasonable valuation model or quoted market prices of similar debt securities issued by entities conducting similar business in similar industries.

Securities are evaluated at each balance sheet date to determine whether there is any objective evidence of

impairment loss. When any such evidence exists, unless there is a clear counter-evidence that recognition of impairment is unnecessary, the Company estimates the recoverable amount of the impaired security and recognizes any impairment loss in current operations. The amount of impairment loss of the held-to-maturity security or non-marketable equity security is measured as the difference between the recoverable amount and the carrying amount. The recoverable amount of held-to maturity security is the present value of expected future cash flows discounted at the securities' original effective interest rate. For available-for-sale debt or equity security, the amount of impairment loss to be recognized in the current period is determined by subtracting the amount of impairment loss of debt or equity security already recognized in prior period from the amount of amortized cost in excess of the recoverable amount for debt security or the amount of the acquisition cost in excess of the fair value for equity security.

If the realizable value subsequently recovers, in case of a security stated at fair value, the increase in value is recorded in current operations, up to the amount of the previously recognized impairment loss, while for the security stated at amortized cost or acquisition cost, the increase in value is recorded in current operation, so that its recovered value does not exceed what its amortized cost would be as of the recovery date if there had been no impairment loss.

When transfers of securities between categories are needed because of changes in an entity's intention and ability to hold those securities, such transfer is accounted for as follows: trading securities cannot be reclassified into available-for-sale and held-to-maturity securities, and vice versa, except when certain trading securities lose their marketability. Available-for-sale securities and held-to-maturity securities can be reclassified into each other after fair value recognition. When held-to-maturity security is reclassified into available-for-sale security, the difference between the book value and fair value is reported in capital adjustments. Whereas, in case available-for-sale security is reclassified into held-to-maturity securities, the difference is reported in capital adjustments and amortized over the remaining term of the securities using the effective interest method. If held-to-maturity securities are disposed or redeemed before the maturity date, any securities could not be categorized to held-to-maturity within 3 fiscal years after the disposal and redemption.

Investment Securities Accounted for Using the Equity Method

Equity securities held for investment in companies in which the Company is able to exercise significant influence over the operating and financial policies of the investees are accounted for using the equity method. Differences between the initial purchase price and the Company's initial proportionate ownership of the net book value of the investee are amortized over five years using the straight-line method. Under the equity method, the change in the Company's portion of an investee's net equity resulting from a change in an investee's net equity is reflected in the Company's net income (loss), retained earnings and capital adjustments, in accordance with the causes of the change, which consist of the investee's net income (loss), changes in retained earnings and changes in capital surplus and capital adjustments. Unrealized profit arising from sales by the Company to equity method investees is fully eliminated. The Company's proportionate unrealized profit arising from sales by the equity method investees to the Company or sales between equity method investees is also eliminated. The Company has used the most available financial statements of the controlled investees, which have not been audited and reviewed due to the timing of closing of the controlled investees' financial statements.

Property, Plant and Equipment and Related Depreciation

Property, plant and equipment are stated at cost, (except for assets revalued upward in accordance with the Asset Revaluation Law of Korea), net of accumulated depreciation. Routine maintenance and repairs are expensed as incurred. Expenditures that result in the enhancement of the value or extension of the useful lives of the facilities involved are treated as additions to property, plant and equipment. The

interest incurred on borrowings to finance the purchase of construction of property, plant and equipment and manufacture of inventories are charged to current operation.

Depreciation is computed using the straight-line method, based on the estimated useful lives of the assets as described below.

	<u>Useful lives (years)</u>
Buildings and structures	20 – 40
Machinery and equipment	10
Ships	12
Vehicles	5
Tools, furniture and fixtures	5

The Company assesses any possible recognition of impairment loss when there is an indication that expected future economic benefits of a tangible asset is considerably less than its carrying amount as a result of technological obsolescence or rapid decline in market value. When it is determined that a tangible asset may have been impaired and that its estimated total future cash flows from continued use or disposal is less than its carrying amount, the carrying amount of a tangible asset is reduced to its recoverable amount and the difference is recognized as an impairment loss.

If the recoverable amount of the impaired asset exceeds its carrying amount in subsequent reporting period, the amount equal to the excess is treated as reversal of the impairment loss; however, it cannot exceed the carrying amount that would have been determined had no impairment loss been recognized.

Lease Transactions

The Company accounts for lease transactions as either capital leases or operating leases, depending on the terms of the underlying lease agreements.

Assets leased under capital lease are recorded at cost, included as property, plant and equipment, and depreciated using the straight-line method over their estimated useful lives. The aggregate lease payments are recorded as a capital lease obligation, net of accrued interest as determined by the excess of lease payments over the cost of the leased asset. Accrued interest is charged to expense over the lease terms using the effective interest rate method.

The lease payments under operating lease are recognized as current expenses on an accrual basis over the term of the lease agreement.

Intangible Assets

Intangible assets, such as development costs and usage rights for the donated properties, are stated at cost, net of accumulated amortization, which is computed using the straight-line method based on the estimated service lives of the intangibles assets as described below.

	<u>Service lives (years)</u>
Development costs	5
Usage right for donated properties	20 - 40

Development costs are incurred in respect of particular development activities and directly related to new products or technology. The Company's management believes that the value of development costs will be recovered through their future economic benefits.

If the recoverable amount of an intangible asset becomes less than its carrying amount as a result of obsolescence, sharp decline in market value or other causes of impairment, the carrying amount of an intangible asset is reduced to its recoverable amount and the reduced amount is recognized as impairment loss. If the recoverable amount of a previously impaired intangible asset exceeds its carrying amount in subsequent periods, an amount equal to the excess shall be recorded as reversal of impairment loss; however, it cannot exceed the carrying amount that would have been determined had no impairment loss been recognized in prior years.

Discounts on Debentures

Discounts on debentures are amortized over the redemption period of the debentures using the effective interest rate method. Amortization of discounts is recognized as interest expense on the debentures.

Foreign Currency Translation

The Company maintains its accounts in Korean won. Transactions in foreign currencies are recorded in Korean won based on the prevailing exchange rates on the transaction date. Monetary accounts with balances denominated in foreign currencies are recorded and reported in the accompanying financial statements at the exchange rates prevailing at the balance sheet dates. The balances have been translated using the Seoul Money Brokerage Service Ltd. Basic Rate, which was ₩1,013.00 and ₩1,043.80 to USD1.00 at December 31, 2005 and 2004, respectively, and translation gains or losses are reflected in current operations.

Provision for Foreseeable Losses from Construction Contracts

When a loss on construction is expected based on cost estimates, the expected loss is charged to operations and is included in the balance sheet as a provision for foreseeable losses from construction contracts.

Provision for Construction Warranty

The Company generally provides a warranty within the contract on rectification of defects after the contract's completion and accrues the rectification expense on defects based on actual claims history as provision for construction warranty.

Accrued Severance Benefits

Employees and directors with more than one year of service are entitled to receive a lump-sum payment upon termination of their services with the Company, based on their length of service and rate of payment at the time of termination. Accrued severance benefits that would be payable assuming all eligible employees were to terminate their employment amount to ₩1,018,835,792 thousand and ₩1,005,940,296 thousand as of December 31, 2005 and 2004, respectively (see Note 10). Accrued severance benefits are funded approximately 80.8% and 78.2% as of December 31, 2005 and 2004, respectively, through certain insurance plans with Kyobo Life Insurance Co., Ltd. and other insurance companies. The unused portion of severance insurance deposits for these insurance plans is deducted from accrued severance benefits.

Before April 1999, the Company and its employees paid 3 percent and 6 percent, respectively, of monthly pay (as defined) to the National Pension Fund in accordance with the National Pension Law of Korea. The Company paid half of the employees' 6 percent and is paid back at the termination of service by netting the receivable against the severance payment. Such receivables are presented as a deduction from accrued severance benefits. Since April 1999, according to a revision in the National Pension Law, the Company and its employees each pay 4.5% of monthly pay to the Fund.

Income Tax Expense

The Company recognizes income tax expenses determined by adding or deducting changes in deferred income tax assets (liabilities) to or from total income tax and surtaxes to be paid by tax law for the current period. The deferred income tax assets or liabilities will be charged or credited to income tax expense in the period each temporary difference (the difference between the tax basis of assets or liabilities and the book value) reverses in the future. The Company recognizes deferred tax liabilities basically for all taxable temporary differences, but recognizes deferred tax assets for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilized. Also, the Company recognizes deferred tax assets for all deductible temporary differences arising from investments in subsidiaries and associates to the extent that it is probable that the

temporary difference will be reversed in the foreseeable future and taxable profit will be available against which the temporary difference can be utilized. In addition, current tax and deferred tax is charged or credited directly to equity if the tax relates to items that are credited or charged directly to equity in the same or different period. Deferred tax assets and liabilities are classified as current or non-current based on the classification of the related assets or liabilities for financial reporting.

Derivative Instruments

All derivative instruments are accounted for at fair value with the valuation gain or loss recorded as an asset or liability. If the derivative instrument is not part of a transaction qualifying as a hedge, the adjustment to fair value is reflected in current operations. The accounting for derivative transactions that are part of a qualified hedge based both on the purpose of the transaction and on meeting the specified criteria for hedge accounting differs depending on whether the transaction is a fair value hedge or a cash flow hedge. Fair value hedge accounting is applied to a derivative instrument designated as hedging the exposure to changes in the fair value of an asset or a liability or a firm commitment (hedged item) that is attributable to a particular risk. The gain or loss both on the hedging derivative instruments and on the hedged item attributable to the hedged risk is reflected in current operations.

Cash flow hedge accounting is applied to a derivative instrument designated as hedging the exposure to variability in expected future cash flows of an asset or a liability or a forecast transaction that is attributable to a particular risk. The effective portion of gain or loss on a derivative instrument designated as a cash flow hedge is recorded as a capital adjustment and the ineffective portion is recorded in current operations. The effective portion of gain or loss recorded as a capital adjustment is reclassified to current earnings in the same period during which the hedged forecasted transaction affects earnings. If the hedged transaction results in the acquisition of an asset or the incurrence of a liability, the gain or loss in capital adjustment is added to or deducted from the asset or the liability.