

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

OVERVIEW

We design, develop and market high performance integrated circuits for power management and security applications, as well as systems security solutions. We also license a limited portion of our proprietary intellectual property to third parties. Our net sales have been derived primarily from the sale of analog and mixed-signal integrated circuit products to customers in the consumer electronics, computer, industrial and communications markets.

Our net sales have grown from US\$92.2 million in 2004 to US\$105.6 million in 2005. This increase in net sales was due primarily to the introduction of new products, higher unit shipments of our existing products and expansion of our customer base. We have continued to diversify our customer base and market focus by providing new products to the consumer electronics, computer, industrial and communications markets. Our overall gross margin has fluctuated in the past and is likely to fluctuate in the future due to the stages of our products in their life cycles, variations in our product mix, the timing of our product introductions and specific product manufacturing costs. New products typically have higher gross margins than products that are more mature. Gross margins on the products we sell will typically decline over the life of these products due to competitive pressures and volume pricing agreements.

Operating expenses grew from US\$41.9 million in 2004 to US\$55.9 million in 2005. Our operating expenses increased as we continued our new product development efforts, expanded our operations and hired additional personnel.

Our net income was US\$14.1 million in 2004 and US\$8.1 million in 2005. We have been profitable in each quarter since the quarter ended September 30, 1999. We believe this profitability has been the result of our strategy to make investments to develop new products and grow net sales, while maintaining a high level of fiscal control, product quality and customer satisfaction. Our profitability resulted in retained earnings of US\$38.7 million as of December 31, 2005.

We utilize a fabless semiconductor business model, which means we focus on designing, developing and marketing products, while having these products manufactured by large independent semiconductor foundries. As a fabless semiconductor company, we do not need to invest significant capital to manufacture semiconductor devices, and can take advantage of some of the cost-efficiencies of third-party foundries. We place purchase orders for specific quantities of packaged semiconductor devices or wafers at set prices. We currently use third parties to test and assemble substantially all of our products, which reduces the capital we need to invest in these activities. However, we intend to bring some of the more critical semiconductor testing activities in-house to safeguard our proprietary technologies. We also use independent assembly suppliers for the production of our systems security solutions products.

We sell our products through a combination of direct sales offices, sales representatives and distributors. We have sales representatives in Hong Kong, Singapore, Taiwan, and the United States, as well as one distributor in Japan. In the years ended December 31, 2004 and 2005, we continued to experience increased sales to customers in China.

Revenue from product sales to customers, other than distributors, is recognized at the time of shipment, including revenue that has been realized and earned. Sales through distributors are recognized when the distributors make a sale. Under certain conditions, customers may return defective products. Allowances for sales returns are provided on the basis of past experience. These provisions are deducted from sales.

FACTORS THAT AFFECT OUR RESULTS OF OPERATIONS

Demand for consumer electronics and computer products

The majority of our net sales is generated from sales of our products used in liquid crystal display (LCD) monitors, LCD televisions and notebook computers. As a result, changes in demand for these products affect our results of operations. The markets for these products have experienced strong growth in the past, driven primarily by the consumer preference toward thinner and larger displays and mobile computing. Although these trends have increased the demand for our products, there can be no assurance that such trends will continue.

Technology migration and new products

Due to rapid technological advances in the semiconductor industry, and frequent new product introductions by our customers and our competitors, our success depends in part on our ability to develop and introduce new products in a timely manner. As a result, we continue to actively develop new products that have improved features and can achieve broad commercial acceptance. In addition, the price of integrated circuit products tends to decline over the product's life cycle as the current generation of integrated circuits is replaced by next-generation products. Price erosion is usually faster in digital integrated circuits compared to analog and mixed-signal integrated circuits, because analog and mixed-signal integrated circuits are relatively more difficult to replace given the physical layout and electrical characteristics of their circuits. We also work closely with customers to identify their future product needs and establish engineering priorities for new product design and development. We intend to continue to leverage our analog and mixed-signal design expertise to develop products with longer life cycles.

Manufacturing costs

As a fabless semiconductor company, we rely on third-party foundries to manufacture our integrated circuits. We also rely on third-party assembly and testing service providers to assemble, package and test our integrated circuits prior to shipping. Our cost of sales includes the cost of these assembly, packaging and testing services and the cost of integrated circuits. Our cost of sales accounted for approximately 40% of our net sales for each of the years ended December 31, 2004 and 2005. In general, the cost of foundry services depends on prevailing wafer costs, which in turn depends on industry capacity and the state of manufacturing process technologies as well as on the complexity of our product designs, order size, cycle time and foundry capacity utilization. We continue to undertake efforts to reduce our cost of sales by developing long-term relationships with third-party foundries and service providers to achieve better pricing, improving our product designs and deploying more advanced product and manufacturing process technologies.

Research and development expenditures

Research and development is a high priority for us. As at December 31, 2005, we had 420 design engineers, representing more than 65% of our total workforce. In 2004 and 2005, we spent 22.0% and 24.1% of our net sales in research and development expenditures, respectively. We believe that these ratios are higher than those for many of our peers in the industry. We have expanded our research and development operations in the PRC substantially over the last few years and, as at December 31, 2005, have more than 258 design engineers located in various facilities in the PRC. We intend to continue to strengthen our design capabilities in China. Higher research and development expenditures increase the cost of our operations and there can be no assurance that such expenditures will enable us to develop better products than our competitors.

Patent litigation

Patent litigation expenses relating to our legal proceedings against Monolithic Power Systems, Inc. ("MPS") and other companies in the United States and Taiwan also affect our results of operations. These expenses primarily consist of the fees of external legal counsel and consultants. We also incur patent litigation expenses defending lawsuits brought against us. As of December 31, 2005, we have deposited an amount of New Taiwan dollars equivalent to approximately US\$14.5 million with the courts in Taiwan in connection with our applications for preliminary injunctions and provisional attachments on the alleged breaches of our patents. These deposits in the form of Taiwan government bonds, certificate of deposits and cash are deposited with the Taiwan courts and are accounted for as restricted assets on our balance sheet. If we lose our lawsuits, we could forfeit some or all of these deposits and face additional penalties as well. We expect to continue to incur patent litigation expenses in future, and such expenses might fluctuate. To date, other than the deposit of court bonds, we have not made any provisions with respect to these patent litigations based on our consultation, from time to time, with our external counsels and technical experts on the probability that a contingent loss may be incurred as result of these litigations.

Seasonality

The consumer electronics and computer markets are characterized by seasonal volume increases in the latter part of the year primarily driven by increased consumer spending during the holiday season. We normally experience the highest sales volume to our customers in these markets in the third and fourth quarter of each year, when such customers increase their inventories in anticipation of increased seasonal demand. Our customers in the industrial and communications markets are to a lesser extent subject to seasonal consumer demand. As a result, our sales volume to those customers has been largely consistent from quarter-to-quarter.

CRITICAL ACCOUNTING POLICIES

Revenue recognition and accounts receivable allowances

We recognize revenue on sales to direct customers in accordance with SEC Staff Accounting Bulletin No. 104, "Revenue Recognition in Financial Statements" ("SAB 104"). SAB 104 requires that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence that an agreement exists, (2) delivery has occurred or services have been rendered, (3) the fee is fixed and determinable, and (4) collectibility is reasonably assured. Determination of criterion (4) is based on management's judgments regarding the collectibility of those fees.

For sales made through distributors, we defer recognition of such sales until the product is sold by the distributors to their end customers. Since we have limited control over these distributors' sales to third parties, we recognize revenues on these sales only when the distributors sell the products. In addition, products held by distributors are included in our inventory balance. Accounts receivable from distributors are recognized and inventory is relieved upon shipment as title to inventories generally transfers upon shipment.

We make allowances for future product returns in the current period revenue. We analyze historical returns, changes in current demand and acceptance of products when evaluating the adequacy of such allowances. Estimates may differ from actual product returns and allowances and these differences may materially affect our reported revenue and amounts ultimately collected on accounts receivable. In addition, we monitor collectability of accounts receivable primarily through review of the accounts receivable aging. When facts and circumstances indicate the collection of specific amounts or from specific customers is at risk, we assess the impact on amounts recorded for bad debts and, if necessary, will record a charge in the period such determination is made. To date, we have not experienced material write-offs of accounts receivable due to uncollectability.

Inventories

Our inventories are stated at the lower of standard cost or market value. Cost is determined on a currently adjusted standard basis, which approximates actual cost on a first-in, first-out basis. Because of the cyclicity of the market, inventory levels, obsolescence of technology and product life cycles, we write down inventories to net realizable value based on backlog, forecasted product demand and historical sales levels. Backlog is subject to revisions, cancellations and rescheduling. Actual demand and market conditions may be lower than those projected by us. This difference could have a material adverse effect on our gross margin should additional inventory write downs become necessary.

Long-lived assets

We evaluate the recoverability of property, plant and equipment in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets". We perform periodic reviews to determine whether facts and circumstances exist that would indicate that the carrying amounts of property, plant and equipment might not be fully recoverable. If facts and circumstances indicate that the carrying amount of property, plant and equipment might not be fully recoverable, we compare projected undiscounted net cash flows associated with the related assets over their estimated remaining useful life against their respective carrying amounts. In the event that the projected undiscounted cash flows are not sufficient to recover the carrying value of the assets, the assets are written down to their estimated fair values based on the expected discounted future cash flows attributable to the assets. Evaluation of impairment of property, plant and equipment requires estimates in the forecast of future operating results that are used in the preparation of the expected future undiscounted cash flows. Actual operating results and the remaining economic lives of the property, plant and equipment could differ from the estimates used in assessing the recoverability of these assets. These differences could result in additional impairment charges, which could have a material adverse effect on our results of operations.

Income taxes

Our income taxes are accounted in accordance with SFAS No. 109, "Accounting for Income Taxes". The provision for income tax represents income tax paid and payable for the current year plus the changes in the deferred income tax assets and liabilities during the years. Deferred income tax assets are primarily the tax effects of the operating loss carry-forwards, research and development credit carryforwards and temporary differences. On a periodic basis we evaluate the deferred tax assets balance for realizability. To the extent we believe it is more likely than not that some portion of deferred tax assets will not be recognized, we will increase the valuation allowance against the deferred tax assets. Realization of the deferred tax assets is dependent

primarily upon future taxable income, changes in tax laws and other factors. These changes, if any, may require possible material adjustment to the deferred tax assets, resulting in a reduction in net income in the period when such determinations are made.

Legal contingencies

We are currently involved in various claims and legal proceedings. We periodically assess each matter in order to determine if a contingent liability in accordance with SFAS No.5, "Accounting for Contingencies", should be recorded. In making the determination, we may, depending on the nature of the matter, consult with external counsel and technical experts. Based on the information obtained combined with our judgment regarding all the facts and circumstances of each matter, we determine whether it is probable that a contingent loss may be incurred and whether the amount of such loss can be estimated. Should a loss be probable and estimable, we record a contingent loss in accordance with SFAS No. 5. In determining the amount of a contingent loss, we take into consideration advice received from experts in the specific matter, current status of legal proceedings, prior case history and other factors. Should the judgments and estimates be incorrect, we may need to record additional contingent losses that could materially adversely impact our results of operations.

Stock-based compensation

We have elected to follow Accounting Principles Board Opinion ("APB") No. 25, "Accounting for Stock Issued to Employees" and comply with the disclosure provisions of SFAS No. 123, "Accounting for Stock-Based Compensation" for our employee stock options. Under APB No. 25, compensation expense is measured based on the difference, if any, on the date of the grant, between the fair value of the ordinary shares of our Company (the "Shares") and the exercise price of the stock option.

At the end of June 2005, our Board approved the acceleration of the vesting of options with exercise prices greater than US\$17.00 (pre-split basis). Our Board evaluated the minimal benefit to our employees of accelerating the remaining vesting on these significantly underwater options against the value to shareholders of not having earnings materially affected and the impact that this may have on our market value. In addition, these options had exercise prices in excess of the then current market values and were not fully achieving their original objectives of incentive compensation and employee retention. Accelerating the vesting of these options accelerated the recognition of any remaining expense associated with these options which is zero under APB No. 25.

However, had the compensation expense for these options been determined on the basis of the fair values under SFAS No. 123, we would have had to record a proforma charge of approximately US\$1.8 million as the remaining expense associated with accelerating the vesting of these options. Please refer to Note 2 of the Accountants' Report which appears on pages 45 to 50 of this annual report for further details.

Treasury stock

We cancel all shares repurchased under our share repurchase plan. Accordingly, the excess of the purchase price over par value will be allocated between additional paid-in capital and retained earnings based on the average issue price of the shares repurchased. Shares that are repurchased and cancelled are not counted as part of our issued share capital.

Patent costs

Patent costs are costs incurred in connection with securing patents, including attorney fees, and are capitalized and amortized over five years. We did not acquire any patents from third parties during the period from 2002 to 2005. For the years ended December 31, 2004 and 2005, we expensed the patent costs incurred in those periods with respect to technologies developed in-house due to the uncertainty in the future applications of the related patents.

Research and development costs

Our research and development costs consist of expenditures incurred during the course of planned research and investigation aimed at the discovery of new knowledge that will be useful in developing new products or processes, or at significantly enhancing existing products or production processes as well as expenditures incurred for the design and testing of product alternatives or the construction of prototypes. We charge all of our expenditures related to research and development activities to operating expenses when incurred.

Years ended December 31, 2004 and 2005

The following table summarizes historical results of operations as a percentage of net sales for the periods indicated:

	Year ended December 31,	
	2004	2005
	%	%
Consolidated Statement of Operations Data:		
Net sales	100.0	100.0
Cost of sales	<u>40.6</u>	<u>38.6</u>
Gross profit	59.4	61.4
Operating expenses:		
Research and development	22.0	24.1
Selling, general and administrative	17.7	19.2
Patent litigation	<u>5.8</u>	<u>9.6</u>
Total operating expenses	<u>45.5</u>	<u>52.9</u>
Income from operations	13.9	8.5
Non-operating income - net	2.9	0.2
Income tax expenses	<u>1.6</u>	<u>1.0</u>
Net income	<u><u>15.2</u></u>	<u><u>7.7</u></u>

The following table sets forth the breakdown of our net sales by product category in each of 2004 and 2005:

	Year Ended December 31,	
	2004	2005
	(US\$000)	(US\$000)
Integrated Circuits:		
Analog	55,268	87,657
Mixed-signal	9,736	6,484
Digital	27,109	11,305
Systems Security Solutions	—	45
Licensed Intellectual Property	<u>83</u>	<u>61</u>
Total	<u><u>92,196</u></u>	<u><u>105,552</u></u>

Net Sales. Net sales consisted of product revenues generated principally by sales of our integrated circuit products. Net sales for the year ended December 31, 2005 were US\$105.6 million, an increase of US\$13.4 million or 14.5% from US\$92.2 million for the year ended December 31, 2004. The increase in sales resulted from increased unit shipments to our existing customers and expansion of our customer base. In particular, the share of our net sales derived from the consumer electronics market continued to increase from 2004 to 2005. This increase resulted primarily from the increase in shipments of analog integrated circuit products to an increased number of intermediaries in the consumer electronics end-market whose end-customers use our products in their desktop monitors, LCD televisions and portable media players. Net sales from analog integrated circuit products in 2005 were US\$87.7 million, an increase of US\$32.4 million or 58.6% from US\$55.3 million in 2004. In 2005, net sales from our digital integrated circuit products were US\$11.3 million, a decrease of US\$15.8 million or 58.3% from US\$27.1 million in 2004, which resulted primarily from a change in product mix with increased focus on proprietary digital integrated circuit products for notebook computers that were less established in the market. In 2005, net sales from our mixed-signal integrated circuit products were US\$6.5 million, a decrease of US\$3.2 million or 33.4% from US\$9.7 million in 2004, which primarily resulted from a continuing shift in the notebook computer industry to the use of analog designs for such products.

Gross Profit. Gross profit represents net sales less cost of sales. Cost of sales primarily consists of the costs of purchasing packaged integrated circuit products manufactured and assembled for us by independent foundries and packaging vendors and other costs associated with the procurement, storage and shipment of these products. Gross profit for the year ended December 31, 2005 was US\$64.8 million, an increase of US\$10.0 million or 18.3% from US\$54.8 million for the year ended December 31, 2004. This increase was due to increased sales. Gross profit as a percentage of net sales for the year ended December 31, 2005 increased to 61.4% from 59.4% for the year ended December 31, 2004 due to increased sales of our higher margin products, which include all of our products other than standard CardBus controller and power switch products. Standard CardBus controller and power switch products are lower margin products because the technology used in these products has become commoditized in our industry. Our other products, which use our proprietary technologies, are more complex with enhanced features, thereby allowing us to command a higher margin on these products. We expect that our gross profit as a percentage of net sales will continue to fluctuate in the future as a result of the stages of our products in their life cycles, variations in our product mix, the timing of our product introductions and specific product manufacturing costs.

Research and Development Expenses. Research and development expenses consist primarily of salaries and related costs of employees engaged in research, design and development activities and, to a lesser extent, expenses for outside engineering consultants. Research and development expenses for the year ended December 31, 2005 were US\$25.4 million, an increase of US\$5.1 million or 25.5% from US\$20.3 million for the year ended December 31, 2004. This increase reflected the increased hiring of design engineers in the PRC resulting from our increased operations in this market and increased consultancy fees paid to outside consultants in respect of certain research and development projects. As a percentage of net sales, research and development expenses were 24.1% for the year ended December 31, 2005, an increase from 22.0% for the year ended December 31, 2004. Research and development expenses as a percentage of net sales will fluctuate from quarter to quarter depending on the amount of net sales and the success of new product development efforts, which we view as critical to our future growth. At any point in time, we have several research and development projects underway, and we believe that none of these projects is material on an individual basis. We expect to continue the development of innovative technologies and processes for new products and we believe that a continued commitment to research and development is essential in order to maintain the competitiveness of our existing products and to provide innovative new product offerings. Therefore, we expect to continue to invest significant resources in research and development in the future.

Selling, General and Administrative Expenses. Selling, general and administrative expenses consist primarily of employee-related expenses, sales commissions to agents, professional fees, travel and other promotional expenses. Selling, general and administrative expenses for the year ended December 31, 2005 were US\$20.3 million, an increase of US\$4.0 million or 24.1% from US\$16.3 million for the year ended December 31, 2004. This increase was primarily due to additional hiring of sales, operations and administrative personnel in Taiwan and the PRC, increased sales commissions relating to higher sales and increased professional fees to external auditors. As a percentage of net sales, selling, general and administrative expenses were 19.2% for the year ended December 31, 2005, an increase from 17.7% for the year ended December 31, 2004. We expect that selling, general and administrative expenses will continue to increase in absolute dollar terms in the foreseeable future for the same reasons.

Patent Litigation Expenses. Patent litigation expenses consist primarily of fees paid to outside counsel and consultants engaged by outside counsel. Patent litigation expenses for the year ended December 31, 2005 were US\$10.2 million, an increase of US\$4.9 million or 90.7% from US\$5.3 million for the year ended December 31, 2004. This increase was primarily due to trial preparation work for the MPS trial in June 2005 and increased activity in other litigation matters. As a percentage of net sales, patent litigation expenses were 9.6% for the year ended December 31, 2005, an increase from 5.8% for the year ended December 31, 2004. We expect that patent litigation expenses will continue to fluctuate for the foreseeable future.

Non-Operating Income-Net. Non-operating income-net reflects primarily interest earned on cash and cash equivalents and short-term investments, The Stock Exchange of Hong Kong Limited (the "Stock Exchange") listing expenses, foreign exchange transaction gains and losses and the gain on sales of long-term investments and cash dividend received on investment in shares of stock. Non-operating income-net was US\$244,000 for the year ended December 31, 2005, decreasing from US\$2.7 million for the year ended December 31, 2004, reflecting an accrual for Stock Exchange listing expenses of US\$2.5 million and a foreign exchange loss of US\$443,000 offset by more interest earned on our cash and cash equivalents and short term investments.

Income Tax Expenses. Income tax expenses were approximately US\$1.0 million for the year ended December 31, 2005, compared to US\$1.5 million for the year ended December 31, 2004. This decrease was primarily due to an accrual of approximately US\$658,000 for Taiwan income tax due on imported products as of December 31, 2004, which was reversed and applied as a credit on our income tax due in the year ended

December 31, 2005, and a decrease in our income before income tax as a result of an accrual for Stock Exchange listing expenses of US\$2.5 million in December 2005. The accrual and reversal related to our application on May 24, 2004 to the Taiwan Customs Authority for the rectification of the value of the imported goods reported for the period from March 2003 to March 2004. We had mistakenly reported a lower amount to the Taiwan Customs Authority than the correct amount that was reported on our tax return for the years ended December 31, 2003 and 2004. However, a rectification of the Taiwan Customs Authority's records usually cannot be made after six months have elapsed, in which case the understated cost of the imported goods reported to the customs officials would have been deemed to be the actual cost, and thus the taxable income for the years ended December 31, 2003 and 2004 would have been higher. We therefore accrued the provision for income tax of US\$658,000 based on our estimate of the most probable impact on income tax as at December 31, 2004. As we have addressed the design flaw in the customized report that was submitted to the Taiwan Customs Authority, we have confirmed that there was no need to make a similar accrual for Taiwan income tax in 2005. Adding back the Stock Exchange listing expenses of US\$2.5 million to our income before income tax and excluding the impact of the reversal of approximately US\$658,000 on our income tax expenses, our effective income tax rate for 2005 would have been 14.5%. Our effective tax rate was 11.3% for the year ended December 31, 2005, compared to 9.5% for the year ended December 31, 2004.

Net income. As a result of the above factors, our net income was US\$8.1 million for the year ended December 31, 2005, a decrease of US\$6.0 million from US\$14.1 million for the year ended December 31, 2004. Our net income as a percentage of net sales decreased to 7.7% for the year ended December 31, 2005 from 15.2% for the year ended December 31, 2004. This decrease was primarily due to an increase in our patent litigation expenses over the same period for the reasons set out above and an accrual for Stock Exchange listing expenses of US\$2.5 million in December 2005.

LIQUIDITY AND CAPITAL RESOURCES

Cash flows

Since our inception, we have financed our operations primarily through private sales of securities and through our initial public offering in August 2000 and our public offering in November 2001 as well as cash provided by operating activities in recent years. As of December 31, 2005, cash and cash equivalents and short-term investments were US\$102.0 million.

Operating activities

Our net cash from operating activities is generally the cash effects of transactions and other events used in the determination of net income, adjusted for changes in our working capital. Our net cash inflows from operating activities were US\$14.1 million and US\$11.0 million for the years ended December 31, 2004 and 2005, respectively.

The decrease between 2004 and 2005 was mainly due to an increase of US\$2.7 million in prepaid expenses and other current assets, an increase of US\$2.0 million in accounts receivable and an increase of US\$4.7 million in inventories. The increase in prepaid expenses and other current assets resulted primarily from a prepayment of approximately US\$3.0 million to a foundry provider, Asia SinoMOS Semiconductor Inc., to ensure our foundry capacity allocation with such provider. The increase in accounts receivable was mainly due to increased sales to customers on credit. The increase in inventories was mainly due to increased production in anticipation of growth in sales and longer production lead times for the manufacture of our integrated circuits by our foundry providers. The decrease in net cash from operating activities was partially offset by an increase of US\$5.6 million in accrued expenses and other current liabilities and an increase of US\$2.1 million in notes and accounts payable. The increase in accrued expenses was mainly due to an accrual for litigation expenses and an accrual for Stock Exchange listing expenses. The increase in notes and accounts payable was primarily due to increased production in anticipation of growth in sales and expenses related to certain research and development projects.

Investing activities

In 2005, we had a net cash outflow from investing activities of US\$19.3 million as compared to a net cash outflow of US\$25.2 million in 2004. This decrease in net cash used in investing activities between 2004 and 2005 was principally due to a net sale of US\$6.6 million in short-term investments in 2005 as compared to a net purchase of US\$11.0 million in 2004 and a decrease of US\$306,000 in restricted assets in 2005 as compared to an increase of US\$1.9 million in 2004. This decrease was partially offset by an increase of US\$5.8 million in the net purchase of long-term investments, an increase of US\$14.9 million in the purchase of fixed assets and an increase of US\$5.5 million in restricted cash and other assets in 2005. The increase in restricted cash and other assets was mainly due to an increase in time deposits pledged to a bank for the issuance of letters of credit to

purchase certain testing equipment and an increase in the amount of court bonds deposited with the Taiwan courts for preliminary injunctions and provisional attachments.

Financing activities

Net cash inflow from our financing activities in 2004 was US\$0.9 million, primarily due to the exercise of stock options and issuance of Shares under our 1997 Stock Plan, 1999 Stock Incentive Plan and 1999 Employee Stock Purchase Plan (the “Existing Equity Incentive Plans”), which was partially offset by the repurchase of our Shares under a share repurchase program. Net cash outflow from our financing activities in 2005 was US\$2.1 million, primarily due to the repurchase of our Shares and American depository shares under a share repurchase program, which was partially offset by proceeds from the exercise of stock options and warrants and issuance of Shares under our Existing Equity Incentive Plans.

Working capital

The Directors believe our cash balances will be sufficient to meet our capital requirements for at least the next 12 months from the date of publication of this document. Our future capital requirements will depend on many factors, including the inventory levels we maintain, the level of investments we make in new technology and improvements to existing technology, the levels of promotion and advertising required to launch new products and attain a competitive position in the marketplace, and the market acceptance of our products. Thereafter, we may need to raise additional funds through public or private financing. No assurance can be given that additional funds will be available or that we can obtain additional funds on terms favorable to us.

DIVIDEND POLICY

Dividend policy

We have never declared or paid dividends on our Shares or other securities and do not anticipate paying dividends in the foreseeable future. As our business continues to grow, we intend to continue to invest the profits generated from our operations to implement our future plans. If we declare dividends in the future, the form, frequency and amount of such dividends will depend on our earnings and financial position, our results of operations, our capital needs, our plans for expansion and other factors we deem relevant. The declaration and payment of dividends will be determined at the sole discretion of our directors, subject to the requirements of the Companies Law, Cap. 22 (Law 3 of 1961, as consolidated and revised) of the Cayman Islands.

Distributable reserves

We have been advised that “profits” as defined under common law and amounts in our share premium account are distributable reserves under Cayman Islands law. As of December 31, 2005, we had no funds reserved for distribution to our shareholders.

Contingent liabilities

As at the close of business on December 31, 2005, we did not have any material contingent liabilities.

CAPITAL EXPENDITURES

Capital expenditures are used to purchase property, plant and equipment such as land, buildings, office furniture and integrated circuit testing equipment. For the years ended December 31, 2003, 2004 and 2005, our total capital expenditures amounted to US\$1.7 million, US\$8.4 million and US\$14.9 million, respectively.

CONTRACTUAL OBLIGATIONS

The table below describes our contractual obligations as of December 31, 2005:

	Total	2006	2007	2008	2009
	(in thousands of U.S. dollars)				
Operating Lease Commitments	1,334	1,009	204	121	0
Purchase Commitments	486	486	0	0	0
Licenses, Maintenance and Support	1,020	279	247	247	247
Total	2,840	1,774	451	368	247

LONG-TERM INVESTMENTS

We have made the long-term investments described below, and may make additional investments in these or other companies in the future. Our current investment strategy is to make small strategic investments in companies involved in our supply chain for the manufacture of our products or that provide products that are used in conjunction with our products by our mutual customers. We do not intend to have significant share ownership in, or active participation in the management of, these companies in which we have made strategic investments. The purpose of our investments is to enhance our business relationships with these suppliers to ensure the adequacy of foundry capacity allocation and the quality of services provided to us.

As of December 31, 2005, our long-term investments were as follows:

<u>Investee Company</u>	<u>Type of Company</u>	<u>Date of Investment</u>	<u>Size of Investment</u>	<u>Approximate percentage of voting power (%)</u>
X-FAB ⁽¹⁾	Semiconductor Foundry	July 2002	US\$5.0 million	2.39%
360 Degree Web Ltd. ⁽²⁾⁽³⁾	Developer of intelligent security software solutions	January 2003 January 2005	US\$1.8 million US\$235,000	19.52%
GEM Services, Inc. ⁽¹⁾	Semiconductor assembly and testing service provider	August 2002	US\$500,000	1.07%
Etrend Hightech Corporation ⁽¹⁾	Semiconductor, assembly and testing service provider	December 2002 July 2003 March 2004	US\$500,000 US\$147,000 US\$313,000	11.20%
Asia SinoMOS Semiconductor Inc. ⁽¹⁾	Semiconductor foundry	January 2005	US\$5.0 million	9.69%
Silicon Genesis Corporation ⁽¹⁾	Developer of silicon products and other engineered multi-layered structures for integrated circuits	December 2000	US\$500,000	0.09%
CSMC ⁽¹⁾	Semiconductor Foundry	August 2004	US\$4.5 million	2.62%
Philip Ventures Enterprise Fund	Fund Management Company	November 2005	S\$1,000,000	10.8%

Notes:

- One of our current suppliers or service providers.*
- We sold 1,000,000 of our shares in 360 Degree Web Ltd. in March 2004 and recognized a gain of US\$340,000. As of December 31, 2005, we held an aggregate of 2,264,102 shares of preferred stock in such company.*
- 360 Degree Web Ltd. sells certain software to several of our customers which is used in connection with our products.*

As at the date of this annual report, we held less than 20% of the shareholding interest in each of our long-term investments.

QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

We are, in the normal course of business, exposed to risks relating to fluctuations in interest rates and exchange rates, as well as credit risks and commodity price risks. Our risk management strategy aims to minimize the adverse effects of these risks on our financial performance.

Foreign currency risk

Fluctuations in exchange rates may adversely affect our financial results. The functional currency for each of our foreign subsidiaries is the local currency. As a result, certain of our assets and liabilities, including certain bank accounts, accounts receivable, restricted assets, short-term investments and accounts payable exist in non-US dollar-denominated currencies, which are sensitive to foreign currency exchange rate fluctuations. As of December 31, 2005, we held approximately US\$35.4 million in government bonds, certificates of deposits and bank accounts denominated in foreign currencies.

We have not engaged in hedging activities to mitigate our foreign currency exposures and may experience economic losses as a result of foreign currency exchange rate fluctuations. We monitor currency exchange fluctuations periodically. For the years ended December 31, 2004 and 2005, we experienced a foreign exchange gain of approximately US\$648,000 and a foreign exchange loss of approximately US\$443,000, respectively, due to foreign currency exchange fluctuations, which are reflected in our results of operations.

Inflation risk

We are exposed to fluctuations in the prices of our raw materials, which we purchase at market prices. In addition, all of our product sales are made at market prices. Therefore, fluctuation in the prices of raw materials, which constitute primarily packaged integrated circuit products, has a significant effect on our results of operations. To date, we have not entered into any futures contracts to hedge against commodity price changes.