

## **CORPORATE GOVERNANCE REPORT**

We are committed to a high standard of business ethics and conduct. It is our policy to conduct our affairs in accordance with applicable laws, rules and regulations of the jurisdictions in which we do business. To this end, we have established a Code of Business Conduct and Ethics which provides employees, officers and non-employee directors with guidelines covering a wide range of business practices and procedures. A copy of our Code of Business Conduct and Ethics can be found on our website at [www.o2micro.com](http://www.o2micro.com).

This report sets out information in respect of our compliance with the Code on Corporate Governance Practice (the "Code") contained in Appendix 14 and the Code of Conduct for securities transactions by the Directors (the "Model Code") contained in Appendix 10 of the Listing Rules since the date of our listing on the Stock Exchange on March 2, 2006.

### **CODE OF CORPORATE GOVERNANCE PRACTICES CONTAINED IN APPENDIX 14 TO THE LISTING RULES**

#### **The Board**

Our Company is headed by a Board of eight Directors, five of whom are independent non-executive Directors. Information on their backgrounds and experiences has been set out on pages 19 to 20 of this annual report.

The Board is responsible for establishing broad corporate policies and for overseeing our overall performance. The Board reviews significant developments affecting us and acts on matters requiring its approval. The other responsibilities of the Board include the following:

- (i) formulating and approving our overall business strategies, objectives, business plans, policies and investment proposals as well as monitoring and supervising management's performance; and
- (ii) monitoring the execution of our strategies and overseeing our operating and financial performance.

The Board is supported by two committees, the audit and compensation committees. Each committee has its own responsibilities, powers and functions. The chairmen of the respective committees report to the Board regularly and make recommendations on matters discussed when appropriate.

The Board of Directors held 7 meetings in 2005, of which Mr. Du attended 7 meetings; Mr. Kuo attended 7 meetings; Mr. Keim attended 7 meetings; Mr. Austin attended 7 meetings; Mr. Goh attended 7 meetings; Mr. Lin attended 7 meetings; Mr. Yawata attended 7 meetings and Mr. Yan, who has been a Director since July 2005, attended 4 meetings, which constituted all of the meetings after July 2005. The audit committee held five meetings in 2005, of which the members, Messrs. Goh, Lin and Yawata, attended all five meetings. The compensation committee held one meeting in 2005, which both members, Messrs. Austin and Lin, attended.

#### **Chairman and Chief Executive Officer**

Sterling Du has been serving as the Chairman of the Board and as our chief executive officer since March 1997. After considering the relevant principle of Code Provision A.2.1 of the Code and examining our management structure, the Board is of the opinion that Board decisions are collective decisions of all Directors made by way of voting and not decisions of the Chairman of the Board alone. Throughout the year under review, each Board meeting was attended by not less than two-thirds of the Directors. Further, there is a clear division of the responsibilities between the management of the Board and the day-to-day management of our business, which relies on the support of the senior management. As such, the management power of our Company is not concentrated in any one individual.

In addition, as five of the eight members of the Board are non-executive Directors, the role of the Chairman of the Board, who is also the chief executive officer, is important as he can maintain a close communication channel between the Board and the day-to-day management.

## **Board composition**

The Board currently comprises eight Directors, of whom three are executive Directors and five are independent non-executive Directors, representing more than one-third of the Board. Each member of the Board has different professional abilities and backgrounds and is well-experienced in their respective fields. There are no financial, business, family or other material relationships among our Board members.

We post the latest list of directors and biographical information on each director on our website at [www.o2micro.com](http://www.o2micro.com).

## **Appointments, re-election and removal**

The Board has established procedures addressing the nominating process, identification and evaluation of candidates for Directors and for the appointment of new Directors. The independent non-executive Directors perform the functions of a nominating committee to suggest and screen candidates for the position of Director. In considering candidates for Director, the independent non-executive Directors will review individuals from various disciplines and backgrounds. Qualifications to be considered include broad experience in business, finance or administration; familiarity with national or international business matters; familiarity with our industry or prominence and reputation.

In accordance with our Articles of Association, we have divided our Board into three classes, designated Class I, Class II and Class III, with each class consisting of an equal number of Directors or as nearly equal in number as the then total number of Directors permits. The Directors of each class have been elected for terms of three years ending in consecutive years. At each annual general meeting, successors to the class of Directors whose terms expire at that annual general meeting shall be elected for new three year terms.

Our Articles of Association allow or shareholders, by special resolution, to remove any director before the expiration of his or her term of office notwithstanding anything in the Articles or in any agreement with the directors (but without prejudice to any claim for damages under any such agreement). Further, our directors have the power at any time to appoint any person to become a director, either to fill a vacancy or as an addition to the existing directors, except that the total number of directors may not exceed the number fixed in accordance with our Articles. We have currently set the number of directors at not less than five or more than nine persons, but a majority of our shareholders may, by ordinary resolution, increase or reduce the limits on the number of directors.

## **Responsibilities of Directors**

Each Director received a comprehensive training session on the requirements of the Code prior to our listing on the Stock Exchange on March 2, 2006, and will receive subsequently such briefing and professional development as necessary to ensure that he has a proper understanding of our operations and business and that he is fully aware of his responsibilities under statute and common law, the Listing Rules, applicable legal requirements and other regulatory requirements and our business and governance policies. Following our listing on the Stock Exchange on March 2, 2006, the Directors will comply with their obligations under the Model Code.

## **Supply of and access to information**

In respect of regular board meetings, and so far as practicable in all other cases, our policy prior to listing on the Stock Exchange on March 2, 2006 was to provide at least four days notice prior to a meeting. Following our listing on the Stock Exchange on March 2, 2006, in respect of regular board meetings, our policy is to provide at least fourteen days notice prior to such a meeting and to provide at least four days notice for other meetings. As far as practicable, an agenda and accompanying board papers are delivered in full to all directors at least three days before the intended date of a board meeting.

We supply the Board and its committees with adequate information in a timely manner to enable it to make informed decisions.

## **Remuneration of Directors and Senior Management**

### ***The level and make-up of remuneration and disclosure***

We have established a compensation committee, comprising Lawrence Lai-Fu Lin and Michael Austin. The Chairman of the compensation committee is Lawrence Lai-Fu Lin.

The responsibilities of the compensation committee include, among other things:

- (i) annually reviewing and approving our goals and objectives relating to, and evaluating the performance of and determining and approving the compensation to be paid to the chief executive officer including long-term incentive compensation;
- (ii) annually reviewing and making recommendation to the Board with respect to compensation for executive officers other than the chief executive officer;
- (iii) administering and periodically reviewing and making recommendations to the Board regarding the long-term incentive compensation or equity plans made available to the employees and consultants; and
- (iv) reviewing and making recommendations to the Board regarding executive compensation philosophy (including determining the compensation of our executive officers), strategy and principles and reviewing new and existing employment, consulting, retirement and severance agreements proposed for our executive officers in view of our corporate performance and goals.

The compensation committee takes several factors into consideration when deciding on the compensation of our executive officers. Such factors include (a) the market median relative to a group of peer companies, (b) the performance of our Company, and (c) the work done by each executive officer.

Prior to our listing on the Stock Exchange, the compensation committee held one meeting in 2005 at which it determined the executive Directors' entire compensation package, approved the independent non-executive directors' board fees, committee fees and retainers as well as a cash bonus plan for executive officers. The compensation committee also approved an amended and restated charter for the committee in 2005. Going forward, the compensation committee will meet at least twice a year.

## **Accountability and Audit**

### ***Financial Reporting***

In accordance with the U.S. Sarbanes-Oxley Act of 2002 and the requirements of the Nasdaq National Market, in fulfilling its oversight responsibilities, the audit committee of the Board of Directors is responsible for overseeing the preparation of financial statements of each financial period, while our management has the primary responsibility for our financial statements and the reporting process, including the system of internal controls.

### ***Internal controls***

We have implemented a system of internal controls to provide reasonable assurance that our assets are safeguarded, proper accounting records are maintained, appropriate legislation and regulations are complied with, reliable financial information is provided for management and publication purposes and that investment and business risks affecting us are identified and managed.

Pursuant to Section 404 of the U.S. Sarbanes-Oxley Act of 2002, beginning with our Annual Report on Form 20-F for the fiscal year ending December 31, 2006, we will be required to furnish a report by our management on our internal control over financial reporting. Such a report will contain, among other matters, an assessment of the effectiveness of our internal control over financial reporting as of the end of our fiscal year, including a statement as to whether or not our internal control over financial reporting is effective. This assessment must include disclosure of any material weaknesses in our internal control over financial reporting

identified by management. Such report must also contain a statement that our auditors have issued an attestation report on management's assessment of such internal controls. In addition, to achieve compliance with Section 404 of the Sarbanes-Oxley Act, we have engaged in a process to document and evaluate our internal controls over financial reporting. We are still performing the system and process documentation and evaluation needed to comply with Section 404, which is both costly and challenging.

In connection with the audit of our financial statements for the three years ended December 31, 2004, in May 2005 our independent registered public accounting firm reported to our audit committee a matter that was a "reportable condition" in our internal controls as defined in standards established by the American Institute of Certified Public Accountants. In general, reportable conditions are significant deficiencies in our internal controls that, in our auditor's judgment, could adversely affect our ability to record, process and report financial data consistent with the assertions of management in the financial statements. The "reportable condition" was our determination that certain volatility assumptions used to compute the fair value of employee stock compensation for pro forma financial disclosure in the footnotes to our financial statements for 2001, 2002 and 2003 were inappropriate. Accordingly, in consultation with the audit committee and our independent accountants, we restated these pro forma amounts in an amended Form 20-F that was filed with the US Securities and Exchange Commission for the fiscal year ended December 31, 2003. This change did not impact our consolidated financial position, results of operations, or cash flows for any of the periods presented.

In 2005, we devoted significant resources to improve our internal controls, including appointing Grant Thornton LLP as a consultant to help review our existing stock option plans and employee stock purchase plan. In addition, in order to enhance our accounting personnel resources and technical accounting expertise, we appointed PricewaterhouseCoopers in Taipei to provide quarterly training sessions for our internal accountants with regard to the U.S. GAAP and SEC reporting requirements and International Financial Reporting Standards. We are also actively seeking to recruit personnel with specific experience in handling U.S. reporting issues.

#### **Audit Committee**

We have established an audit committee, comprising Keisuke Yawata, Geok Ling Goh and Lawrence Lai-Fu Lin. The Chairman of the audit committee is Keisuke Yawata.

The audit committee of the Board of Directors is responsible for overseeing the preparation of financial statements of each financial period, while our management has the primary responsibility for our financial statements and the reporting process, including the system of internal controls.

The other responsibilities of the audit committee include, among other things:

- (i) appointing, evaluating, compensating and overseeing the work of our independent auditor, including reviewing the experience, qualifications and performance of the senior members of the independent audit team and pre-approving all non-audit services to be provided by the independent auditor;
- (ii) reviewing the annual and interim financial statements, earnings releases, critical accounting policies and practices used to prepare financial statements, alternative treatments of financial information and other material written communications between the independent auditors and management, and any deficiency in, or suggested improvement to, the procedures or practices employed by us as reported by the independent auditors in their annual management letter;
- (iii) reviewing and overseeing the independence of the independent auditors, including a review of management consulting services and related fees, and obtaining a formal statement delineating all relationships between us and the independent auditors;
- (iv) providing oversight and review of our asset management policies;
- (v) reviewing any significant changes required in the independent auditors' audit plan or auditing and accounting principles; any difficulties during the course of the audit, the effect or potential effect of any regulatory regime, accounting initiatives or off-balance sheet structures on our financial statements; and any other matters related to the conduct of the audit;

- (vi) reviewing the planning and staffing of internal audits, the organization, responsibilities, plans, results, budget and staffing of our internal audit team and the quality and effectiveness of our internal controls;
- (vii) establishing procedures for the treatment of complaints received by us regarding accounting, internal accounting controls or auditing matters, potential violations of law and questionable accounting or auditing matters; and
- (viii) overseeing compliance with the requirements of the US Securities and Exchange Commission, the rules and regulations of the Nasdaq for disclosure of independent auditor's services and audit committee members and activities and with other specified laws and regulations.

Management has the primary responsibility for the financial statements and the reporting process, including the systems of internal controls. In fulfilling its oversight responsibilities, the audit committee reviewed the audited financial statements for the year ended December 31, 2005 with management, including a discussion of the quality, not just the acceptability, of the accounting principles, the reasonableness of significant judgments, and the clarity of disclosures in the financial statements.

The audit committee held five meetings in 2005 at which it, among other things, reviewed with the independent auditors, who are responsible for expressing an opinion on the conformity of those audited financial statements with generally accepted accounting principles in the United States, their judgments as to the quality, not just the acceptability, of our accounting principles and such other matters as are required to be discussed with the audit committee under general accepted auditing standards. In addition, the audit committee has discussed with the independent auditors' independence from management and our Company.

During 2005, the fees paid to our external auditors amounted to HK\$6,950,000, of which HK\$4,443,000 related to non-audit related service.

## **Delegation by the Board**

### ***Management functions***

The Board is responsible for formulating and approving our business strategies, objectives, policies and plans. It is also responsible for monitoring the execution of our strategies and overseeing our operating and financial performance.

The Board has delegated to Sterling Du the power to make and sign all agreements and contracts which he may consider necessary or expedient, provided that he cannot without the consent of a committee of the Board, as described below, or the full Board, commit us to a transaction which will or may require us to expend a sum or sums, or incur liabilities exceeding US\$1 million (whether as one sum or in aggregate as part of a series of connected or related transactions).

The Board has delegated to a committee of the Board, which must consist of three board members, one of whom must be Sterling Du and one of whom must be an independent director, the power, authority and discretions of the Board with respect to (a) matters which do not involve us incurring expenditure or liabilities of more than US \$5 million (whether as one sum or in aggregate as part of a series of connected or related transactions); or (b) matters which would otherwise require a resolution of the Board to be properly authorized but owing to the nature of such matters or circumstances (including but not limited to time sensitivity, the possibility of lost opportunity and the preservation of or risk of harm to our business or operations) cannot be delayed so as to be considered by the Board (the question whether a matter or circumstance is such that it may be considered by the Committee being determined by the Committee in its absolute discretion).

### ***Board Committees***

The Board has prescribed sufficiently clear terms of reference for the audit committee and compensation committee. Each of the audit committee and the compensation committee have adopted charters that describe their purpose, policies, membership, authority and responsibilities. The committees report back to the Board on their decisions or recommendations to the extent required by legal or regulatory requirements.

## **Communication with Shareholders**

### ***Effective Communication***

We and the Board highly value the opinions of our shareholders. We communicate with our shareholders through various channels, including publication of financial results, earnings estimates, press releases and announcements of our latest developments on our corporate website.

The annual general meeting also provides an opportunity for shareholders to exchange views with the Board members.

### ***Voting by poll***

The right of shareholders to demand a poll and voting by poll at a general meeting of shareholders is described in the proxy statement for our annual general meeting of shareholders, which will be dispatched to our shareholders.

**O<sub>2</sub>Micro International Limited and  
Subsidiaries**

**Consolidated Financial Statements as of  
December 31, 2004 and 2005 and  
Report of Independent Registered Public  
Accounting Firm**