Chapter 6. Review and Analysis of Financial Conditions, Operating Results and Risk Management

Balance Sheet Analysis

Standalone balance sheet analysis

Explanation of significant changes – i.e., at least a 10% change amounting to more than NT$10 million – in the past two years' assets, liabilities and shareholders' equity:

1. Current assets were higher due to increased inventory for handset campaigns and rise in receivables from subsidiaries in use of lower parent company's funding cost.
2. Fixed assets declined owing to depreciation.
3. Amendment of Article 5 of the Income Tax Act provides that the corporate statutory tax rate shall be reduced from 20% to 17% effective June 15, 2010. Deferred income tax assets that are non-current have been revised downward accordingly. Thus, other assets decreased.
4. Current liabilities rose as a result of increased short-term borrowing and advanced subscription receivables from customers.
5. Long-term liabilities increased due to a drawdown of syndicated loans amounting to NT$800mn.

2009- 2010 Standalone Balance Sheet

Unit: NT$'000, %

	2009	2010	YoY change	
			Amount	%
Current assets	13,530,729	23,819,685	10,288,956	76.04
Fixed assets	39,033,012	35,014,385	(4,018,627)	(10.30)
Other assets	4,823,691	4,144,036	(679,655)	(14.09)
Total assets	80,763,936	87,155,457	6,391,521	7.91
Current liabilities	18,833,732	25,621,285	6,787,553	36.04
Long-term liabilities	8,000,000	8,800,000	800,000	10.00
Total liabilities	28,690,710	36,285,902	7,595,192	26.47
Paid-in capital	38,009,254	38,009,254	-	-
Capital surplus	12,431,704	12,432,489	785	0.01
Retained earnings	33,449,530	32,243,481	(1,206,049)	(3.61)
Total shareholders' equity	52,073,226	50,869,555	(1,203,671)	(2.31)

Consolidated balance sheet analysis

Explanation of significant changes – i.e., at least a 10% change amounting to more than NT$10 million – in the past two years' assets, liabilities and shareholders' equity:

1. Current assets increased due to a rise in cash position from higher operating cash inflows, and in inventory due to the procurement of more smartphones at a higher unit price.
2. Long-term borrowings increased due to the raising of syndicated loans to pay for short-term debts.

2009 - 2010 Consolidated Balance Sheet

Unit: NT$'000, %

	2009	2010	YoY change	
			Amount	%
Current assets	11,564,180	15,242,392	3,678,212	31.81%
Fixed assets	46,543,617	43,613,993	(2,929,624)	(6.29%)

	2009	2010	YoY change	
			Amount	%
Other assets	3,353,626	3,078,905	(274,721)	(8.19%)
Total assets	85,886,115	85,484,200	(401,915)	(0.47%)
Current liabilities	24,747,402	23,231,653	(1,515,749)	(6.12%)
Long-term liabilities	8,000,000	10,300,000	2,300,000	28.75%
Total liabilities	33,803,006	34,584,782	781,776	2.31%
Paid-in capital	38,009,254	38,009,254	-	-
Capital surplus	12,431,704	12,432,489	785	0.01%
Retained earnings	33,449,530	32,243,481	(1,206,049)	(3.61%)
Total shareholders' equity	52,083,109	50,899,418	(1,183,691)	(2.27%)

Impact of changes on financial results: No significant impact

Preventive measures: Not applicable

Income Statement Analysis

Standalone income statement analysis

1. Increase in operating costs: Cost of handsets sold increased in 2010 due to higher smartphone sell-through.
2. Increase in non-operating income: The Company recognized higher investment income from its subsidiary, TFN Media Co., Ltd., due to steady growth in both pay TV and cable internet accesses services.
3. Decrease in non-operating expense: Interest expense decreased due to repayment of the Company's first unsecured corporate bonds due at the end of 2009. Likewise, asset write-off and disposal losses decreased compared with a year ago.

2009 – 2010 Standalone Income Statement

Unit: NT$'000, %

	2009	2010	YoY change	
			Amount	%
Revenue	57,015,452	58,547,285	1,531,833	2.69
Operating costs	(27,165,925)	(32,808,712)	5,642,787	20.77
Gross profit	29,849,527	25,738,573	(4,110,954)	(13.77)
Operating expense	(13,216,730)	(12,038,007)	(1,178,723)	(8.92)
Operating income	16,632,797	13,700,566	(2,932,231)	(17.63)
Non-operating income	3,730,713	4,465,716	735,003	19.70
Non-operating expense	(2,231,019)	(1,768,138)	(462,881)	(20.75)
Income before tax	18,132,491	16,398,144	(1,734,347)	(9.56)
Net income	13,888,862	13,822,186	(66,676)	(0.48)

Consolidated income statement analysis

1. Increase in operating costs: Cost of handsets sold increased in 2010 due to higher smartphone sell-through.
2. Increase in non-operating income: Non-operating income increased in 2010 due to the disposal gain from selling of shares in New Century InfoComm Tech. Co., Ltd. and an idle property.

3. Decrease in non-operating expense: Interest expense decreased due to repayment of the first unsecured corporate bonds due at the end of 2009. Likewise, asset write-off and disposal losses decreased compared with a year ago.

2009 – 2010 Consolidated Income Statement

Unit: NT$'000, %

	2009	2010	YoY change	
			Amount	%
Revenue	68,470,232	70,146,004	1,675,772	2.45%
Operating costs	(33,209,461)	(38,162,363)	4,952,902	14.91%
Gross profit	35,260,771	31,983,641	(3,277,130)	(9.29%)
Operating expense	(14,812,637)	(13,675,930)	(1,136,707)	(7.67%)
Operating income	20,448,134	18,307,711	(2,140,423)	(10.47%)
Non-operating income	596,131	739,516	143,385	24.05%
Non-operating expense	(2,397,934)	(1,945,905)	(452,029)	(18.85%)
Income before tax	18,646,331	17,101,322	(1,545,009)	(8.29%)
Net income	13,890,516	13,817,778	(72,738)	(0.52%)

Consolidated financial ratio analysis

			2009	2010
Financial structure (%)	Debt to asset ratio		39.36	40.46
	Long-term capital to fixed asset ratio		129.09	140.32
Solvency (%)	Current ratio		46.73	65.61
	Quick ratio		42.06	57.83
	Interest coverage ratio (x)		34.22	54.53
Operations	Accounts receivable turnover (x)		8.81	9.25
	Average collection days		41.43	39.46
	Inventory turnover (x)		7.48	10.31
	Accounts payable turnover (x)		11.33	11.68
	Average days sales		48.80	35.40
	Fixed asset turnover (x)		1.47	1.61
	Total asset turnover (x)		0.80	0.82
Profitability (%)	Return on assets		16.10	16.41
	Return on equity		26.97	26.84
	% of paid-in capital	Operating income	53.80	48.17
		Pre-tax income	49.06	44.99
	Net profit margin		20.29	19.70
	EPS (NT$)		4.66	4.62
Cash flow (%)	Cash flow ratio		96.78	111.89
	Cash flow adequacy ratio		157.94	140.61
	Cash reinvestment rate		11.64	12.87
Leverage	Operating leverage		1.83	1.91
	Financial leverage		1.03	1.02

Explanation for items in 2010 with major changes (>20%) from the previous year:

(1) Significant increases in sales and in procurement of smartphones resulted in higher advanced receipts from customers and accounts payable to vendors, leading to an increase in the ratio of liabilities to asset. As cost of handsets sold grew faster than average inventories, inventory turnover went up while average days sales went down. The operating income and pre-tax income as a % of paid-in capital dropped due to higher handset sales losses, i.e. subsidies, for the year.
(2) The decrease in interest payable and the increase in working capital were due to repayment of the first unsecured corporate bonds in 2009. As a result, current ratio, quick ratio and interest coverage ratio all increased.
(3) The cash flow ratio and cash reinvestment rate both increased due to higher cash inflows from operating activities.

Revenue outlook, key assumptions, potential impact on the Company's business and corresponding proposal:

In 2011, the Company will continue to leverage mobile internet products to expand its wireless market share. Telecom operators are expected to become more aggressive in devising new acquisition strategies and investing more in the VAS market as the demand for smart devices continues to grow. To realize the full potential of this growth, the Company will focus on developing attractive value-added products and services in order to increase average revenue per user (ARPU). The Company will also pursue a bigger market share of mid to high-usage customers. To meet these targets, the Company will utilize the full potential of its growing number of direct stores, as well as use its competitive edge in handset procurement to help boost cost and marketing efficiency.

Cash Flow Analysis

Standalone cash flow analysis

1. Cash flow from operating activities: Cash inflow decreased in 2010 as less cash dividends were distributed from equity method investees.
2. Cash flow from investment activities: Cash outflow increased in 2010 due to increase in financing to related parties.
3. Cash flow from financing activities: Cash outflow was higher in 2009 resulting from repayment of the first unsecured corporate bonds and long-term borrowings.

2009 – 2010 Standalone Cash Flow Statement

Unit: NT$'000, %

	2009	2010	YoY change	
			Amount	%
Cash inflow (outflow) from operating activities	26,196,820	23,318,054	(2,878,766)	(10.99)
Cash inflow (outflow) from investment activities	(5,082,512)	(11,109,826)	(6,027,314)	(118.59)
Cash inflow (outflow) from financing activities	(21,601,641)	(9,384,389)	(12,217,252)	(56.56)
Net cash	(487,333)	2,823,839	3,311,172	679.45

Consolidated cash flow analysis

1. Cash flow from operating activities: Cash inflow increased in 2010 due to increase in advanced receivables from the sale of smartphones to customers.
2. Cash flow from financing activities: Cash outflow was higher in 2009 resulting from repayment of the first unsecured corporate bonds.

2009 – 2010 Consolidated Cash Flow Statement

Unit: NT$'000, %

	2009	2010	YoY change	
			Amount	%
Cash inflow (outflow) from operating activities	23,950,872	25,993,528	2,042,656	8.53%
Cash inflow (outflow) from investment activities	(6,751,173)	(6,319,636)	431,537	6.39%
Cash inflow (outflow) from financing activities	(18,064,262)	(16,630,430)	1,433,832	7.94%
Net cash	(869,026)	3,050,294	3,919,320	451.00%

Plans to improve negative liquidity: Not applicable

Projected cash flow for 2011

1. Projected cash inflow from operating activities: Expected to remain stable
2. Projected cash outflow from investment activities: For capital expenditures
3. Projected cash outflow from financing activities: For cash dividend distribution and capital reduction

2011 Cash Flow Analysis

Unit: NT$'000

Cash balance, beginning of the year (1)	Forecast net cash inflow from operations (2)	Forecast cash outflow from investment and financing activities (3)	Cash balance, end of the year (1) + (2) - (3)	Source of funding for negative cash balance	
				Cash inflow from investment activities	Cash inflow from financing activities
3,880,881	21,799,000	23,211,389	2,468,492	-	-

Source of funding for negative cash flow in 2010: Not applicable

Analysis of Major Capex and its Impact on Finance and Operations

Owing to stable operations and cash flows, the Company was able to fund all major capital expenditures using internal capital; therefore, the Company's financials were not affected.

Investment Policies, Reasons for Profit/Loss, Plans for Improvement, and Future Investment Plan

Unit: NT$'000

Item \ Explanation	Carrying Value as of end of 2010	Rationale	Source of income/ loss	Improvement plans	Future investment plans
Taiwan Cellular Co., Ltd.	10,618,840	Investing in fixed network and other telecom-related business	Investment income from Taiwan Fixed Network Co., Ltd. and TCC Investment Co., Ltd.	-	-
Taipei New Horizons Co., Ltd.	388,002	Investing in a property development project located at the old Songshan tobacco factory site for use as headquarters	In preparatory stage as of end of 2010	-	Dependent on future construction plans and fund requirements
Wealth Media Technology Co., Ltd. (WMT)	301,977	Investing in CATV-related business	Investment income from Tai Fu Media Technology Co., Ltd.	-	The Company's BOD approved the funding of up to NT$6.5bn to WMT in July 2009
Bridge Mobile Pte Ltd.	50,324	Cooperation with other operators in Asia to enhance the Company's competitiveness	- (Note)	- (Note)	-

Note: Investment was booked as "Financial assets carried at cost." The Company has no significant influence over it.

Risk Management

Impact of inflation, as well as interest and exchange rate fluctuations, and preventive measures:

1. Impact of interest rate fluctuations

As the Company had no floating interest rate borrowing in 2010, interest rate fluctuations had a minimal impact on its profit.

2. Impact of exchange rate fluctuations

The Company's main service area is Taiwan. Except for its international roaming business, all operating revenues are denominated in NT dollars. Some of the Company's capital expenditures are denominated in Euros and US dollars. To minimize the impact from foreign exchange rate fluctuations, the Company hedges risks through foreign currency deposits and forward contracts.

The Company booked an exchange gain of NT$0.97mn as of end of 2010. Overall, exchange rate fluctuations had a minimal impact on the Company.

3. Impact of inflation

Inflation had a minimal impact on the Company's operating performance in the past year up to the publication date.

Investment policy and reasons for gains & losses for high-risk/ high-leverage financial products, derivatives, loans to others and guarantees of debts:

1. The Company was not involved in any high-risk, high-leverage financial investment.
2. The Company passed the "Rules and Procedures on Lending and Making Endorsement/Guarantees" to supervise its financing and endorsement activities. As the counterparties in its loans and guarantees are all its subsidiaries, there is minimal operating risk.
3. Derivatives transaction: None.

Research and development plans

1. Strategic plans

Project name	Objective	Status	Completion date
Femtocell end to end troubleshooting technology	Develop a troubleshooting mechanism for femtocell and build proof of concept prototype.	Technical specs study and femtocell test log analysis	Dec. 2011
M2M cloud platform architecture	Develop a cloud platform architecture for future machine to machine (M2M) applications and build proof of concept prototype.	Working on systems analysis	Dec. 2011
Electronic Customer Relationship Management (eCRM)	Set up embedded product links on TWM's website that best meet a customer's personal preferences and needs. Customers can easily click on the link to complete an order.	Working on system implementation	Mar. 2011
Private cloud computing	Integrated infrastructure as a service (IIaS) to IT infrastructure to deliver a virtual platform for TWM's private cloud computing environment.	Continuously evaluate and utilize new technology solutions (including server and storage) and improve standard operating procedures	Oct. 2011
ERP IFRS	Adopt International Financial Reporting Standards (IFRS) of accounting to provide domestic and international investors more transparent and reliable financial information. Ensure that TWM's daily operations and internal reports comply with internal control provisions set by regulators.	Implementation of accounting and information systems ongoing	Jan. 2012
IT reusable assets	Develop and establish IT reusable assets, including processes, technical guidelines, frameworks, applications, common services, tools and components, to avoid a duplication of these efforts, thereby enhancing productivity, improving quality and saving on costs.	Several reusable assets have been identified, established and applied to different projects. Further research is being conducted.	Dec. 2011

Project name	Objective	Status	Completion date
New IDCs (Internet Data Center)	Build new IDCs to meet future demand for digital convergence.	Requirements identification and technical evaluation ongoing	Jan. 2011~ Aug. 2012
Customer perceived network quality analysis	Communication logs between customer devices and base stations were parsed to generate customer perceived network quality reports. These results can be used in network planning and to deal with complaints about poor customer service.	Technical evaluation and system structure finished	Sep. 2011
Device Management Service	Build a web-based monitoring platform to provide customers with network equipment (router / firewall / switch) that alert them to systems or service flaws or obstacles to enhance the competitiveness of TWM's data products.	Working on system design	Sep. 2011
Mobile office	Convert MIS systems into mobile services for different types of smart devices, so employees can browse, sign and deal with workflow forms any time any place to enhance employee productivity and increase business competitiveness.	Data collection and systems analysis ongoing	Aug. 2011
3C electronic commerce (EC) trial run	Expand current EC platform for selling 3C products as well as accepting pre-paid card deposits.	Basic functions platform completed	Aug. 2011
App-store transactions settlement	Open current "match" mobile internet portal to non-TWM consumers and expand the app-store platform to include individual vendors. An automated system for settling vendor-host revenue split will be also implemented.	Working on systems analysis and design	Jun. 2011

2. Systems development

Project name	Objective	Status	Completion date
Cooperative multiple-input and multiple-output (MIMO) relay and carrier aggregation for Long Term Evolution (LTE)	The project comprises two parts: (1) carrier aggregation for LTE-advanced mobile communication systems (2) coordinated multipoint transmission/reception techniques for LTE	Simulation in progress.	Jun. 2011
Investigation of data throughput improvement at base station cell edge	The project comprises four parts: (1) tracking algorithms based on Kalman filter to determine the location of the mobile device (2) cooperative communication techniques to improve data throughput (3) virtual MIMO to improve data throughput (4) hybrid automatic repeat request (HARQ) mechanism to correct data error and reduce bit error rate (BER)	Completed the study of the tracking algorithm based on Kalman filter to determine where the mobile device located cooperative communication techniques to improve data throughput.	Jun. 2011

3. Value-added services

Project Name	Objective	Status	Completion date
"match Market" opened to off-net mobile users	Extend "match Market" service to off-net users. App-store can be accessed by anyone interested in content.	Working on systems development	Apr. 2011
myBook	Extend "myBook" services from smartphone products to tablet products.	Working on testing system	Jun. 2011
myPhoto	Build a digital convergence platform for users to view their photos on TV / mobile / tablets / PC through the internet. Both on-net and off-net mobile users and digital TV viewers can avail of the service.	Working on testing system	Aug. 2011
Advertisement platform	Expand the platform to support mobile banners and location base advertisement for services such as "MoFun" service and portals.	Working on service plan	Nov. 2011
Voice-Over Internet Protocol (VoIP)	Build VoIP service through integration of IT and telecoms systems.	Working on service plan	Nov. 2011

Regulatory changes

1. Revision of digital convergence regulation

(1) Status

In response to the trend toward digital convergence, new technological developments and increasing competition in the telecommunications and broadcasting markets, the National Communications Commission (NCC) plans to review its fee structure for frequency utilization to reflect actual economic value and improve efficiency.

The NCC also plans to review its phone number management system as the expanding range of content and applications that can be used on different devices or systems boosts demand for phone numbers.

(2) Countermeasures

The Company will continue to communicate with and forward suggestions and recommendations concerning related policy and regulations to the NCC.

2. Second round of mobile tariff cuts from April 1, 2010

(1) Status

On January 6, 2010, the NCC announced that mobile retail tariffs should be cut per annum for three consecutive years from April 1, 2010 to March 31, 2013. The adjustment coefficient (X value) of 5% was applied to text messages and off-net mobile outgoing calls. Under the formula: tariff reduction = $\triangle$CPI – X, CPI contraction of 0.87% in 2010 translates into a tariff cut of 5.87%, while the tariff cut will be reduced to 4.04% for 2011. The NCC also plans to place mobile voice interconnection under tariff control. The wholesale price for 2G/3G mobile voice interconnection will be affected after legal revisions.

(2) Countermeasures

As developed countries no longer regulate mobile retail tariffs, the Company will continue to communicate with the NCC on this issue to reduce its impact on revenues.

3. Expiration of GSM licenses

(1) Status

On November 12, 2010, the Executive Yuan passed a measure governing the expiration of GSM licenses, with the Ministry of Transportation and Communications (MOTC) duly publicizing the measure on November 25, 2010. The measure states that GSM licenses will be extended to June 2017, and the operators will be allowed to renew their licenses from December 2011. After this period, the spectrum will be reclaimed and no longer partially allocated for the use of GSM. To make full use of its resources, the reclaimed spectrum will be regrouped with neighboring blocks, i.e., two 15MHz*2 on 900MHz, and three 20MHz*3 on 1800MHz. After reviewing related regulations on licensing fees, renewal process amongst others, the NCC will release five new technology-neutral licenses before July 2015. Bidding for the new licenses is expected to be intense.

(2) Countermeasures

The Company is committed to continuously providing subscribers with advanced mobile communications and digital convergence services. It has also recommended that the NCC promote public awareness of the expiration of 3G (800MHz/2.1GHz) services and 700MHz spectrum before releasing technology-neutral (900/1800MHz) licenses in July 2015.

4. Fixed-line interconnecting charge adjustment

(1) Status

In August 2010, the NCC amended the “Regulations Governing Network Interconnection among Telecommunication Enterprises,” returning price-setting rights for fixed-to-mobile calls from mobile operators to fixed-line operators effective January 1, 2011. To promote competition in the fixed-line market and reduce its impact on mobile operators, Chunghwa Telecoms (significant market player) shall pay mobile operators a termination fee and a transition fee (NT$1.956/per minute in 2011, gradually dropping to NT$0/per minute within a six-year period); other fixed-line operators shall only pay a termination fee.

The amendment is positive for the Company’s fixed-line business. While it could impact on its mobile business, this could be mitigated by the transition fee the Company receives from CHT.

(2) Countermeasures

The Company will use this opportunity to explore the enterprise market and expand its business in value-added and mobile data services to stabilize its revenue.

5. Reducing IP peering and other wholesale charges

(1) Status

In March 2010, the NCC approved Chunghwa Telecom’s new wholesale pricing scheme, lowering IP peering and data leased circuit fees by 5.7% and asynchronous transfer mode (ATM)-based circuit fees by about 10%, thereby reducing the Company’s operating cost.

(2) Countermeasures

The Company will continue pushing for lower IP peering costs and other leased line wholesale prices as it develops its broadband business.

6. Policy planning for mobile TV services

(1) Status

At the end of 2009, the Executive Yuan approved the MOTC’s “Digital Wireless TV Plan” to offer five digital wireless television licenses and two mobile TV licenses. The NCC is charged with the task of issuing licenses and overseeing management, and is still evaluating whether to issue mobile TV licenses.

(2) Countermeasures

In the meantime, the Company will provide customers with mobile video streaming services through 3G network, and continue to assist the NCC in evaluating new broadcasting technologies and whether to issue mobile TV licenses.

7. Femtocell management regulation

(1) Status

In response to developments in base station technology, the NCC completed its review and published regulations relating to femtocell base stations, including processes for model certification, system qualification, device certification and licensing in August 2010. The commission expects femtocell to enhance competition in the fixed-mobile convergence (FMC) business.

(2) Countermeasures

The Company has planned to provide related femtocell products and services to improve customer satisfaction.

Technology changes and development

1. Wireless Broadband Access (WBA)

(1) Status

WBA is a communications technology based on orthogonal frequency division multiplexing (OFDM). WiMAX is one of the examples of OFDM technologies and is capable of providing speeds of up to 10 Mbps on 3G's 5MHz equivalent frequency bandwidth. All six local WiMAX operators have launched regional services one after another since 2Q09. However, WiMAX network coverage still suffers in comparison with 3G coverage. To boost their competitiveness, some WiMAX operators have launched free VoIP services with a flat WiMAX data rate. When WIMAX coverage improves, WiMAX VoIP might affect 3G voice and data revenue.

(2) Countermeasures

3.5G technology for high-speed downlink packet access (HSDPA) is mature and has been commercialized. The speed of the connection throughput for HSDPA reaches 21Mbps, already surpasses that of WBA technology, and is a more commercially competitive technology.

TWM has aggressively deployed 3.5G technology since late 2007, and offered 14.4Mbps wireless broadband services in urban areas starting from 2009. In 2010, TWM expanded deployment of 7.2Mbps and 14.4Mbps in 3.5G base stations to provide more comprehensive higher-speed mobile internet services. In 2011, some 3.5G base stations will be further upgraded to 21Mbps and 42Mbps. The Company will also continue its evaluation of 3G extended LTE technology – another promising technology that could rival WiMAX – and plans to launch trial runs this year.

2. Rising popularity of internet protocol

(1) Status

The popularity of internet protocol (IP) has revolutionized the telecommunications business and network infrastructure, giving rise to increased IP-based communications traffic. IP-based telecom is able to simplify network infrastructure, translating into big savings on operating costs. The increasing availability of cheap or free VoIP services have had a great impact on traditional fixed-line operators' long distance and international voice call revenue, and might affect mobile voice revenue in the future.

(2) Countermeasures

The necessity of building an IP core network infrastructure based on next generation network (NGN) is an urgent task. TWM has been building the latest IP-based optical core network and started to deploy IP core access and transmission technologies. It is also conducting laboratory tests of various IMS (IP Multimedia System) and VoIP application services to lead industry development.

The Company will continue to develop and test new IP application services and conduct research on the latest optical packet carrier ethernet technologies to introduce more services that provide households with the most advanced and innovative broadband services.

3. Digital convergence

(1) Status

The mobile and fixed-line communications and media industries, which have similar service models and technologies, have been on a converging trend in recent years. This has facilitated the exchange and transmission of digital content and services among different carriers, systems and platforms, and is a factor for potential consolidation in the telecommunications and broadcasting industries.

(2) Countermeasures

After merging Taiwan Fixed Network (TFN) and Taiwan Telecommunication Network Services (TTN) in 2007, the Company enhanced its status as a leader in the digital convergence era. TWM had integrated the group's resources to facilitate research and development in digital convergence and launched fixed-mobile convergence (FMC) services for corporate accounts. It is also aggressively planning new digital convergence services that will integrate cable TV, digital TV, cable broadband, and interactive entertainment services. At the end of 2010, the Company launched its four-screen-one-cloud digital convergence service, integrating handset, PC, tablet and TV. TWM was not only the first to introduce such services in Taiwan, but also an industry pioneer in Asia.

4. Popularity of mobile smart devices and femto/WiFi technologies

(1) Status

The popularity of the iPhone, Android phone and other mobile smart devices have dramatically boosted the growth of 3G data usage. This has forced global mobile operators to expand their 3G access network's backhaul bandwidth and network capacity, which in turn has increased the pressure on their operating costs. Some mobile operators have started building femtocells or WiFi networks to offload 3G data traffic.

(2) Countermeasures

In 2010, the Company not only expanded the backhaul bandwidth and network capacity of its 3G/HSDPA network, but also aggressively initiated femto and WiFi solution trial runs with partner vendors. The results of these trials were designed to serve as a reference for the Company's final decision on deploying these technologies.

In 2011, the Company will start to deploy femtocells and consider deploying WiFi network to improve indoor coverage and offload 3G data traffic.

Impact of changes in brand image to the Company's risk management policies: None

Expected benefits and risks from mergers in recent years until the publication date: Not applicable as the Company had no merger activity during 2010 up to the publication date of January 31, 2011.

Expected benefits and risks related to plant facility expansions: Not applicable

Risks from concentration in supply and sales in the recent years until the publication date

The Company's main supplier is Chunghwa Telecom (CHT) for network interconnections and leased lines. These costs accounted for 14.76% of total operating costs in 2010. The Company has been increasing usage of leased lines supplied by Taiwan Fixed Network, the Company's 100% owned subsidiary, to diversify supplier risk.

On the revenue side, CHT is the Company's largest source of interconnection revenue. However, the Company has a very diverse subscriber base for its mobile services. As such, there is no customer concentration risk.

Changes in shareholdings of directors, supervisors and major shareholders

From 2010 up to the publication date in 2011, the Company's directors and major shareholders who own more than 10% of the Company's outstanding shares did not conduct any major share transfers. The Company has maintained a good relationship with its directors and major shareholders. With maximizing shareholder value as its goal, the Company is focused on maintaining a stable management to reduce shareholder risk.

Changes in management controls: Not applicable

Significant lawsuits and non-litigious matters

1. The Company: None

2. The Company's directors, supervisors, general manager, any person with actual responsibility for the Company, any major shareholder holding greater than 10 percent of the Company's shares: None

3. The Company's subsidiaries

(1) Taiwan Fixed Network Co., Ltd. (TFN)

Dispute between TFN and Kaohsiung City Government over land usage fee.

Parties Involved: TFN is the plaintiff and Kaohsiung City Government is the defendant.

Amount Claimed: NT$11,972,865

Date of Filing: December 24, 2007

Grounds for Lawsuit:

TFN laid pipes under land owned by the Kaohsiung City Government. Citing related regulations, the city government said in 2007 that TFN should pay NT$13,094,147 for land usage fees from 2002 to 2004. Disagreeing with the administrative disposition, TFN filed an administrative appeal with the Ministry of Finance. Following the Ministry's dismissal of the administrative appeal, TFN brought the case to the Kaohsiung High Administrative Court, which revoked charges amounting to NT$1,121,282 claimed by the city government on the grounds that they had already expired, but ordered TFN to pay the remaining amount. TFN believed the Kaohsiung High Administrative Court's ruling was in contravention of the laws and regulations and filed an appeal with the Supreme Administrative Court.

Status: The Supreme Administrative Court dismissed TFN's appeal on September 16, 2010. The judgment is final and binding.

(2) Globalview Cable TV Co., Ltd., Phoenix Cable TV Co., Ltd., Union Cable TV Co., Ltd., and Yeong Jia Leh Cable TV Co., Ltd. (collectively "4 SOs")

The NCC fined the four SOs NT$100,000 each and ordered them to divest holdings by the Taipei City Government within one year after the ruling.

Parties Involved: The four SOs are the defaulting parties.

Date of Filing: The four SOs filed an administrative appeal in January 2010 and a second one in July 2010.

Grounds for Lawsuit:

The NCC ruled that the four SOs had violated Paragraph 4, Article 19 of the "Cable Radio and Television Act," which states that the government, political parties, as well as foundations established with their endowments, and those commissioned thereof, shall not directly or indirectly invest in cable, radio and/or television system operators. The four SOs disagreed with the NCC's administrative disposition fining them NT$100,000 each and ordering them to divest holdings by the Taipei City Government, and filed individual administrative appeals. The Executive Yuan revoked the NCC's administrative disposition, but in June and July 2010, the NCC issued new administrative dispositions (hereinafter referred to as the "second disposition") with the same administrative penalty and conditions mentioned in the first. The four SOs disagreed with the second disposition and filed individual administrative appeals.

Status: The Executive Yuan revoked both the NCC's first and second disposition.

(3) Win TV Broadcasting Co., Ltd.

The NCC fined Win TV broadcasting Co., Ltd. NT$200,000 as an administrative penalty and instructed it to dispose of holdings by the Taipei City Government within one year after the ruling.

Parties Involved: Win TV is the defaulting party.

Date of Filing: Win TV filed an administrative appeal in February 2010 and a second one in October 2010.

Grounds for Lawsuit:

The NCC ruled that Win TV had violated Paragraph 3, Article 9 of the "Satellite Broadcasting Act," which stipulates that political parties, the government and foundations established with their endowments, and those commissioned thereof, shall not invest directly or indirectly in satellite broadcasting businesses. Win TV was fined NT$200,000 as an administrative penalty and ordered to divest indirect holdings by the Taipei City Government within one year after receiving the administrative disposition. Win TV disagreed with the NCC's disposition and filed an administrative appeal. The Executive Yuan revoked the NCC's disposition. However, the NCC in September 2010 issued a second administrative disposition with the same penalty and conditions as the first one. Win TV filed an appeal.

Status: The Executive Yuan both revoked the NCC's first and second disposition.

Other major risks

Customer fraud management policy

1. Verification before activation

(1) ID confirmation: An application shall be denied if the applicant's ID matches one on the blacklist. Approval may be given if the ID has been removed from the blacklist (e.g. after clearing unpaid bills).

(2) Customer profile confirmation: After passing the aforementioned process, if the applicant's customer profile falls into the high risk group, conditional approval may be granted (e.g. requiring advanced payment of bills).

2. Monitoring after activation

(1) Verification calls: After activation, relatively "high-risk" applicants will receive a follow-up call from the Company to guard against fraud/fake accounts.

(2) Credit classification: The system grades and authorizes credit based on customers' usage and payment history.

(3) Unusual usage / call behavior: When a customer's usage exceeds his credit and a verifying call confirms that usage is unusual and abnormal, the Company will temporarily suspend the service to protect customers' interests until the bill is paid. Furthermore, in incidents where fraud is suspected (e.g. fake accounts), the Company will suspend phone service during the investigation period.

Other significant items: None