1. PRINCIPAL ACTIVITIES, ORGANISATION AND BASIS OF PRESENTATION

Principal activities

China Petroleum & Chemical Corporation ("the Company") is an oil and energy company that, through its subsidiaries (hereinafter collectively referred to as the "Group"), engages in fully integrated oil and gas and chemical operations in the People's Republic of China ("the PRC", "China" or the "State"). Oil and gas operations consist of exploring for, developing and producing crude oil and natural gas; transporting crude oil, natural gas and products by pipelines; refining crude oil into finished petroleum products; and marketing crude oil, natural gas and refined petroleum products. Chemical operations include the manufacture and marketing of a wide range of chemicals for industrial uses.

Organisation

The Company was established in the PRC on 25 February 2000 as a joint stock limited company as part of the reorganisation (the "Reorganisation") of China Petrochemical Corporation ("Sinopec Group Company"), a ministry-level enterprise under the direct supervision of the State Council of the PRC. Prior to the incorporation of the Company, the oil and gas and chemical operations of the Group were carried on by oil administration bureaux, petrochemical and refining production enterprises and sales and marketing companies of Sinopec Group Company.

As part of the Reorganisation, certain of Sinopec Group Company's core oil and gas and chemical operations and businesses together with the related assets and liabilities that were to be transferred to the Company were segregated such that the operations and businesses were separately managed beginning 31 December 1999. On 25 February 2000, in consideration for Sinopec Group Company transferring such oil and gas and chemical operations and businesses and the related assets and liabilities to the Company, the Company issued 68.8 billion domestic state-owned ordinary shares with a par value of RMB 1.00 each to Sinopec Group Company. The shares issued to Sinopec Group Company on 25 February 2000 represented the entire registered and issued share capital of the Company at that date. The oil and gas and chemical operations and businesses transferred to the Company related to (i) the exploration, development and production of crude oil and natural gas, (ii) the refining, transportation, storage and marketing of crude oil and petroleum products, and (iii) the production and sale of chemicals (collectively the "Predecessor Operations"). Sinopec Group Company retained certain refining and production enterprises and facilities that were not considered strategically competitive with the Company's oil and gas and chemical operations. In addition, Sinopec Group Company retained units providing certain social services, government functions and other ancillary and supporting services.

Basis of presentation

As Sinopec Group Company controlled the businesses and operations transferred to the Company before the Reorganisation and continues to control the Company after the Reorganisation, the Group's accounts for the two years ended 31 December 2000 have been prepared as a reorganisation of businesses under common control in a manner similar to a pooling-of-interests. Accordingly, the assets and liabilities transferred to the Company have been stated at historical amounts.

The group accounts for the year ended 31 December 1999 present the results of the Company and its subsidiaries as if the Group had been in existence throughout the year and as if the Predecessor Operations were transferred to the Company from Sinopec Group Company at 1 January 1999. In addition, the group accounts for the year ended 31 December 1999 include the results of certain other operations that were historically associated with the Predecessor Operations but were retained by Sinopec Group Company. Pursuant to the Reorganisation, certain assets and liabilities relating principally to refining and production operations and marketing and distribution operations, and other individual assets and liabilities that were historically associated with the Predecessor Operations, were not transferred to the Company and were retained by Sinopec Group Company. These assets and liabilities were primarily related to certain refining and petrochemical complexes, individual production plants and service stations and at 31 December 1999 consisted of the following:

	RMB millions
Current assets	36,890
Property, plant and equipment	27,758
Construction in progress	11,576
Investments	7,587
Interests in associates and jointly controlled entities	1,080
Other assets	5,678
Current liabilities	(37,509)
Long-term debts and other liabilities	(26,459)
Net assets distributed to Sinopec Group Company in connection with the Reorganisation	**26,601**

The group accounts for the year ended 31 December 1999 have been prepared to include the assets, liabilities, revenues and expenses that are applicable to the Predecessor Operations and the assets, liabilities, revenues and expenses of the operations retained by Sinopec Group Company that were historically associated with the Predecessor Operations as described above. As a result of the segregation and separate management beginning 31 December 1999 of the core oil and gas and chemical operations and businesses that were to be transferred to the Company, the assets and liabilities retained by Sinopec Group Company, as set out in the table above, are reflected as a distribution to Sinopec Group Company on 31 December 1999.

Management believes that all historical costs of operations have been reflected in the group accounts for the year ended 31 December 1999. Expenses that could be specifically identified to the Predecessor Operations and the other operations that are included in the group accounts for the year ended 31 December 1999 but were retained by Sinopec Group Company, include the following:

- purchases, services and other
- personnel expenses
- exploration expenses
- depreciation, depletion and amortisation
- taxes other than income tax
- exchange gains and losses
- interest expense

1. **PRINCIPAL ACTIVITIES, ORGANISATION AND BASIS OF PRESENTATION** *(Continued)*

For the year ended 31 December 1999, the allocation of those expenses for which a specific identification method was not practical was made as a percentage of the historical number of employees or revenues as appropriate. The number of employees and revenue data used to allocate expenses represented historical operating data that existed during the year for which they are being used to allocate costs. Expenses related to ancillary, social and supporting services that are attributable to the businesses and operations included in the group accounts for the year ended 31 December 1999 were allocated to the Group primarily based on the total historical number of employees. Selling, general and administrative expenses not specifically identifiable to the Predecessor Operations and the other operations that are included in the group accounts for the year ended 31 December 1999 which were retained by Sinopec Group Company were principally allocated on the following basis:

	Basis
Transportation and storage	Revenues
Promotion	Revenues
Staff training and education	Number of employees
Medical and insurance	Number of employees
Office expenses	Number of employees

The allocation methodology used for each operating segment of the Group is the same as that used to allocate costs from Sinopec Group Company to the Group. Management believes that the foregoing presents a reasonable basis of estimating what the Group's expenses would have been on a stand alone basis for the year ended 31 December 1999.

These accounts have been prepared in accordance with International Accounting Standards ("IAS'') issued by the International Accounting Standards Committee ("IASC"), and interpretations issued by the Standing Interpretations Committee of the IASC, and are prepared on the historical cost basis as modified by the revaluation of certain property, plant and equipment. These accounts also comply with the disclosure requirements of the Hong Kong Companies Ordinance and the applicable disclosure provisions of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited.

The IASC has issued IAS 39 "Financial Instruments: Recognition and Measurement" and IAS 40 "Investment Property" which are effective for accounts covering periods beginning on or after 1 January 2001. The Group considers the adoption of IAS 39 and IAS 40 will not have material impact on its financial position or results of operations.

The preparation of accounts in accordance with IAS requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the year. Actual results could differ from those estimates.

2. **PRINCIPAL ACCOUNTING POLICIES**

(a) Basis of consolidation

The consolidated accounts include the accounts of the Company and its subsidiaries. Subsidiaries are those entities controlled by the Company. Control exists when the Company has the power, directly or indirectly, to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

The results of subsidiaries are included in the consolidated profit and loss account from the date that control effectively commences until the date that control effectively ceases, and the share attributable to minority interests is deducted from or added to profit from ordinary activities after taxation. All significant inter-company transactions and balances, and any unrealised gains arising from inter-company transactions, have been eliminated on consolidation.

The particulars of the Group's principal subsidiaries are set out in Note 35.

(b) Translation of foreign currencies

The functional and reporting currency of the Group is Renminbi. Foreign currency transactions during the year are translated into Renminbi at the applicable rates of exchange quoted by the People's Bank of China ("PBOC rates") prevailing on the transaction dates. Foreign currency monetary assets and liabilities are translated into Renminbi at the applicable PBOC rates at the balance sheet date.

Exchange differences, other than those capitalised as construction in progress, are recognised as income or expenses in the profit and loss account.

(c) Cash and cash equivalents

Cash equivalents consist of time deposits with financial institutions with an initial term of less than three months.

(d) Trade accounts receivable

Trade accounts receivable are stated at cost less allowance for doubtful accounts. Allowance for doubtful accounts is provided based upon the evaluation of the recoverability of these accounts at the balance sheet date.

(e) Inventories

Inventories, other than spare parts and consumables, are carried at the lower of cost and net realisable value. Cost includes the cost of purchase computed using the weighted average method and, in the case of work in progress and finished goods, direct labour and an appropriate proportion of production overheads. Net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

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

2. PRINCIPAL ACCOUNTING POLICIES *(Continued)*

(f) Property, plant and equipment

Property, plant and equipment are initially recorded at cost less accumulated depreciation and impairment losses. The cost of an asset comprises its purchase price and any directly attributable costs of bringing the asset to working condition and location for its intended use. Subsequent to the revaluation, which was based on depreciated replacement costs, as at 30 September 1999, property, plant and equipment are carried at revalued amount, being the fair value at the date of the revaluation less any subsequent accumulated depreciation and impairment losses. Revaluations are performed periodically to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet date. Expenditure incurred after the asset has been put into operation is capitalised only when it increases the future economic benefits embodied in the item of property, plant and equipment. All other expenditure is charged to the profit and loss account in the period in which it is incurred.

Gains or losses arising from the retirement or disposal of property, plant and equipment, other than oil and gas properties, are determined as the difference between the net disposal proceeds and the carrying amount of the asset and are recognised as income or expense in the profit and loss account on the date of retirement or disposal. On disposal of a revalued asset, the related revaluation surplus is transferred from the revaluation reserve to retained earnings.

Depreciation is provided to write off the cost/revalued amount of each asset, other than oil and gas properties, over its estimated useful life on a straight-line basis, after taking into account its estimated residual value, as follows:

Buildings	15 to 45 years
Plant, machinery, equipment and others	4 to 18 years
Oil depots, storage tanks and service station equipment	8 to 14 years

Land and buildings use rights are amortised on a straight-line basis over the respective periods of the grants.

(g) Oil and gas properties

The Group uses the successful efforts method of accounting for its oil and gas producing activities. Under this method, costs of development wells and the related support equipment are capitalised. The cost of exploratory wells is initially capitalised as construction in progress pending determination of whether the well has found proved reserves. The impairment of exploratory well costs occurs upon the determination that the well has not found proved reserves. Exploratory wells that find oil and gas reserves in any area requiring major capital expenditure are expensed unless the well has found a sufficient quantity of reserves to justify its completion as a producing well if the required capital expenditure is made, and drilling of the additional exploratory wells is under way or firmly planned for the near future. However, in the absence of a determination of the discovery of proved reserves, exploratory well costs are not carried as an asset for more than one year following completion of drilling. If, after one year has passed, a determination of the discovery of proved reserves cannot be made, the exploratory well costs are impaired and charged to expense. All other exploration costs, including geological and geophysical costs, other dry hole costs and annual lease rentals, are expensed as incurred. Capitalised costs relating to proved properties are amortised at the field level on a unit-of-production method. The amortisation rates are determined based on oil and gas reserves estimated to be recoverable from existing facilities over the shorter of the economic lives of crude oil and natural gas reservoirs and the terms of the relevant production licenses.

Gains and losses on the disposal of proved oil and gas properties are not recognised unless the disposal encompasses an entire property. The proceeds on such disposals are credited to the carrying amounts of oil and gas properties.

Future dismantlement, restoration and abandonment costs are estimated taking into account the anticipated method of dismantlement and restoration, and are provided using the unit-of-production method.

(h) Construction in progress

Construction in progress represents buildings, oil and gas properties, various plant and equipment under construction and pending installation, and is stated at cost less impairment losses. Cost comprises direct costs of construction as well as interest charges, and foreign exchange differences on related borrowed funds to the extent that they are regarded as an adjustment to interest charges, during the periods of construction.

Capitalisation of these costs ceases and the construction in progress is transferred to property, plant and equipment when the asset is substantially ready for its intended use.

No depreciation is provided in respect of construction in progress.

(i) Investments in subsidiaries

In the Company's balance sheet, investments in subsidiaries are accounted for using the equity method.

(j) Investments

Investments in unlisted equity securities are stated at cost less provision for impairment losses. A provision is made where, in the opinion of management, there is an impairment in the value of an investment.

(k) Investments in associates and jointly controlled entities

An associate is a company, not being a subsidiary, in which the Group exercises significant influence in its management. A jointly controlled entity is an entity over which the Group can exercise joint control with other venturers. Significant influence is the power to participate in the financial and operating policy decisions of the investee but is not control over those policies. Joint control is the contractually agreed sharing of control over an economic activity.

Investments in associates and jointly controlled entities are accounted for using the equity method in the Company's and the Group's accounts, from the date that significant influence or joint control commences until the date that significant influence or joint control ceases.

(l) Provisions

A provision is recognised in the balance sheet when the Group has a legal or constructive obligation as a result of a past event, and it is probable that an outflow of economic benefits will be required to settle the obligation.

2. PRINCIPAL ACCOUNTING POLICIES *(Continued)*

(m) Revenue recognition

Revenues associated with the sale of crude oil, natural gas, petroleum and chemical products and all other items are recorded when the customer accepts the goods and the significant risks and rewards of ownership and title have been transferred to the buyer. Revenue from the rendering of services is recognised in the profit and loss account upon performance of the services. No revenue is recognised if there are significant uncertainties regarding recovery of the consideration due, the possible return of goods, or when the amount of revenue and the costs incurred or to be incurred in respect of the transaction cannot be measured reliably.

Interest income is recognised on a time apportioned basis that takes into account the effective yield on the asset.

Gains arising from the issuance of shares by subsidiaries are recognised in the profit and loss account. Further information is set out in Note 10.

(n) Borrowing costs

Borrowing costs are expensed in the profit and loss account in the period in which they are incurred, except to the extent that they are capitalised as being attributable to the construction of an asset which necessarily takes a period of time to get ready for its intended use.

(o) Repairs and maintenance expenditure

Repairs and maintenance expenditure, including cost of major overhaul, is expensed as incurred.

(p) Environmental expenditures

Environmental expenditures that relate to current ongoing operations or to conditions caused by past operations are expensed as incurred.

Liabilities related to future remediation costs are recorded when environmental assessments and/or cleanups are probable and the costs can be reasonably estimated. As facts concerning environmental contingencies become known to the Group, the Group reassesses its position both with respect to accrued liabilities and other potential exposures.

(q) Research and development costs

Research and development costs are recognised as expenses in the period in which they are incurred.

(r) Operating leases

Operating lease payments are charged to the profit and loss account on a straight-line basis over the period of the respective leases.

(s) Retirement benefits

The contributions payable under the Group's retirement plans are charged to the profit and loss account according to the contribution determined by the plans. Further information is set out in Note 33.

(t) Impairment loss

The Group early adopted IAS 36, "Impairment of Assets" in 1998.

The carrying amounts of long-lived assets are reviewed periodically in order to assess whether the recoverable amounts have declined below the carrying amounts. These assets are tested for impairment whenever events or changes in circumstances indicate that their recorded carrying amounts may not be recoverable. When such a decline has occurred, the carrying amount is reduced to the recoverable amount. The recoverable amount is the greater of the net selling price and the value in use. In determining the value in use, expected future cash flows generated by the asset are discounted to their present value. The amount of the reduction is recognised as an expense in the profit and loss account unless the asset is carried at revalued amount for which an impairment loss is recognised directly against any related revaluation reserve to the extent that the impairment loss does not exceed the amount held in the revaluation reserve for that same asset.

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

(u) Income tax

Income tax comprises current and deferred tax. Current tax is calculated on taxable income by applying the applicable tax rates. Tax refunds received are recorded as a reduction of income tax expense.

Deferred tax is provided using the balance sheet liability method on all temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes.

Deferred tax is calculated on the basis of the enacted tax rates that are expected to apply in the period when the asset is realised or the liability is settled. The effect on deferred tax of any changes in tax rates is charged or credited to the profit and loss account.

The tax value of losses expected to be available for utilisation against future taxable income is set off against the deferred tax liability within the same legal tax unit and jurisdiction to the extent appropriate, and is not available for set-off against the taxable profit of another legal tax unit. Net deferred tax assets are reduced to the extent that it is no longer probable that the related tax benefit will be realised.

The deferred tax effect of (1) changes in the financial statement carrying amounts and tax bases of property, plant and equipment caused by the 30 September 1999 revaluation as part of the Reorganisation and (2) changes in the tax bases of property, plant and equipment of subsidiaries as a result of revaluations in connection with the listings of such subsidiaries, in accordance with PRC rules and regulations, are included in reserves.

(v) Dividends

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

(w) Segmental reporting

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