O_2Micro International Limited and Subsidiaries

Consolidated Financial Statements as of December 31, 2005 and 2006 and Report of Independent Registered Public Accounting Firm

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and the Shareholders of O_2Micro International Limited:

We have audited the accompanying consolidated balance sheet of O_2Micro International Limited and subsidiaries (the "Company") as of December 31, 2005 and 2006 and the related consolidated statements of operations and comprehensive income, shareholders' equity, and cash flows for the year ended December 31, 2004, 2005 and 2006 (expressed in United States dollars). These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of O_2Micro International Limited and subsidiaries as of December 31, 2005 and 2006, and the results of their operations and their cash flows for the years ended December 31, 2004, 2005 and 2006, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 2 to the consolidated financial statements, the Company changed its method of accounting for stock-based compensation in accordance with Statement of Financial Accounting Standards No. 123(R), "Share-Based Payment" and recorded the effect of a change an accounting principle.

Deloitte Touche Tohmatsu
Certified Public Accountants
Hong Kong

April 19, 2007

O_2MICRO INTERNATIONAL LIMITED AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS
(In Thousand US Dollars, Except Per Share Amounts)

	December 31	
ASSETS	**2005**	**2006**
CURRENT ASSETS		
Cash and cash equivalents (note 3)	$ 46,375	$ 45,438
Restricted cash	5,605	8,342
Short-term investments (note 4)	55,653	19,697
Accounts receivable, net (note 5)	11,460	18,987
Inventories (note 6)	15,943	14,076
Prepaid expenses and other current assets (note 7)	6,665	7,379
Total current assets	141,701	113,919
LONG-TERM INVESTMENTS (note 8)	16,898	24,059
PROPERTY AND EQUIPMENT, NET (note 9)	23,319	41,427
RESTRICTED ASSETS	14,492	14,540
OTHER ASSETS (note 10)	3,245	3,075
TOTAL	$ 199,655	$ 197,020
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES		
Notes and accounts payable (note 11)	$ 5,760	$ 9,851
Income tax payable	3,907	991
Accrued expenses and other current liabilities (note 12)	14,092	12,212
Total current liabilities	23,759	23,054
ACCRUED RETIREMENT BENEFIT COSTS	-	455
Total liabilities	23,759	23,509
COMMITMENTS AND CONTINGENCIES		
SHAREHOLDERS' EQUITY		
Preference shares at $0.00002 par value per share; Authorized - 250,000,000 shares;	-	-
Ordinary shares at $0.00002 par value per share; Authorized - 4,750,000,000 shares; Issued - 1,967,824,350 shares and 1,906,969,950 shares as of December 31, 2005 and 2006, respectively	39	38
Treasury stock - 15,030,000 shares and nil as of December 31, 2005 and 2006, respectively	(3,296)	-
Additional paid-in capital	141,532	140,224
Retained earnings	38,739	33,877
Accumulated other comprehensive loss	(1,118)	(628)
Total shareholders' equity	175,896	173,511
TOTAL	$ 199,655	$ 197,020

The accompanying notes are an integral part of the consolidated financial statements.

O_2MICRO INTERNATIONAL LIMITED AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME
(In Thousand US Dollars, Except Per Share Amounts)

	Years Ended December 31		
	2004	**2005**	**2006**
NET SALES	$ 92,196	$ 105,552	$ 124,915
COST OF SALES	37,403	40,741	56,772
GROSS PROFIT	54,793	64,811	68,143
OPERATING EXPENSES			
Research and development (a)	20,260	25,421	31,751
Selling, general and administrative (a)	16,348	20,279	29,209
Patent related litigation	5,334	10,174	10,962
Stock Exchange of Hong Kong listing expenses	-	2,460	786
Total operating expenses	41,942	58,334	72,708
INCOME (LOSS) FROM OPERATIONS	12,851	6,477	(4,565)
NON-OPERATING INCOME (EXPENSES)			
Interest income	1,455	2,824	3,627
Impairment loss on long-term investments	-	-	(756)
Gain on sale of long-term investments	340	-	-
Foreign exchange gain (loss), net	648	(443)	(261)
Other, net	262	323	248
Total non-operating income	2,705	2,704	2,858
INCOME (LOSS) BEFORE INCOME TAX (note 13)	15,556	9,181	(1,707)
INCOME TAX EXPENSE (BENEFIT) (note 13)	1,472	1,034	(2,450)
NET INCOME (note 14)	14,084	8,147	743
OTHER COMPREHENSIVE INCOME (LOSS)			
Foreign currency translation adjustments	714	(238)	695
Unrealized loss on available-for-sale Securities	(303)	(770)	(205)
Total other comprehensive income (loss)	411	(1,008)	490
COMPREHENSIVE INCOME	$ 14,495	$ 7,139	$ 1,233
EARNINGS PER SHARE:			
Basic	$ 0.0072	$ 0.0042	$ 0.0004
Diluted	$ 0.0070	$ 0.0041	$ 0.0004

(Continued)

	Years Ended December 31		
	2004	**2005**	**2006**
SHARES USED IN EARNINGS PER SHARE CALCULATION:			
Basic (in thousands)	1,957,800	1,961,168	1,932,575
Diluted (in thousands)	2,005,100	1,997,459	1,946,896

(a) INCLUDES STOCK-BASED COMPENSATION CHARGE AS FOLLOWS:			
Research and development	$ -	$ -	$ 1,181
Selling, general and administrative	$ -	$ -	$ 1,408

The accompanying notes are an integral part of the consolidated financial statements.

O_2MICRO INTERNATIONAL LIMITED AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
(In Thousand US Dollars, Except Per Share Amounts)

	Ordinary Shares		Additional Paid-in Capital			Treasury Stock	Accumulated Other Comprehensive Income (Loss)			Retained Earnings	Total Shareholders' Equity
	Shares	Amount	Ordinary Shares	Stock Options	Total		Unrealized Investment Gain (Loss)	Cumulative Translation Adjustment	Total		
BALANCE, JANUARY 1, 2004	1,951,630,800	$ 39	$ 136,077	$ 999	$ 137,076	$ -	$ 149	$ (670)	$ (521)	$18,133	154,727
Issuance of:											
Shares issued for exercise of stock options	7,858,350	-	1,359	(77)	1,282	-	-	-	-	-	1,282
Shares issued for 1999 Purchase Plan	5,923,950	-	1,032	-	1,032	-	-	-	-	-	1,032
Acquisition and retirement of treasury stock	(6,010,000)	-	(422)	-	(422)	-	-	-	-	(946)	(1,368)
Options granted to nonemployees	-	-	-	613	613	-	-	-	-	-	613
Net income for 2004	-	-	-	-	-	-	-	-	-	14,084	14,084
Foreign currency translation adjustments	-	-	-	-	-	-	-	714	714	-	714
Unrealized loss on available-for-sale securities	-	-	-	-	-	-	(303)	-	(303)	-	(303)
BALANCE, DECEMBER 31, 2004	1,959,403,100	39	138,046	1,535	139,581	-	(154)	44	(110)	31,271	170,781
Issuance of:											
Shares issued for exercise of stock options	7,422,050	-	1,203	(18)	1,185	-	-	-	-	-	1,185
Shares issued for 1999 Purchase Plan	6,389,200	-	1,110	-	1,110	-	-	-	-	-	1,110
Acquisition of treasury stock - 20,420,000 shares	-	-	-	-	-	(4,355)	-	-	-	-	(4,355)
Retirement of treasury stock	(5,390,000)	-	(380)	-	(380)	1,059	-	-	-	(679)	-
Options granted to nonemployees	-	-	-	36	36	-	-	-	-	-	36
Net income for 2005	-	-	-	-	-	-	-	-	-	8,147	8,147
Foreign currency translation adjustments	-	-	-	-	-	-	-	(238)	(238)	-	(238)
Unrealized loss on available-for-sale securities	-	-	-	-	-	-	(770)	-	(770)	-	(770)
BALANCE, DECEMBER 31, 2005	1,967,824,350	39	139,979	1,553	141,532	(3,296)	(924)	(194)	(1,118)	38,739	175,896
Issuance of:											
Shares issued for exercise of stock options	5,643,000	-	396	(42)	354	-	-	-	-	-	354
Shares issued for 1999 Purchase Plan	6,980,050	-	985	-	985	-	-	-	-	-	985
Acquisition of treasury stock - 58,447,450 shares	-	-	-	-	-	(7,550)	-	-	-	-	(7,550)
Retirement of treasury stock	(73,477,450)	(1)	(5,240)	-	(5,240)	10,846	-	-	-	(5,605)	-
Options granted to nonemployees	-	-	-	4	4	-	-	-	-	-	4
Stock-based compensation	-	-	-	2,589	2,589	-	-	-	-	-	2,589
Net income for 2006	-	-	-	-	-	-	-	-	-	743	743
Foreign currency translation adjustments	-	-	-	-	-	-	-	695	695	-	695
Unrealized loss on available-for-sale securities	-	-	-	-	-	-	(205)	-	(205)	-	(205)
BALANCE, DECEMBER 31, 2006	1,906,969,950	$ 38	$ 136,120	$ 4,104	$ 140,224	$ -	$(1,129)	$ 501	$ (628)	$ 33,877	$ 173,511

The accompanying notes are an integral part of the consolidated financial statements.

O2MICRO INTERNATIONAL LIMITED AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS
(In Thousand US Dollars)

	Years Ended December 31		
	2004	**2005**	**2006**
OPERATING ACTIVITIES			
Net income	$ 14,084	$ 8,147	$ 743
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	2,692	3,684	4,947
Amortization of stock options granted for services	386	264	239
Stock-based compensation	-	-	2,589
Gain on sale of long-term investments	(340)	-	-
Gain on sale of short-term investments	-	(10)	(24)
Deferred income taxes	(68)	527	(845)
Impairment loss on long-term investments	-	-	756
Loss on sale/disposal of property and equipment	3	18	76
Reversal of income tax payable	(375)	(658)	(2,513)
Changes in operating assets and liabilities:			
Accounts receivable, net	363	(2,029)	(7,527)
Inventories	(1,618)	(4,712)	1,867
Prepaid expenses and other current assets	(1,278)	(2,721)	(819)
Notes and accounts payable	(2,699)	2,125	4,091
Income tax payable	1,274	814	(403)
Accrued expenses and other current liabilities	1,705	5,570	11
Accrued retirement benefit costs	-	-	90
Net cash provided by operating activities	14,129	11,019	3,278
INVESTING ACTIVITIES			
Receivables from employees	116	-	402
Acquisition of:			
Property and equipment	(8,354)	(14,870)	(23,367)
Long-term investments	(4,861)	(5,819)	(8,073)
Short-term investments	(166,045)	(151,562)	(98,755)
(Increase) decrease in:			
Restricted assets	(1,945)	306	383
Restricted cash	5	(3,718)	(2,699)
Other assets	(187)	(1,750)	(496)
Proceeds from:			
Sale of short-term investments	155,021	158,132	134,297
Sale of long-term investments	1,020	-	-
Sale of property and equipment	2	-	4
Net cash (used in) provided by investing activities	(25,228)	(19,281)	1,696
FINANCING ACTIVITIES			
Acquisition of treasury stock	(1,368)	(4,355)	(7,550)
Proceeds from:			
Exercise of stock options	1,282	1,185	354
Issuance of ordinary shares under 1999 Purchase Plan	1,032	1,110	985
Net cash provided by (used in) financing activities	946	(2,060)	(6,211)

(Continued)

	Years Ended December 31		
	2004	2005	2006
EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATE	$ (16)	$ 377	$ 300
NET DECREASE IN CASH AND CASH EQUIVALENTS	(10,169)	(9,945)	(937)
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	66,489	56,320	46,375
CASH AND CASH EQUIVALENTS AT END OF YEAR	$ 56,320	$ 46,375	$ 45,438
SUPPLEMENTAL DISCLOSURES OF CASH FLOWS			
Cash paid for interest	$ -	$ -	$ -
Cash paid for tax	$ 641	$ 292	$ 1,311
NON-CASH INVESTING AND FINANCING ACTIVITIES			
Increase in payable for acquisition of equipment	$ -	$ 1,183	$ -
Short-term investments reclassified to restricted assets	$ 1,144	$ 1,430	$ 307

The accompanying notes are an integral part of the consolidated financial statements.

O$_2$MICRO INTERNATIONAL LIMITED AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Expressed in United States Dollars Unless Otherwise Noted)

1. GENERAL

Business

O$_2$Micro, Inc. was incorporated in the state of California in the United States of America on March 29, 1995 to design, develop, and deliver semiconductor components primarily for mobile applications. In March 1997, O$_2$Micro International Limited (the “Company”) was formed in the Cayman Islands and all authorized and outstanding common stock, preferred stock and stock options of O$_2$Micro, Inc. were exchanged for the Company’s ordinary shares, preference shares and stock options with identical rights and preferences. O$_2$Micro, Inc. became the Company’s subsidiary after the share exchange.

The Company has incorporated various wholly-owned subsidiaries, including (among others) O$_2$Micro Electronics, Inc. (“O$_2$Micro-Taiwan”), O$_2$Micro International Japan Ltd. (“O$_2$Micro-Japan”), O$_2$Micro Pte Limited-Singapore (“O$_2$Micro-Singapore”) and O$_2$Micro (China) Co., Ltd (“O$_2$Micro-China”). O$_2$Micro-Taiwan is engaged in operations. O$_2$Micro-Japan is engaged in trading. O$_2$Micro-Singapore, O$_2$Micro-China and other subsidiaries are mostly engaged in research and development. To assure the testing capacity and flexibility, the Company also established a subsidiary, OceanOne Semiconductor (Ningbo) Limited (“OceanOne”) in NingBo of the People’s Republic of China (the “PRC”) in August 2005. OceanOne is engaged in semiconductor testing service and was still in its development stage as of December 31, 2006. The Company also established a Taiwanese branch office, O$_2$Micro International Limited-Taiwan Branch (“O$_2$Micro-Taiwan Branch”) to engage in marketing and customer support related services. Due to the duplicated functions between O$_2$Micro-Taiwan Branch and O$_2$Micro-Taiwan, the Board of Directors (“Board”) determined to dissolve O$_2$Micro-Taiwan Branch on October 31, 2002. The dissolution process of O$_2$Micro-Taiwan Branch was not completed as of December 31, 2006.

At the extraordinary general meeting of shareholders of the Company held on November 14, 2005, the shareholders approved a public global offering of the Company’s Ordinary Shares and the proposed listing of the Company's Ordinary Shares on the Main Board of The Stock Exchange of Hong Kong Limited (“SEHK”) and various matters related to the proposed listing and offering, including the adoption of an Amended and Restated Memorandum and Articles of Association, the 2005 Share Incentive Plan (“2005 SIP”) and the 2005 Share Option Plan (“2005 SOP”), general issue and repurchase mandates which would authorize the Company for a period of time to issue or purchase a limited number of shares in accordance with the Listing Rules of HKSE, and a 50-for-1 share split and the implementation of an American depositary share (“ADS”) program with respect to the Company’s Ordinary Shares quoted on The Nasdaq National Market (“Nasdaq”). Following approval of these matters, the Company effected the cessation of trading of its Ordinary Shares on Nasdaq and share split of Ordinary Shares on November 25, 2005, and the commencement of trading of ADSs on Nasdaq on November 28, 2005. All share and per share data have been retroactively restated in the accompanying consolidated financial statements and notes to the consolidated financial statements for all periods presented to reflect the share split.

On December 30, 2005, the Board determined to file with the SEHK for listing by way of introduction without issuing new shares instead of a global offering after taking market conditions and other factors into consideration.

The adoption of the Amended and Restated Memorandum and Articles of Association, the 2005 SIP and the 2005 SOP, general issue and repurchase mandates have become effective upon the listing of the Ordinary Shares on SEHK on March 2, 2006.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America. The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All intercompany accounts and transactions have been eliminated on consolidation.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect certain reported amounts and disclosures. Accordingly, actual results could differ from those estimates.

Concentration of Credit Risk

Financial instruments that potentially subject the Company to a concentration of credit risk consist of cash, cash equivalents, short-term investments and accounts receivable. Cash is deposited with high credit quality financial institutions. For cash equivalents and short-term investments, the Company invests in debt securities with credit rating of A and better. For accounts receivable, the Company performs ongoing credit evaluations of its customers' financial condition and the Company maintains an allowance for doubtful accounts receivable based upon a review of the expected collectibility of individual accounts.

Fair Value of Financial Instruments

The Company's financial instruments, including cash and cash equivalents, restricted cash, accounts receivable, and notes and accounts payable are carried at cost, which approximates the fair value due to the short-term maturity of those instruments. Fair values of available-for-sale investments including short-term investments and long-term investments represent quoted market prices. Long-term investments in private company equity securities are accounted for under the cost method because the Company does not exercise significant influence over the entities. The Company evaluates related information including operating performance, subsequent rounds of financings, advanced product development and related business plan in determining the fair value of these investments and whether an other-than-temporary decline in value exists. Fair value of restricted assets, which are composed of government bonds, negotiable certificates of deposit and cash, is estimated based on the combination of fair value of each component.

Cash and Cash Equivalents

The Company considers all highly liquid investments with maturities of not more than three months when purchased to be cash equivalents. Time deposits with maturities of more than three months, the Company classifies them as short-term investments.

Restricted Assets

The Company classifies deposits made for customs, collateral for obtaining foundry capacity, cash pledged to a bank for the issuance of letters of credit as restricted cash. The deposits are classified as current assets if refundable within a twelve-month period from the balance sheet date. Restricted assets consist of deposits made for Taiwan court cases in the form of Taiwan Government bonds, negotiable certificates of deposit and cash. Restricted assets can be released only upon the resolution of the related litigation.

Short-term Investments

The Company maintains its excess cash in US treasury bills, government and corporate bonds issued with high ratings. The specific identification method is used to determine the cost of securities sold, with realized gains and losses reflected in non-operating income and expenses. As of December 31, 2006, all of the above-mentioned investments were classified as available-for-sale securities and were recorded at market value. Unrealized gains and losses on these investments are included in accumulated other comprehensive income and loss as a separate component of shareholders' equity, net of any related tax effect, unless unrealized losses are deemed other-than-temporary. Unrealized losses are recorded as a charge to income when deemed other-than-temporary.

Inventories

The Company outsources the wafer fabrication, assembly, and testing of its products. 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.

Long-term Investments

Long-term investments in private companies over which the Company does not exercise significant influence are accounted for under the cost method of accounting. Management evaluates related information in addition to quoted market prices, if any, in determining the fair value of these investments and whether an other-than-temporary decline in value exists. Factors indicative of an other-than- temporary decline include recurring operating losses, credit defaults and subsequent rounds of financings at an amount below the cost basis of the investment. The list is not all-inclusive and management periodically weighs all quantitative and qualitative factors in determining if any impairment loss exists.

Long-term investments in listed companies are classified as available-for-sales securities and are recorded at market value. Unrealized gains and losses on these investments are included in accumulated other comprehensive income and loss as a separate component of shareholders' equity, net of any related tax effect, unless unrealized losses are deemed other-than-temporary. Unrealized losses are recorded as a charge to income when deemed other-than-temporary.

Property and Equipment

Property and equipment are stated at cost less accumulated depreciation. Major additions, renewals and betterments are capitalized, while maintenance and repairs are expensed as incurred.

Depreciation is provided on the straight-line method over estimated service lives that range as follows: buildings - 35 to 49.7 years, equipment - 3 to 10 years, furniture and fixtures - 3 to 15 years, leasehold improvements - the shorter of the estimated useful life or the lease term, which is 2 to 6 years, and transportation equipment - 5 years.

Long-lived Asset Impairment

The Company evaluates the recoverability of long-lived assets whenever events or changes in circumstances indicate the carrying value may not be recoverable. The carrying value of a long-lived asset is considered impaired when the anticipated undiscounted cash flows from the asset is separately identifiable and is less than the carrying value. If impairment occurs, a loss based on the excess of the carrying value over the fair market value of the long-lived asset is recognized. Fair market value is determined by reference to quoted market prices, if available, or discounted cash flows, as appropriate.

Treasury Stock

The Company retires ordinary shares repurchased under a share repurchase plan. Accordingly, upon the retirement the excess of the purchase price over par value was allocated between additional paid-in capital and retained earnings based on the average issuance price of the shares repurchased. A repurchase of ADSs is recorded as treasury stock until the Company completes the withdrawal of the underlying ordinary shares from the ADS program.

Revenue Recognition

Revenue from product sales to customers, other than distributors, is recognized at the time of shipment and when title and right of ownership transfers to customers. The four criteria for revenue being realized and earned are the existence of evidence of sale, actual shipment, fixed or determinable selling price, and reasonable assurance of collectibility.

Allowances for sales returns and discounts are provided at the time of the recognition of the related revenues on the basis of experience and these provisions are deducted from sales.

In certain limited instances, the Company sells its products through distributors. The Company has limited control over these distributors' selling of products to third parties. Accordingly, the Company recognizes revenue on sales to distributors when the distributors sell the Company's products to third parties. Thus, products held by distributors are included in the Company's inventory balance.

Research and Development

Research and development costs consist of expenditure 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 expenditure incurred for the design and testing of product alternatives or construction of prototypes. All expenditure related to research and development activities of the Company are charged to operating expenses when incurred.

Advertising Expenses

The Company expenses all advertising and promotional costs as incurred. These costs were $1,108,000 in 2004, $1,447,000 in 2005 and $3,200,000 in 2006, respectively. A portion of these costs was for advertising, which amounted to $367,000 in 2004, $453,000 in 2005 and $535,000 in 2006, respectively.

Pension Costs

For employees who participate in the defined benefit pension plan, their pension costs are recorded based on actuarial calculations.

Income Tax

The Company is not subject to income or other taxes in the Cayman Islands. However, subsidiaries are subject to taxes of the jurisdiction where they are located.

Income taxes are accounted for in accordance with Statement of Financial Accounting Standards ("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 relevant years. Deferred income tax assets are recognized for operating loss carryforwards, research and development credits, and temporary differences. The Company believes that uncertainty exists regarding the realizability of certain deferred income tax assets and, accordingly, has established a valuation allowance for those net deferred income tax assets to the extent the realizability is not deemed to be more likely than not. In addition, The Company recognizes liabilities for potential income tax contingencies based on its estimate of whether, and the extent to which, additional taxes may be due. If the Company determines that payment of these amounts is unnecessary or if the recorded tax liability is less than its current assessment, the Company may be required to recognize an income tax benefit or additional income tax expense in its financial statements, accordingly.

Stock-based Compensation

The Company grants stock options to its employees and certain non-employees. Prior to January 1, 2006, the Company accounted for options granted under Accounting Principles Board Opinion ("APB") No. 25, "Accounting for Stock Issued to Employees" and complied with the disclosure provisions of SFAS No. 123, "Accounting for Stock-Based Compensation" for its employee stock options. Under APB No. 25, compensation expense is measured based on the difference, if any, on the date of the option grant, between the fair value of the Company's stock and the exercise price of the option.

Effective January 1, 2006, the Company adopted the fair value recognition provisions of SFAS No. 123(R), "Share-Based Payment", using the modified prospective application method. Under this transition method, compensation cost recognized for the year ended December 31, 2006, includes the applicable amounts of: (a) compensation cost of all stock-based payments granted prior to, but not yet vested as of, December 31, 2005 (based on the grant-date fair value estimated in accordance with the original provisions of SFAS No. 123 and previously presented in pro forma footnote disclosures), and (b) compensation cost for all stock-based payments granted subsequent to January 1, 2006 (based on the grant-date fair value estimated in accordance with the new provisions of SFAS No. 123(R)). Results for periods prior to January 1, 2006, have not been restated.

As a result of adopting SFAS No. 123 (R) on January 1, 2006, the Company recorded stock-based compensation of $ 2,589,000 to income before income tax and net income for the year ended December 31, 2006, and resulted in a decrease of $0.0013 both to basic and diluted earnings per share. Total stock-based compensation includes the impact of stock options, restricted stock units grants and the employee stock purchase plan. The Company's policy for attributing the value of graded vest share-based payments is a straight-line approach.

At the end of June 2005, the Board approved the acceleration of vesting of certain options. The Board evaluated the minimal benefit to its 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 the Company's market value. In addition, these options had exercise prices in excess of 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 was zero under APB No. 25.

The following pro forma information, as required by SFAS No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure, an amendment of FASB Statement No. 123," is presented for comparative purposes and illustrates the pro forma effect on net income and related earnings per share for the years ended December 31, 2004 and 2005, as if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock-based compensation for that period.

	Years Ended December 31	
	2004	**2005**
Net income as reported (in thousands)	$ 14,084	$ 8,147
Add: Stock-based compensation expense included in net income, including tax expense of $0 for 2004 and 2005	-	-
Deduct: Stock-based compensation expense determined under SFAS No. 123. including tax expense of $0 for 2004 and 2005	(6,940)	(15,862)
Pro forma net income (loss)	$ 7,144	$ (7,715)
Pro forma shares used in calculation - basic (in thousands)	1,957,800	1,961,168
Pro forma earnings (loss) per share - basic	$ 0.0036	$ (0.0039)
Earnings per share - basic as reported	$ 0.0072	$ 0.0042
Pro forma shares used in calculation - diluted (in thousands)	2,005,100	1,997,459
Pro forma earnings per share - diluted	$ 0.0036	$ NA
Earnings per share - diluted as reported	$ 0.0070	$ 0.0041

Pro forma loss per share for the year ended December 31, 2005 was not disclosed because the results were antidilutive.

This table includes a pro forma charge of $1,831,000 for the year ended December 31, 2005 related to the above accelerated vesting event.

In September, November and December 2005, the Company granted 1,100,000, 100,000 and 70,600,000 stock options to employees with the following features:

a. Employees will be granted fully vested, immediately exercisable stock options to purchase the Company's ordinary shares.

b. The Company has the right but is not required to repurchase exercised stock options upon termination of an employee's service with the Company at the closing market price on the date of repurchase. The shares subject to repurchase are those which qualify as mature shares at the date of such employee's termination. Mature shares are those that have been held by the employee for a period of more than six months.

c. Employees are restricted from selling shares which are issued upon the exercise of stock options for a total of four years with 25% of the restriction lapsing each year.

d. There is no requisite service period or other performance criteria required by the employee to earn the stock option.

The total pro forma charge for the immediately vested options was $8,588,000 in 2005 and is included in the table above.

Foreign Currency Transactions

The functional currency is the local currency of the respective entities. Foreign currency transactions are recorded at the rate of exchange in effect when the transaction occurs. Gains or losses, resulting from the application of different foreign exchange rates when cash in foreign currency is converted into the entities' functional currency, or when foreign currency receivable and payable are settled, are credited or charged to income in the period of conversion or settlement. At year-end, the balances of foreign currency monetary assets and liabilities are restated based on prevailing exchange rates and any resulting gains or losses are credited or charged to income.

Translation of Foreign Currency Financial Statements

The reporting currency of the Company is the US dollar. Accordingly, the financial statements of the foreign subsidiaries are translated into US dollars at the following exchange rates: Assets and liabilities - current rate on balance sheet date; shareholders' equity - historical rate; income and expenses - weighted average rate during the year. The resulting translation adjustment is recorded as a separate component of shareholders' equity.

Comprehensive Income (Loss)

Comprehensive income represents net income plus the results of certain changes in shareholders' equity during a period from non-owner sources that are not reflected in the consolidated statement of operations.

Legal Contingencies

The Company is currently involved in various claims and legal proceedings. Periodically, the Company reviews the status of each significant matter and assesses the potential financial exposure. If the potential loss from any claim or legal proceeding is considered probable and the amount can be estimated, the Company accrues a liability for the estimated loss. In view of uncertainties related to these matters, accruals are based only on the best information available at the time. As additional information becomes available, the Company reassesses the potential liability related to the pending claims and litigation and revises these estimates as appropriate. Such revisions in the estimates of the potential liabilities could have a material impact on the results of operations and financial position.

The Company indemnifies third parties with whom it enters into contractual relationships, including customers, however, it is not possible to determine the range of the amount of potential liability under these indemnification obligations due to the lack of prior indemnification claims. These indemnities typically hold these third parties harmless against specified losses, such as those arising from a breach of representation or covenant, or other third party claims that the Company's products when used for their intended purposes infringe the intellectual property rights of such other third parties. The indemnities are triggered by any claim of infringement of intellectual property rights brought by a third party with respect to the Company's products. The terms of these indemnities may not be waived or amended except by written notice signed by the both parties and may only be terminated with respect to the Company's products.

Recent Accounting Pronouncements

On February 15, 2007, the Financial Accounting Standards Board ("FASB") issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities". Under this statement, the Company may elect to report financial instruments and certain other items at fair value on a contract-by-contract basis with changes in value reported in earnings. This election is irrevocable. SFAS No. 159 provides an opportunity to mitigate volatility in reported earnings that is caused by measuring hedged assets and liabilities that were previously required to use a different accounting method than the related hedging contracts when the complex provisions of SFAS No. 133 hedge accounting are not met. There is no impact to the Company as a result of the adoption of this statement.

In September, 2006, the FASB issued SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans - an amendment of FASB Statements No. 87, 88, 106, and 132(R)" (hereinafter "SFAS No. 158"). This statement requires an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income of a business entity or changes in unrestricted net assets of a not for profit organization. This statement also requires an employer to measure the funded status of a plan as of the date of its year end statement of financial position, with limited exceptions. The adoption of this statement had no material effect on the Company's financial statements.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements", effective for financial statements issued for fiscal years beginning after November 15, 2007, the beginning of the Company's 2008 fiscal year. This statement defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. This statement establishes a fair value hierarchy that distinguishes between valuations obtained from sources independent of the entity and those from the entity's own unobservable inputs that are not corroborated by observable market data. SFAS No. 157 expands disclosures about the use of fair value to measure assets and liabilities in interim and annual periods subsequent to initial recognition. The disclosures focus on the inputs used to measure fair value and for recurring fair value measurements using significant unobservable inputs, the effect of the measurements on earnings or changes in net assets for the period. The Company is currently assessing the impact of this guidance on its financial statements.

In June 2006, the FASB issued FASB Interpretation ("FIN") No. 48, "Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109." The interpretation contains a two step approach to recognizing and measuring uncertain tax positions accounted for in accordance with SFAS No.109. The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates it is more likely than not that the position will be sustained on audit, including resolution of related appeals or litigation processes, if any. The second step is to measure the tax benefit as the largest amount which is more than 50% likely of being realized upon ultimate settlement. The provisions are effective for the Company beginning in the first quarter of 2007. The Company expects that the adoption of FIN No.48 will not have a significant impact on the Company's financial statements.

In September 2006, the Securities and Exchange Commission ("SEC") issued Staff Accounting Bulletin ("SAB") No. 108. This Bulletin provides the Staff's views on the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. The guidance in SAB No. 108 is effective for financial statements on fiscal years ending after November 15, 2006. The adoption of this Bulletin had no material effect on the Company's financial statements.

Reclassifications

Certain amounts reported in previous years have been reclassified to conform to the current year presentation.

3. CASH AND CASH EQUIVALENTS

(In Thousands)

	December 31	
	2005	**2006**
Time deposits	$ 23,444	$ 20,200
Savings and checking accounts	18,411	13,180
US treasury bills and corporate bonds	-	12,041
Petty cash	14	17
Cash management account	4,506	-
	$ 46,375	$ 45,438

The Company's cash management account is administered by the Bank of China to receive a fixed-rate return and as of December 31, 2005, it held foreign currency which was equivalent to $4,506,000. The cash management account came due on January 16, 2006 and the Company received $4,528,000. It reinvested this amount at 3.9% of return which came due on February 21, 2006.

4. SHORT-TERM INVESTMENTS

(In Thousands)

	December 31 2005	December 31 2006
Time deposits	$ 15,993	$ 19,697
Available-for-sale securities		
US treasury bills	13,909	-
Corporate bonds	24,642	-
Foreign government bonds	1,075	-
Others	34	-
	39,660	-
	$ 55,653	$ 19,697

Short-term investments by contractual maturity are as follows:

(In Thousands)

	December 31 2005	December 31 2006
Due within one year	$ 55,592	$ 19,668
Due after one year through two years	-	29
Due after two years	61	-
	$ 55,653	$ 19,697

The Company's gross realized gains and losses on the sale of investments for the year ended December 31, 2004 were both $0, for the year ended December 31, 2005 were $12,000 and $2,000, respectively, and for the year ended December 31, 2006 were $26,000 and $2,000, respectively. Gross unrealized gains and losses at December 31, 2004 were $293,000 and $182,000, respectively, gross unrealized gains and losses at December 31, 2005 were $55,000 and $11,000, respectively, and at December 31, 2006 were $0 and $6,000, respectively.

The following table shows the gross unrealized losses and fair value of the Company's investments with unrealized losses that were not deemed to be other-than-temporarily impaired, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at December 31, 2004, 2005 and 2006.

(In Thousands)

	December 31							
	2005						2006	
	Less Than 12 Months		12 Months or Greater		Total		Less Than 12 Months	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Corporate bonds	$ 24,642	$ 11	$ -	$ -	$ 24,642	$ 11	$ -	$ -
Investment in CSMC (note 8)	-	-	3,580	968	3,580	968	2,668	1,123
Total	$ 24,642	$ 11	$ 3,580	$ 968	$ 28,222	$ 979	$ 2,668	$ 1,123

5. ACCOUNTS RECEIVABLE, NET

(In Thousands)

	December 31	
	2005	**2006**
Accounts receivable	$ 11,810	$ 19,310
Allowances for		
Doubtful accounts	(34)	(7)
Sales returns and discounts	(316)	(316)
	$ 11,460	$ 18,987

The Group allows an average credit period from 30 to 45 days to its trade customers. The following is an aging analysis of accounts receivables net of impairment losses at the respective balance sheet dates:

(In Thousands)

	December 31	
	2005	**2006**
0 to 30 days	$ 10,613	$ 18,510
31 to 60 days	714	449
61 to 90 days	133	28
91 to 120 days	-	-
	$ 11,460	$ 18,987

The changes in the allowances are summarized as follows:

(In Thousands)

	Years Ended December 31	
	2005	**2006**
Allowances for doubtful receivables		
Balance, beginning of the year	$ 90	$ 34
Additions	-	-
Reversal and write-off	(56)	(27)
Balance, end of the year	$ 34	$ 7
Allowances for sales returns and discounts		
Balance, beginning of the year	$ 317	$ 316
Additions	587	848
Write-off	(588)	(848)
Balance, end of the year	$ 316	$ 316

6. INVENTORIES

	(In Thousands)	
	December 31	
	2005	2006
Finished goods	$ 2,954	$ 5,412
Work-in-process	8,401	5,375
Raw materials	4,588	3,289
	$ 15,943	$ 14,076

7. PREPAID EXPENSES AND OTHER CURRENT ASSETS

	(In Thousands)	
	December 31	
	2005	2006
Prepayment to foundry providers	$ 3,000	$ 2,940
Interest receivable	1,656	2,203
Prepaid expense	895	1,418
Value-added-tax paid	309	174
Other receivable	211	76
Deferred tax assets	10	31
Others	584	537
	$ 6,665	$ 7,379

8. LONG-TERM INVESTMENTS

	(In Thousands)	
	December 31	
	2005	2006
Cost method		
X-FAB Semiconductor Foundries AG ("X-FAB")	$ 4,968	$ 4,968
360 Degree Web Ltd. ("360 Degree Web")	1,305	1,305
GEM Services, Inc. ("GEM")	500	500
Etrend Hightech Corporation ("Etrend")	960	960
Asia SinoMOS Semiconductor Inc. ("Sinomos")	5,000	13,073
Philip Ventures Enterprise Fund ("PVEF")	585	585
	13,318	21,391
Available for sale securities - noncurrent		
CSMC Technologies Corporation ("CSMC")	3,580	2,668
	$ 16,898	$ 24,059

The Company invested in X-FAB's ordinary shares in July 2002. X-FAB is a European-American foundry group that specializes in mixed signal application. As of December 31, 2006, the Company held 530,000 shares at the value of $4,968,000 (4,982,000 EURO), which represents a 1.60% ownership of X-FAB.

The Company converted its convertible loans in 360 Degree Web to Series B and B2 preference shares of 360 Degree Web in January 2003. 360 Degree Web designs, develops and markets intelligent security software solutions that provide secure computing environment for personal computer mobile devices and the internet. In March 2004, the Company sold 1,000,000 shares of its stock in 360 Degree Web and recognized a gain of $340,000. In January 2005, the Company purchased additional 180,769 Series D preference shares of 360 Degree Web at $1.3 per share. As of December 31, 2006, the Company held 19.52% ownership of 360 Degree Web.

The Company invested in GEM's preference shares in August 2002. GEM is a multinational semiconductor assembly and test company. As of December 31, 2006, the Company held 333,334 shares at the value of $500,000, which represented a 0.96% ownership of GEM.

The Company invested in Etrend's ordinary shares in December 2002, July 2003 and March 2004. Etrend is a wafer probing, packing and testing company. As of December 31, 2006, the Company held 9.07% ownership of Etrend.

In January 2005, the Company invested ordinary shares of Sinomos, a privately owned foundry company, at a total amount of $5,000,000. In May and December 2006, the Company further invested preferred shares of $3,288,000 and $4,785,000, respectively. As of December 31, 2006, the Company held 30,101,353 of ordinary and preference shares, representing an 18.44% ownership of Sinomos.

In November 2005, the Company invested in PVEF, a fund management company in Singapore, with investment amount of SG$1,000,000 for 20 units in the placement at SG$50,000 per unit. The Company held 2.00% of the fund as of December 31, 2006.

The Company invested in Silicon Genesis Corporation ("SiGen") preferred shares in December 2000. SiGen is an advanced nanotechnology company that develops Silicon-on-insulator ("SOI"), stained-silicon products and other engineered multi-layer structures to microelectronics and photonic for advanced electronic and opto-electronic device applications. In 2002 and 2003, the Company reviewed the qualitative factors of the investment, determined that the decline in value was other-than-temporary and the carrying value was decreased to zero. The Company held 23,946 shares of SiGen as of December 31, 2006, representing a 0.09% ownership in SiGen.

In August 2004, the Company invested in CSMC's ordinary shares which are listed on the SEHK at a purchase price of $4,547,000. CSMC is a semiconductor foundry company. As of December 31, 2006, the Company held 70,200,000 shares, which represent approximately 2.58% ownership of CSMC. The Company considered that the investment to be other-than-temporary impaired at June 30, 2006 due to the fact that the stock price has been below the cost of HKD 0.50 per share for continuous 12 months and recognized an impairment loss of $756,000 based on the quoted market price of HKD 0.42 per share on June 30, 2006. As of December 31, 2006, the Company recognized unrealized losses of $1,123,000. No additional impairment loss was recognized as the Company does not believe any of the unrealized losses represented an other-than-temporary impairment based on its evaluation of available evidence as at December 31, 2006.

9. PROPERTY AND EQUIPMENT, NET

(In Thousands)

	December 31	
	2005	**2006**
Cost		
Freehold Land	$ 2,510	$ 11,299
Buildings	8,055	8,055
Equipment	19,056	30,599
Furniture and fixtures	1,229	1,393
Leasehold improvements	2,045	3,385
Transportation equipment	241	514
Prepayment for property and equipment	3,034	1,426
	36,170	56,671

	December 31	
	2005	**2006**
Accumulated depreciation		
Buildings	$ 132	$ 313
Equipment	11,116	12,569
Furniture and fixtures	586	786
Leasehold improvements	966	1,465
Transportation equipment	51	111
	12,851	15,244
	$ 23,319	$ 41,427

Depreciation expense recognized during the years ended December 31, 2005 and 2006 were approximately $3,388,000 and $4,545,000, respectively.

In view of the expansion of the Company's operations in the PRC, the Company acquired buildings located in Shanghai, the PRC in October 2005. The total purchase price was $7,077,000 of which $1,414,000 was paid for land use rights and the balance of $5,663,000 was paid for the building. The land use right was accounted for as other assets (see note 10). In April 2006, the Company purchased 29,935 square feet of freehold land in Hsin-Chu, Taiwan for a future facility for a total purchase price of approximately $8,789,000 (NT$286,421,000) which is included above.

10. OTHER ASSETS

	(In Thousands)	
	December 31	
	2005	2006
Land use rights, net	$ 1,407	$ 1,379
Deferred charges, net	665	618
Refundable deposits	493	560
Deferred income tax assets - noncurrent	62	295
Prepayment for land use rights	208	215
Long-term notes receivable from employees	410	8
	$ 3,245	$ 3,075

All land within municipal zones in the PRC is owned by the PRC government. Limited liability companies, joint stock companies, foreign-invested enterprises, privately held companies and individual natural persons must pay fees for granting of rights to use land within municipal zones. Legal use of land is evidenced and sanctioned by land use certificates issued by the local municipal administration of land resources. Land use rights granted for industrial purposes are limited to a term of no more than 50 years.

Land use rights are recorded at cost less accumulated amortization. Amortization is provided on the straight-line method over the term of the land use rights agreement which is 49.7 years.

In view of the expansion of the Company's operations in the PRC, the Company entered into a purchase contract to acquire land use rights located in Ningbo, the PRC. The total contracted price was $717,000 (RMB 5,600,000) (2005: $694,000) of which $215,000 (RMB 1,680,000) (2005: $208,000) has been paid as of December 31, 2006 and such amount has been included in the prepayment for land use rights.

Deferred charges consist of consultant and maintenance contracts and are amortized over the term of the contract which is 3 to 8 years.

In 2001, James Keim, one of the Company's directors, accepted the assignment of Head of Marketing and Sales in the Cayman Islands, and moved to the Cayman Islands in December 2001. In connection with the move and to assist Mr. Keim to purchase a residence in the Cayman Islands, the Company entered into a loan agreement with Mr. Keim in February 2002, under which the Company made an interest free, unsecured loan in the amount of $400,000 to Mr. Keim. The loan is repayable in February 2007 and has been repaid in full as of December 31, 2006.

11. NOTES AND ACCOUNTS PAYABLE

The following is an aging analysis of notes and accounts payable at the respective balance sheet dates:

(In Thousands)

	December 31	
	2005	**2006**
0 to 30 days	$ 5,747	$ 9,448
31 to 60 days	1	262
61 to 90 days	-	90
91 to 120 days	-	-
Over 120 days	12	51
	$ 5,760	$ 9,851

12. ACCRUED EXPENSES AND OTHER CURRENT LIABILITIES

(In Thousands)

	December 31	
	2005	**2006**
Salaries, bonus and benefits	$ 3,424	$ 3,844
Legal and audit fees	3,916	3,187
Promotional expenses	48	743
Withholding tax payable	223	260
Payable for acquisition of equipment	1,183	248
Value-added tax payable	209	243
Deferred income tax liabilities	698	107
Commissions	145	105
SEHK listing expenses	1,970	-
Other accrued expenses	2,276	3,475
	$ 14,092	$ 12,212

13. INCOME TAX

Income (loss) before income taxes consisted of:

(In Thousands)

	Years Ended December 31		
	2004	**2005**	**2006**
Cayman Islands	$ 15,496	$ 6,226	$ (3,395)
Foreign	60	2,955	1,688
	$ 15,556	$ 9,181	$ (1,707)

Income tax expense (benefit) consisted of:

(In Thousands)

	Years Ended December 31		
	2004	**2005**	**2006**
Current	$ 1,540	$ 507	$ (1,605)
Deferred	(68)	527	(845)
Income tax expense (benefit)	$ 1,472	$ 1,034	$ (2,450)

The Company and its subsidiaries file separate income tax returns. Reconciliation of the significant differences between the statutory income tax rate and the effective income tax rate on pretax income (loss) is as follows:

	Years Ended December 31		
	2004	**2005**	**2006**
Cayman statutory rate	0%	0%	0%
Foreign in excess of statutory rate	7.09%	15.69%	35.21%
Research and development credits	(6.08%)	(9.56%)	(20.86%)
Adjustments to prior years' taxes	3.49%	(9.11%)	(190.22%)
Change in valuation allowance	4.59%	9.74%	35.62%
Others	0.37%	4.50%	(3.28%)
Effective tax rate	9.46%	11.26%	(143.53%)

The deferred income tax assets and liabilities as of December 31, 2005 and 2006 consisted of the following:

(In Thousands)

	December 31	
	2005	**2006**
Deferred income tax assets		
Research and development credits	$ 5,189	$ 5,553
Net operating loss carryforwards	46	51
Accrued vacation	30	158
Depreciation and amortization	238	353
Deferred interest deductions	31	326
Others	90	29
	5,624	6,470
Valuation allowance	(5,552)	(6,144)
Total net deferred income tax assets	72	326
Deferred income tax liabilities		
Withholding tax liabilities	647	-
Unrealized foreign exchange	-	42
Unrealized capital allowance	51	65
Total deferred income tax liabilities	698	107
Net deferred income tax (liabilities) assets	$ (626)	$ 219
Balance sheet caption reported in:		
Prepaid expenses and other current assets (note 7)	$ 10	$ 31
Other assets (note 10)	62	295
Accrued expenses and other current liabilities (note 12)	698	107
	$ (626)	$ 219

The valuation allowance shown in the table above relates to net operating loss and credit carryforwards and temporary differences for which the Company believes that realization is uncertain. The valuation allowance increased $871,000 and $592,000 for the years ended December 31, 2005 and 2006, respectively.

As of December 31, 2006, O_2 Micro, Inc. had US federal and state research and development credit carryforwards of approximately $3,300,000 and $2,253,000, respectively. The US federal research and development credit will expire from 2012 through 2026 if not utilized, while the state research and development credit will never expire.

The Company reversed $375,000 and $2,513,000 of income tax payable for the 2000 and 2001 tax years in September 2004 and in September 2006, respectively, due to completion of the examination and approval of its filed Taiwan income tax return for the years ended December 31, 2000 and 2001. The tax authorities also determined a tax refund for 2001 income tax; therefore, the Company recognized additional income tax benefit of $69,000 and received the refund in October 2006.

On May 24, 2004, O2Micro-Taiwan applied to the Taiwan Customs officials for the rectification of the value of the imported goods reported for the period from March 2003 to March 2004. The Company had mistakenly reported a lower value to the Taiwan Customs Authority than the correct value that was reported on O2Micro-Taiwan's tax return for the tax years of 2003 and 2004. The Taiwan Ministry of Finance approved the rectification of the value of the imported goods in 2005. The completion of the rectification resulted in the reversal of a contingent income tax liability of $658,000 reversed and an income tax benefit was recognized in 2005.

14. NET INCOME

(In Thousands)

	Years Ended December 31		
	2004	**2005**	**2006**
Net income is arrived at after charging (crediting) :			
Staff cost excluding directors' emoluments	$ 19,508	$ 24,388	$ 35,345
Auditors' remuneration	312	665	409
Depreciation and amortization	2,692	3,684	4,947
Amortization of stock option granted for services	386	264	239
Stock-based compensation	-	-	2,589
Gain on sale of long-term investments	(340)	-	-
Gain on sale of short-term investments	-	(10)	(24)
Impairment loss on long-term investments	-	-	756
Loss on sales of property and equipments	3	18	76

15. DIRECTORS' REMUNERATION AND FIVE HIGHEST PAID INDIVIDUALS

Directors

Details of emoluments paid by the Company to the directors of the Company during the three years periods ended December 31, 2006 are as follows:

(In Thousands)

	Years Ended December 31		
	2004	**2005**	**2006**
Fees	$ 113	$ 139	$ 208
Salaries and other benefits	495	485	639
Retirement benefit contribution	-	2	3
Total emoluments	$ 608	$ 626	$ 850

The emoluments of the directors were within the following bands:

	Years Ended December 31		
	2004 Number of directors	**2005 Number of directors**	**2006 Number of directors**
Nil to HK$1,000,000	5	6	5
HK$1,000,001 to HK$1,500,000	2	2	-
HK$1,500,001 to HK$2,000,000	-	-	3

Five highest paid individuals' emoluments

Total emoluments payable to these five individuals are as follows:

(In Thousands)

	Years Ended December 31		
	2004	**2005**	**2006**
Salaries and other benefits	$ 738	$ 800	$ 915
Bonuses	883	796	964
Total emoluments	$ 1,621	$ 1,596	$ 1,879

None of the directors was the five highest paid individuals of the Company for the years ended December 31, 2004 and 2005. One of the directors was the five highest paid individuals of the Company for the year ended December 31, 2006.

	Years Ended December 31		
	2004 Number of individuals	**2005 Number of individuals**	**2006 Number of individuals**
HK$1,000,001 to HK$1,500,000	3	-	-
HK$1,500,001 to HK$2,000,000	-	4	2
HK$2,000,001 to HK$2,500,000	1	-	2
HK$5,500,001 to HK$6,000,000	-	1	-
HK$6,000,001 to HK$6,500,000	1	-	-
HK$7,000,001 to HK$7,500,000	-	-	1

During the three years ended December 31, 2006, no emoluments were paid by the Company to any of the directors or the five highest paid individuals as an inducement to join or upon joining the Company or as a compensation for loss of office as a director of any member of the Company or in connection with the management of the affairs of any members of the Company. None of the directors waived any emoluments during the three years ended December 31, 2006.

16. RETIREMENT AND PENSION PLANS

The Company has a savings plan for that qualifies under Section 401(k) of the US Internal Revenue Code. Participating employees may defer up to the U.S. Internal Revenue Service statutory limit amounts of pretax salary. The Company may make voluntary contributions to the savings plan but has made no contributions since the inception of the savings plan in 1997.

The Company also participates in mandatory pension funds and social insurance schemes, if applicable, for employees in jurisdictions in which other subsidiaries or office are located to comply with local statutes and practices. For the years ended December 31, 2004, 2005 and 2006, pension costs charged to income in relation to the contributions to these schemes were $568,000, $861,000 and $1,293,000 respectively. In October 2006, the Company adopted a defined benefit pension plan and established an employee pension fund committee for certain employees of O2Micro-Taiwan who are subject to the Taiwan Standards Labor Law ("Labor Law") to comply with local requirements. This benefit pension plan provides benefits based on years of service and average salary computed based on the final six months of employment. The Labor Law requires the Company to contribute between 2% to 15% of employee salaries to a government specified plan, which the Company currently makes monthly contributions equal to 2% of employee salaries. Contributions are required to be deposited in the name of the employee pension fund committee with the Central Trust of China in Taiwan. The measurement date of the plan is December 31.

The component of net periodic benefit cost is as follows:

	(In Thousands)
	2006
Service cost	$ 4
Interest cost	16
Expected return on plan assets	-
Amortization of the transition obligation	70
Net Periodic benefit cost	$ 90

The funded status of the plan is as follows:

	(In Thousands)
	December 31, 2006
Project benefit obligation	$ (464)
Plan assets at fair value	9
Funded status of the plan	$ (455)

The change in fair value on plan assets is follows:

	(In Thousands)
	2006
Employer contributions	$ 9
Actual return on plan assets	-
Fair value of plan assets, end of year	$ 9

The actuarial assumptions are as follows:

	2006
Discount rate	3.5%
Rate of compensation increases	2.0%
Expected long-term rate of return on plan assets	2.5%

17. STOCK-BASED COMPENSATION

Employee Stock Purchase Plan

In October 1999, the Board adopted the 1999 Purchase Plan ("1999 Purchase Plan"), which was approved by the shareholders prior to the consummation of its initial public offering in August 2000. A total of 50,000,000 ordinary shares have been reserved for issuance under the 1999 Purchase Plan, plus annual increases on January 1 of each year, commencing in 2001, up to 40,000,000 shares as approved by the Board. The 1999 Purchase Plan is subject to adjustment in the event of a stock split, stock dividend or other similar changes in ordinary shares or capital structure.

The 1999 Purchase Plan permits eligible employees to purchase ordinary shares through payroll deductions, which may range from 1% to 10% of an employee's regular base pay. Beginning November 1, 2005, the 1999 Purchase Plan shall be implemented through consecutive offer periods of 3 months' duration commencing each February 1, May 1, August 1 and November 1. Under the 1999 Purchase Plan, ordinary shares may be purchased at a price equal to the lesser of 90% of the fair market value of the Company's ordinary shares on the date of grant of the option to purchase (which is the first day of the offer period) or 90% of the fair market value of the Company's ordinary shares on the applicable exercise date (which is the last day of the offer period). Employees may elect to discontinue their participation in the purchase plan at any time, however, all of the employee's payroll deductions previously credited to the employee's account will be applied to the exercise of the employee's option on the next exercise date. Participation ends automatically on termination of employment with the Company. If not terminated earlier, the 1999 Purchase Plan will have a term of 10 years. During 2005 and 2006, 6,389,200 and 6,980,050 ordinary shares, respectively, had been purchased under the 1999 Purchase Plan. As of December 31, 2006, 15,851,950 shares were available for issuance.

Stock Option Plans

In 1997, the Board adopted the 1997 Stock Plan, and in 1999, adopted the 1999 Stock Incentive Plan. The plans provide for the granting of stock options to employees, directors and consultants of the Company.

Under the 1997 Stock Plan, the Board reserved 185,000,000 ordinary shares for issuance. After the completion of an initial public offering, no further options were granted under the 1997 Stock Plan. Under the 1999 Stock Incentive Plan, the maximum aggregate number of shares available for grant shall be 150,000,000 ordinary shares plus an annual increase on January 1 of each year, commencing in 2001, equal to the least of 75,000,000 shares or 4% of the outstanding ordinary shares on the last day of the preceding fiscal year or a smaller number determined by the plan administrator. As of December 31, 2006, the number of options outstanding and exercisable was 17,520,850 and 17,520,850, respectively, under the 1997 Stock Plan, and 272,942,250 and 221,683,400 under the 1999 Stock Incentive Plan.

The Board adopted the 2005 SOP which was effective on March 2, 2006, the date the Company completed the SEHK listing, and then the Board terminated the 1997 Stock Plan and 1999 Stock Incentive Plan. The Company began issuing stock options solely under the 2005 SOP for up to 100,000,000 ordinary shares. Under the terms of the 2005 SOP, stock options are generally granted at fair market value of the Company's ordinary shares. The stock options have a contractual term of 8 years from the date of grant and vest over a requisite service period of 4 years. As of December 31, 2006, the number of options outstanding and exercisable was 16,279,900 and 1,654,200, respectively, under the 2005 SOP.

A summary of the Company's stock option activity under the plans as of December 31, 2006, and changes during the year then ended is presented as follows:

	Number of Outstanding Options Shares	Weighted Average Exercise Price	Weighted Average Remaining Contract Life	Aggregate Intrinsic Value
Outstanding Options, January 1, 2006	310,484,350	$ 0.2364		
Granted	21,988,400	$ 0.1731		
Exercised	(5,643,000)	$ 0.0630		
Forfeited or expired	(20,086,750)	$ 0.2451		
Outstanding Options, December 31, 2006	306,743,000	$ 0.2344	6.80	$1,644,000
Vested and Expected to Vest Options at December 31, 2006	286,332,400	$ 0.2350	6.74	$1,546,000
Exercisable Options at December 31, 2006	240,858,450	$ 0.2354	6.62	$1,346,000

The total intrinsic value of options exercised during the years ended December 31, 2004, 2005 and 2006 were $1,528,000, $841,000 and $177,000, respectively.

The following table summarizes information about outstanding and vested stock options:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	**Number Outstanding**	**Weighted Average Remaining Contractual Life**	**Weighted Average Exercise Price**	**Number Exercisable and Vested**	**Weighted Average Exercise Price**
$0.0017-$0.0010	2,758,300	1.99	$ 0.0087	2,758,300	$ 0.0087
$0.0790-$0.1198	8,149,050	3.38	$ 0.0945	7,673,650	$ 0.0930
$0.1292-$0.1948	63,871,700	5.73	$ 0.1672	48,746,800	$ 0.1711
$0.2013-$0.2994	178,082,000	7.54	$ 0.2310	136,095,900	$ 0.2283
$0.3076-$0.4836	53,881,950	6.38	$ 0.3577	45,583,800	$ 0.3632
Balance, December 31, 2006	306,743,000	6.80	$ 0.2344	240,858,450	$ 0.2354

Share Incentive Plan

The Board adopted the 2005 SIP which was effective on March 2, 2006, the date the Company completed the SEHK listing. The 2005 SIP provides for the grant of restricted shares, restricted share units ("RSU"), share appreciation rights and dividend equivalent rights (collectively referred to as "Awards") up to 75,000,000 ordinary shares. Awards may be granted to employees, directors and consultants. The Company granted RSUs to employees in 2006. The RSUs vest over a requisite service period of 4 years and expire 8 years from the date of grant.

A summary of the status of the Company's RSUs as of December 31, 2006, and the changes during the year ended December 31, 2006 is presented as follows:

	Number of Outstanding Awards	Weighted Average Exercise Price
Initial shares authorized	-	
Granted	8,085,250	$ 0.1736
Vested	-	$ -
Forfeited and expired	(170,500)	$ 0.1736
Nonvested at December 31, 2006	7,914,750	$ 0.1736

As of December 31, 2006, there was $3,778,000 of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the plans including stock options and RSUs. The cost is expected to be recognized over a weighted-averaged period of 3.01 years. The total fair value of RSUs vested during the year ended December 31, 2006 was $ 0.

Cash received from option exercise under all share-based payment arrangements for the years ended December 31, 2004, 2005 and 2006, was $2,314,000, $2,295,000 and $1,339,000, respectively.

For purposes of measuring compensation expense under APB No. 25, the fair value of the shares on the date of grant was determined by the Board for grants prior to August 23, 2000. The fair value of subsequent option grants or RSU grants was based on the market price of ordinary shares on the day of grant.

The Company calculated the fair value of each option grant on the date of grant using the Black-Scholes option pricing model that use the assumptions in the following table. Risk-free interest rate is based on the US Treasury yield curve in effect at the time of grant. The Company uses the simplified method as provided by Staff Accounting Bulletin No. 107 by average vesting term and contractual term of the options as their expected term. Expected volatilities are based on historical volatility for a period equal to the options' expected term when the Company has sufficient historical data as a public company; otherwise, the Company uses historical volatilities of stock prices of companies similar to the Company. The dividend yield is zero as the Company has never declared or paid dividends on the ordinary shares or other securities and do not anticipate paying dividends in the foreseeable future.

	Stock Options		Employee Stock Purchase Plan	
	Years Ended December 31		Years Ended December 31	
	2005	2006	2005	2006
Risk-free interest rate	4.06%	4.45%-5.10%	2.20%-3.96%	4.47%-5.12%
Expected life	5-7 years	5-7 years	0.26-0.51 years	0.25-0.26 years
Volatility	65%	67%-71%	38%-78%	44%-51%
Dividend	-	-	-	-

The weighted-average grant-date fair values of options granted during the years ended December 31, 2004, 2005 and 2006 were $0.1726, $0.1338 and $0.1062, respectively. The weighted-average fair values for purchase rights granted pursuant to the 1999 Purchase Plan during the years ended December 31, 2005 and 2006 were $0.0675 and $0.0316, respectively. There is no purchase rights granted pursuant to the 1999 Purchase Plan during the year ended December 31, 2004.

Ordinary Shares Reserved

As of December 31, 2006, ordinary shares reserved for future issuance were as follows:

Outstanding stock options	306,743,000
Outstanding RSUs	7,914,750
Shares reserved for future stock option grants	83,720,100
Shares reserved for 1999 Purchase Plan	15,851,950
Shares reserved for Awards	67,085,250
	481,315,050

18. EARNINGS PER SHARE

Basic earnings per share is calculated by dividing net income by the weighted average number of ordinary shares outstanding during the period. Diluted earnings per share is calculated by dividing net income by the weighted average number of ordinary and dilutive ordinary equivalent shares outstanding during the period, using the treasury stock method for options.

A reconciliation of the numerator and denominator of basic and diluted earnings per share calculations is provided as follows:

	Years Ended December 31		
	2004	2005	2006
Net income (in thousands)	$ 14,084	$ 8,147	$ 743
Weighted average thousand shares outstanding – basic	1,957,800	1,961,168	1,932,575
Effect of dilutive securities:			
Options (in thousands)	47,300	36,291	14,321
Weighted average thousand shares outstanding – diluted	2,005,100	1,997,459	1,946,896
Earnings per share – basic	$ 0.0072	$ 0.0042	$ 0.0004
Earnings per share – diluted	$ 0.0070	$ 0.0041	$ 0.0004

Certain outstanding options were excluded from the computation of diluted EPS since their effect would have been antidilutive. The antidilutive stock options excluded and their associated exercise prices per share were 61,351,850 shares at $0.2994 to $0.4836 as of December 31, 2004, 128,293,200 shares at $0.2538 to $0.4836 as of December 31, 2005 and 254,805,913 shares at $0.1198 to $0.4836 as of December 31, 2006.

The antidilutive RSUs excluded were 5,295,000 shares as of December 31, 2006.

19. COMMITMENTS

Capital Commitments

As described in note 10, the land use right purchase commitment was $502,000 as of December 31, 2006.

Lease Commitments

The Company leases office space and certain equipment under non-cancelable operating lease agreements that expire at various dates through December 2011. The Company’s office lease provides for periodic rental increases based on the general inflation rate.

As of December 31, 2006, minimum lease payments under all noncancelable leases were as follows:

Year	Operating Leases (In Thousands)
2007	$ 1,670
2008	723
2009	365
2010	369
2011	62
Total minimum lease payments	$ 3,189

20. CONTINGENCIES

The Company is involved in a variety of litigation matters involving patents. For example, the Company has initiated and is pursuing certain patent infringement actions in Taiwan. The Company has obtained preliminary injunctions and provisional attachment orders against numerous competitors, their customers and users. As of December 31, 2006, the Company has deposited an amount of New Taiwan dollars equivalent to approximately $14.5 million with the Taiwan courts for court bonds, which was accounted for as restricted assets, in connection with those actions, other preliminary injunction actions and related provisional attachment actions. The court bonds provide security for the enjoined party to claim damages against the Company incurred from the preliminary injunctions, provisional attachments or the provision of a countersecurity in the event the Company does not ultimately succeed in the underlying infringement actions. However, these preliminary injunctions or provisional attachments may be rescinded if the relevant court allows the opposing party to make its own deposit or countersecurity with the court.

The Company has been in litigation against Monolithic Power Systems (“MPS”) in the United States District Court in the Northern District of California. MPS has alleged that certain of the Company’s products infringe on one of its patents and a continuation of that patent. In May 2004, the court granted the Company’s motion for summary judgment that MPS lacked evidence of damages. Trial on MPS’ claim commenced in June 2005 and, in July 2005, the Company received a jury verdict that all patent claims asserted by MPS were invalid and were not infringed by the Company. MPS has appealed the jury verdict. As the case currently stands, MPS will not be able to recover damages unless it is able to overturn both the summary judgment and the jury verdict or seek injunctive relief or attorneys' fees unless it is able to overturn the jury verdict.

In addition, the Company has filed patent infringement actions in the US District Court in the Eastern District of Texas, the US District Court in the Northern District of California and the Taiwan District Courts against various defendants. In response, several defendants have counterclaimed for antitrust violations, interference, unfair competition and trade secrets misappropriation.

While the Company cannot make any assurance regarding the eventual resolution of these matters, the Company does not believe the final outcome will have a material adverse effect on its consolidated results of operations or financial condition.

The Company, as a normal course of business, is a party to various litigation matters, legal proceedings and claims. These actions may be in various jurisdictions, and may involve patent protection and/or patent infringement. While the results of such litigations and claims cannot be predicted with certainty, the final outcome of such matters is not expected to have a material adverse effect on its consolidated financial position or results of operations. No assurance can be given, however, that these matters will be resolved without the Company becoming obligated to make payments or to pay other costs to the opposing parties, with the potential for having an adverse effect on the Company's financial position or its results of operations. As of December 31, 2006, no provision for any litigation has been provided.

21. FINANCIAL INSTRUMENTS

Information on the Company's financial instruments is as follows:

(In Thousands)

	December 31			
	2005		2006	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Assets				
Cash and cash equivalents	$ 46,375	$ 46,375	$ 45,438	$ 45,438
Restricted cash	5,605	5,605	8,342	8,342
Short-term investments	55,653	55,653	19,697	19,697
Long-term investment in CSMC	3,580	3,580	2,668	2,668
Restricted assets	14,492	14,416	14,540	14,507

The carrying amounts of cash and cash equivalents and restricted cash reported in the consolidated balance sheets approximate their estimated fair values. The fair values of short-term investments and long-term investment in CSMC are based on quoted market prices.

Fair value of restricted assets made in the form of Taiwan Government bonds are based on quoted market price; the remaining restricted assets are carried at amounts which approximate fair value.

Long-term investments, except for investment in CSMC, are in privately-held companies where there is no readily determinable market value. The Company periodically evaluates these investments for impairment. If it is determined that an other-than-temporary decline has occurred in the carrying value, an impairment loss is recorded in the period of decline in value.

22. SEGMENT INFORMATION

The Company designs, develops and markets high performance semiconductors for power management and security applications. The Company's semiconductor products are produced with digital, analog, and mixed signal integrated circuit manufacturing processes. The Company's Chief Operating Decision Maker ("CODM"), the Chief Executive Officer, reviews information on an enterprise-wide basis to assess performance and allocate resources and has determined the Company has one reporting segment.

Net sales to unaffiliated customers by geographic region are based on the customer's ship-to location and were as follows:

(In Thousands)

	Years Ended December 31		
	2004	**2005**	**2006**
PRC	$ 55,930	$ 60,889	$ 92,801
Korea	10,345	22,957	15,018
Japan	6,092	6,323	9,603
Taiwan	18,898	14,891	6,559
Others	931	492	934
	$ 92,196	$ 105,552	$ 124,915

Long-lived assets consist of property and equipment and are based on the physical location of the assets at the end of each year, and were as follows:

(In Thousands)

	December 31		
	2004	**2005**	**2006**
Taiwan	$ 2,772	$ 7,795	$ 21,261
PRC	757	8,244	13,015
U.S.A.	6,551	6,804	6,669
Singapore	327	274	335
Others	351	202	147
	$ 10,758	$ 23,319	$ 41,427

For the year ended December 31, 2004, one customer accounted for 17.5% of net sales. For the year ended December 31, 2005 and 2006, no customers accounted for 10% or more of net sales.

23. DIFFERENCES BETWEEN ACCOUNTING PRINCIPLES GENERALLY ACCEPTED IN THE UNITED STATES AND HONG KONG FINANCIAL REPORTING STANDARDS

I. The consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States ("US GAAP"), which differ in certain significant respects from Hong Kong Financial Reporting Standards ("HKFRS").

(a) Stock Based Compensation

Prior to January 1, 2006, under US GAAP the Company could account for stock-based compensation issued to employees using one of the two following methods.

1) Intrinsic value based method

Under the intrinsic value based method, compensation expense is the excess, if any, of the fair value of the stock at the grant date or other measurement date over the amount an employee must pay to acquire the stock. Compensation expense, if any, is recognized over the applicable service period, which is usually the vesting period.

2) Fair value based method

For stock options, fair value is determined using an option pricing model that takes into account the stock price at the grant date, the exercise price, the expected life of the option and the annual rate of quarterly dividends.

Under either approach compensation expense, if any, is recognized over the applicable service period, which is usually the vesting period.

The FASB issued SFAS No. 123 (R) "Share-Based Payment" which requires companies to recognize compensation expense equal to the fair value of stock options or other share based payments for the annual reporting period that begins after June 15, 2005. Prior to the adoption of SFAS No. 123 (R) on January 1, 2006, the Company has adopted the intrinsic value method of accounting for its stock options and the fair value of the stock options was presented for disclosure purpose (see Note 2).

There has been no HKFRS covering the recognition and measurement of these transactions prior to issue of HKFRS 2 "Share-based payments" which became effective on January 1, 2005. HKFRS 2 requires recognition of the fair value of shares and options awarded to employees over the period to which the employee's services relate. Under HKFRS 2, an entity is required to measure the employee services received by reference to the fair value of the equity instruments at the grant date.

There is generally no significant difference in the fair value used under SFAS No. 123 (R) and HKFRS 2 for measuring the compensation cost of employee arrangements, except for the guidance in related to share-based payments with grade vesting features. Under SFAS No. 123 (R), an accounting policy choice exists for awards with a service condition only either: (a) amortize the entire grant on a straight-line basis over the longest vesting period, or (b) recognize a charge similar to HKFRS 2. Under HKFRS 2, compensation charge is recognized on an accelerated basis to reflect the vesting as it occurs. Accordingly, adjustments are made to record the additional charge resulted from different amortization method used for stock-based awards granted subsequent to January 1, 2006.

Had the Company prepared the financial statements under HKFRS, the Company would have adopted the fair value based method in accounting for stock options and details of the corresponding effect on the net income are set out in Part II (a) below.

(b) Property and equipment

HKFRS requires the recognition of an item of property and equipment as an asset only if it is probable that future economic benefits associated with the item were flow to the entity and the cost of the item can be measured reliably.

In relation to the prepayment of property and equipment, no future economic benefits flow to the entity as the property and equipment are not held for use in the production or supply of goods or services.

Under US GAAP, the prepayment of property and equipment are allowed to be included into the category of property and equipment.

No significant GAAP difference in respect of the accounting for property and equipment is noted for the three years ended December 31, 2006 except for the classification of the balance sheet items as set out in Part II (b) below.

(c) Inventory valuation

Inventories are carried at cost under both US GAAP and HKFRS. However, if there is evidence that the utility of goods, in their disposal in the ordinary course of business, will be less than cost, whether due to physical obsolescence, changes in price levels, or other causes, the difference should be recognized as a loss of the current period. This is generally accomplished by stating such goods at a lower level commonly known as "market value". Under US GAAP, a write-down of inventories to the lower of cost or market value at the close of a fiscal period creates a new cost basis that subsequently cannot be marked up based on changes in underlying facts and circumstances. Market value under US GAAP is the lower of the replacement cost and net realizable value minus normal profit margin. Under HKFRS, a write-down of inventories to the lower of cost or market value at the close of a fiscal period is a valuation allowance that can be subsequently reversed if the underlying facts and circumstances changes. Market value under HKFRS is net realizable value.

No significant GAAP difference in respect of the accounting for inventory valuation is noted for the three years ended December 31, 2006.

(d) Leases

Under HKFRS, leases of land and buildings are classified as operating or finance leases in the same way as leases of other assets. However, a characteristic of land is that it normally has an indefinite economic life and, if title is not expected to pass to the lessee by the end of the lease term, the lessee normally does not receive substantially all of the risks and rewards incidental to ownership, in which case the lease of land will be an operating lease. A payment made on entering into or acquiring a leasehold that is accounted for as an operating lease represents prepaid lease payments that are amortized over the lease term in accordance with the pattern of benefits provided. For balance sheet presentation, the prepayment of land use rights should be disclosed as current and non-current.

Under US GAAP, land use rights are also accounted as an operating lease and represent prepaid lease payments that are amortized over the lease term in accordance with the pattern of benefits provided. Current and non-current asset reclassification is not required under US GAAP.

No significant GAAP difference in respect of the accounting for leases is noted for the three years ended December 31, 2006 except for the classification of the balance sheet items as set out in Part II (b) below.

(e) Deferred income taxes

Deferred tax liabilities and assets are recognized for the estimated future tax effects of all temporary differences between the financial statements carrying amounts of assets and liabilities and their respective tax bases under both US GAAP and HKFRS.

Under HKFRS, deferred tax asset is recognized to the extent that it is probable that future profits will be available to offset the deductible temporary differences or carry-forward of unused tax losses and unused tax credits. Under US GAAP, all deferred tax assets are recognized, subject to a valuation allowance, to the extent that it is "more likely than not" that some portion or all of the deferred tax assets will not be realized. "More likely than not" is defined as a likelihood of more than 50%.

With respect of the measurement of the deferred taxation, HKFRS requires recognition of the effects of a change in tax laws or rates when the change is "substantively enacted". US GAAP requires measurement using local tax laws and rates enacted at the balance sheet date. Under HKFRS, deferred tax assets and liabilities are always classified as non-current items.

Under US GAAP, deferred tax liabilities and assets are classified as current or non-current based on the classification of the related asset or liability for financial reporting.

No significant GAAP difference in respect of the accounting for deferred income taxes is noted for the three years ended December 31, 2006 except for the classification of the balance sheet items as set out in Part II (b) below.

(f) Impairment of asset

HKFRS requires an enterprise to evaluate at each balance sheet date whether there is any indication that an asset may be impaired. If any such indication exists, an enterprise should estimate the recoverable amount of the assets. Recoverable amount is the higher of an asset's net selling price and its value in use. Value in use is measured on a discounted present value basis. An impairment loss is recognized for the excess of the carrying amount of such assets over their recoverable amounts. A reversal of previous provision of impairment is allowed to the extent of the loss previously recognised as expense in the income statement.

Under US GAAP, an entity reviews for impairment whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable. An impairment loss is recognized if the expected future cash flows (undiscounted) are less than the carrying amount of the assets. The impairment loss is measured based on the fair value of the assets. Subsequent reversal of the loss is prohibited.

No significant GAAP difference in respect of the accounting for impairment of asset is noted for the three years ended December 31, 2006.

(g) Research and development costs

HKFRS requires classification of the costs associated with the creation of intangible assets by research phase and development phase. Costs in the research phase must always be expensed. Costs in the development phase are expensed unless the entity can demonstrate all of the following:

1. the technical feasibility of completing the intangible asset so that it will be available for use or sale;
2. its intention to complete the intangible asset and use or sell it;

3. its ability to use or sell the intangible asset;
4. how the intangible asset will generate probable future economic benefits. Among other things, the enterprise can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset;
5. the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset; and
6. its ability to measure the expenditure attributable to the intangible asset during the development phase.

Under US GAAP, research and development costs are expensed as incurred except for:

1. those incurred on behalf of other parties under contractual arrangements;
2. those that are unique for enterprises in the extractive industries;
3. certain costs incurred internally in creating a computer software product to be sold, leased or otherwise marketed, whose technological feasibility is established, i.e. upon completion of a detailed program design or, in its absence, upon completion of a working model; and
4. certain costs related to the computer software developed or obtained for internal use.

The general requirement to write off expenditure on research and development as incurred is extended to research and development acquired in a business combination.

No significant GAAP difference in respect of the accounting for research and development costs is noted for the three years ended December 31, 2006.

(h) Statements of cash flows

There are no material differences on statements of cash flows between US GAAP and HKFRS. Under US GAAP, interest received and paid must be classified as an operating activity. Under HKFRS, interest received and paid may be classified as an operating, investing, or financing activity.

(i) Other comprehensive income

Comprehensive income is net income plus gains and losses that are recognized directly in equity rather than in net income.

Under HKFRS, there is no specific guidance on the presentation of other comprehensive income. Items of gain and loss that are not recognized in the income statements (such as foreign exchange translation gain or loss) are recognized in reserves separate from retained earnings and are disclosed in the statement of changes in equity.

US GAAP requires disclosure of total comprehensive income and accumulated other comprehensive income, either as a separate primary statement or combined with income statement, or with statement of changes in stockholders' equity.

(j) Segment reporting

Under HKFRS, a listed enterprise is required to determine its primary and secondary segments on the basis of lines of business and geographical areas, and to disclose results, assets and liabilities and certain other prescribed information for each segment. The determination of primary and secondary segment is based on the dominant source of the enterprise's business risks and returns. Accounting policies adopted for preparing and presenting the financial statements of the Company should also be adopted in reporting the segmental results and assets.

Under US GAAP, a public business enterprise is required to report financial and descriptive information about its reportable operating segments. Operating segments are components of an enterprise about which separate financial information is available that is evaluated regularly by the Chief Operating Decision Maker in deciding how to allocate resources and in assessing performance. US GAAP also permits the use of the accounting policies used for internal reporting purposes that are not necessarily consistent with the accounting policies used in consolidated financial statements.

The segment information prepared under HKFRS is presented below in Part II (d).

II (a) The adjustments necessary to restate net income attributable to holders of ordinary shares and stockholders' equity in accordance with HKFRS are summarized as follows:

(In Thousands)

	Years Ended December 31		
	2004	**2005**	**2006**
Net income attributable to holders of ordinary shares as reported under US GAAP	$ 14,084	$ 8,147	$ 743
HKFRS adjustments			
(i) Stock-based compensation under HKFRS 2 for the years ended December 31, 2004 and 2005, respectively (Note)	(6,940)	(15,862)	-
(ii) Additional stock-based compensation recognized under HKFRS 2 for the year ended December 31, 2006	-	-	(456)
Net income (loss) attributable to holders of ordinary shares under HKFRS	$ 7,144	$ (7,715)	$ 287
Net income (loss) per share under HKFRS			
- basic	$ 0.0036	$ (0.0039)	$ 0.0001
- diluted	$ 0.0036	$ NA	$ 0.0001

Note: For the purpose of this reconciliation, the stock-based compensation costs under HKFRS 2 for each of the years ended December 31, 2004 and 2005 are determined based on the assumption that the Company would have adopted the fair value based method in accounting for stock options granted prior to and during these years without adoption of the transitional provision allowed under HKFRS 2.

(b) Under HKFRS, the Company's consolidated total assets and liabilities at December 31, 2005 and 2006 are as follows:

(In Thousands)

	December 31	
	2005	**2006**
Non-current assets		
Long-term investments	$ 16,898	$ 24,059
Property and equipment, net	20,285	40,001
Restricted assets	14,492	14,540
Deferred tax assets	72	326
Prepayment for property and equipment	3,034	1,426
Prepaid lease payments	1,378	1,350
Other assets	1,776	1,401
	57,935	83,103
Current assets		
Cash and cash equivalents	46,375	45,438
Restricted cash	5,605	8,342
Short-term investments	55,653	19,697
Accounts receivables, net	11,460	18,987
Inventories	15,943	14,076
Prepaid lease payments	29	29
Prepaid expenses and other current assets	6,655	7,348
	141,720	113,917
Total assets	199,655	197,020
Current liabilities		
Notes and accounts payable	5,760	9,851
Income tax payable	3,907	991
Accrued expenses and other current liabilities	13,394	12,105
	23,061	22,947
Total assets less current liabilities	176,594	174,073
Non-current liabilities		
Deferred tax liabilities	698	107
Accrued retirement benefit costs	-	455
	698	562
Net assets	$ 175,896	$ 173,511
Net current assets	$ 118,659	$ 90,970

Except for the reclassification as current or non-current items with respect to deferred tax assets and liabilities, prepayment for property and equipment and land use rights, there are no other adjustments and reclassification made to the Company's consolidated balance sheets prepared under US GAAP for conversion into HKFRS.

(c) Reconciliation of shareholders' equity as at December 31, 2004, 2005 and 2006 is as follows:

(In Thousands)

	US GAAP	Stock based compensation recognized under US GAAP	Stock-based compensation recognized under HKFRS 2	HKFRS
		Note 1	Note 2	
At December 31, 2004				
Shareholders' equity				
Ordinary shares	$ 39			$ 39
Additional paid-in capital	139,581	(2,928)	31,667	168,320
Accumulated other comprehensive loss (gain):				
Unrealized investment gain reserve	(154)			(154)
Translation reserve	44			44
Retained earnings	31,271	2,928	(31,667)	2,532
	$ 170,781			$ 170,781
At December 31, 2005				
Shareholders' equity				
Ordinary shares	$ 39			$ 39
Treasury stock	(3,296)			(3,296)
Additional paid-in capital	141,532	(2,928)	47,529	186,133
Accumulated other comprehensive loss :				
Unrealized investment gain reserve	(924)			(924)
Translation reserve	(194)			(194)
Retained earnings (deficit)	38,739	2,928	(47,529)	(5,862)
	$ 175,896			$ 175,896
At December 31, 2006				
Shareholders' equity				
Ordinary shares	$ 38			$ 38
Additional paid-in capital	140,224	(2,928)	47,985	185,281
Accumulated other comprehensive loss (gain):				
Unrealized investment gain reserve	(1,129)			(1,129)
Translation reserve	501			501
Retained earnings (deficit)	33,877	2,928	(47,985)	(11,180)
	$ 173,511			$ 173,511

Notes:

1. Included in this reconciliation item was the cumulative stock based compensation expense recognized under US GAAP for the periods prior to year 2004 amounted to approximately $2,928,000.

2. Included in this reconciliation item was the cumulative stock based compensation costs recognized under HKFRS 2 for the periods prior to year 2004 amounted to approximately $24,727,000.

(d) Segment information presented under HKFRS for the three years ended December 31, 2006:

The Company has only one business segment which designs, develops and markets high performance semiconductors for power management and security applications.

The five largest customers of the Group accounted for about 46.5%, 30.3% and 33.1% of the total revenue of the Group fro the year ended December 31, 2004, 2005 and 2006 respectively. The largest customer accounted for about 17.5%, 8.3% and 8.5% of the total revenue of the Group for the year ended December 31, 2004, 2005 and 2006 respectively.

The five largest suppliers of the Group accounted for about 74.8%, 76.2% and 79.5% of the total purchases of the Group fro the year ended December 31, 2004, 2005 and 2006 respectively. The largest supplier accounted for about 17.2%, 31.3% and 23.1% of the total purchases of the Group for the year ended December 31, 2004, 2005 and 2006 respectively.

An analysis by geographical segment, as determined by the customer's ship-to-location is as follows:

(In Thousands)

	Years Ended December 31		
	2004	**2005**	**2006**
Turnover:			
PRC	$ 55,930	$ 60,889	$ 92,801
Korea	10,345	22,957	15,018
Japan	6,092	6,323	9,603
Taiwan	18,898	14,891	6,559
Others	931	492	934
	$ 92,196	$ 105,552	$ 124,915
Segment results:			
PRC	$ 33,386	$ 38,426	$ 50,453
Korea	7,163	14,865	8,968
Japan	4,144	3,434	4,138
Taiwan	9,428	7,738	3,958
Others	672	348	626
	54,793	64,811	68,143

(Continued)

	Years Ended December 31		
	2004	2005	2006
Research and development	(20,260)	(25,421)	(30,570)
Selling, general and administrative	(16,348)	(20,279)	(27,801)
Patent related litigation	(5,334)	(10,174)	(10,962)
Stock Exchange of Hong Kong listing expenses	-	(2,460)	(786)
Stock-based compensation	(6,940)	(15,862)	(3,045)
Income (loss) from operations	5,911	(9,385)	(5,021)
Non-operating income, net	2,705	2,704	2,858
Income (loss) before income tax	8,616	(6,681)	(2,163)
Income tax (expense) benefit	(1,472)	(1,034)	2,450
Net income (loss)	$ 7,144	$ (7,715)	$ 287

24. DISTRIBUTABLE RESERVES

In the opinion of the directors of the Company, the Company did not have any distributable profits as at December 31, 2005 and 2006. However, the directors have not made any determination as to whether any of the share premium account of the Company may be distributable for the purposes of Cayman Islands law.

25. SUBSEQUENT EVENT

There is no significant event which has occurred to any business or group company since December 31, 2006.