O2MICRO INTERNATIONAL LTD
Form 20-F
June 19, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549
FORM 20-F

(Mark One)

[ ] Registration statement pursuant to Section 12(b) or 12(g) of the Securities Exchange Act of 1934 or

[x] Annual report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 For the fiscal year ended December 31, 2006 or

[ ] Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 For the transition period from ____ to_____. or

[ ] Shell company report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 Date of event requiring this shell company report

Commission file number: 0-30910

O2MICRO INTERNATIONAL LIMITED
(Exact Name of Registrant as Specified in Its Charter)
The Cayman Islands
(Jurisdiction of Incorporation or Organization)
Grand Pavilion Commercial Centre, West Bay Road
P.O. Box 32331 SMB, George Town
Grand Cayman, Cayman Islands
(Address of Principal Executive Offices)

Securities registered or to be registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange On Which Regi
American Depositary Shares	Nasdaq Global Select Market
Ordinary Shares, par value $0.00002 per share	The Stock Exchange of Hong Kong Li
	Cayman Islands Stock Exchange

Securities registered or to be registered pursuant to Section 12(g) of the Act:

None
(Title of Class)

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act:

None
(Title of Class)

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report.

As of December 31, 2006, there were 1,906,969,950 ordinary shares, par value US$0.00002 per share, outstanding.

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes [ ] No [x]

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

Yes [ ] No [x]

Note - Checking the box above will not relieve any registrant required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 from their obligations under those Sections.

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes [x] No [ ]

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer [] Accelerated filer [x] Non-accelerated filer []

Indicate by check mark which financial statement item the registrant has elected to follow:

Item 17 [ ] Item 18 [x]

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes [ ] No [x]

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Certain Definitions and Conventions

In this annual report on Form 20-F (this "Annual Report"), references to "$" and "dollars" are to United States dollars. Percentages and certain amounts contained herein have been rounded for ease of presentation. Any discrepancies in any table between totals and the sums of amounts listed are due to rounding.

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This Annual Report contains statements of a forward-looking nature. These statements are made under the "safe harbor" provisions of the U.S. Private Securities Litigation Reform Act of 1995. You can identify these forward-looking statements by terminology such as "may," "will," "expects," "should," "could," "plans," "intends," "anticipates," "believes," "estimates," "predicts," "potential" or "continue" or the negative of these terms and other comparable terminology. These forward-looking statements include, without limitation, statements regarding our expectation to increase expenses for personnel, new product development, to protect our technology and to expand our product offerings, our anticipation that sales to a relatively small number of customers will continue to account for significant portion of net sales, our expectation that non-U.S. operations and sales will continue to grow and account for a substantial percentage of our net sales, our statements regarding the growing popularity of thinner displays, mobile computing and portable devices, and the emergence and continued development of the Internet and wireless communications networks, our belief that we participate in large and growing markets, our belief that potential future growth in the LCD television market, especially units with larger-size panels, represents an attractive growth opportunity for us, our belief that manufacturers are turning to innovative new semiconductor technologies to manage the available power source capacity more efficiently, our belief that there is an increasing need for higher levels of system integration, our belief in the need for mixed-signal and analog integrated circuits specifically designed to optimize the power system usage in devices, our belief in the need to use advanced design methodologies to allow manufacturers to achieve rapid time-to-market with their new products, our expectation that our markets will be dominated by a small number of major brand name companies, our expectation that we will experience the highest sales volume in the third and fourth quarter of each year, our ability to develop and introduce products in a timely manner to meet customer demands, our expectation that analog and mixed-signal circuits have substantially longer life-cycles than digital integrated circuits, our ability to take advantage of cost-efficiencies associated with the "fabless" semiconductor business model, our future gross profit, our expectation that gross margin on products we sell will typically decline over the life of the products, our expectation that gross profit as a percentage of net sales will continue to fluctuate, our expectation that research and development expenses as a percentage of net sales will continue to fluctuate, our expectation to continue development of innovative technologies and processes, and continued expansion and investment of our engineering, research and development resources, our expectation to continue to invest significant resources into research and development in the future, our expectation that selling, general and administrative expenses will continue to increase in absolute dollars, our expectation that patent litigation expenses will continue to fluctuate in absolute dollars and will remain significant leading up to and during our trials scheduled for July 2007 and February 2008, our expectations regarding the outcome of litigation matters, our belief that cash balances will be sufficient to meet our capital requirements for at least the next 12 months, our belief that our research and development staffing will increase in the next 12 months primarily due to expansion of existing design

centers and the opening of additional design centers, our intention to continue expanding research and development operations, our intention to expand the scope of our international operations, our expectation that semiconductor companies will increasingly be subject to infringement claims as the number of products and competitors in the semiconductor industry grows, our belief that we operate in compliance with all applicable transfer pricing laws in all of the jurisdictions in which we operate, our belief regarding our efforts to remediate concerns relating to our internal controls, our anticipation that we will not declare any dividend in the foreseeable future,

our belief that our system-level expertise and extensive experience with power management systems allow us to develop proprietary solutions and foster long-term relationships with our customers, our intention to continue to evaluate additional investment opportunities in our supply chain, our belief that our current facilities are adequate for our needs for the foreseeable future, and that any additional space required will be available to us on commercially reasonable terms, our expectation that our results of operations or cash flows will not be affected to any significant degree by a sudden short-term change in market interest rates, and our statements regarding the effect of adoption of certain accounting policies. These forward-looking statements are based on our current assumptions and beliefs in light of the information currently available to us. Actual results, levels of activity, performance or achievements may differ materially from those expressed or implied in these forward-looking statements for a variety of reasons, including: changes in demand for devices that use our products; market conditions in the semiconductor industry and the economy as a whole; the stages of our products in their life cycles, variations, expansions or reductions in the mix of our product offerings, the timing of our product introductions, specific product manufacturing costs, increased competition, introduction of new competing technologies and the increase of unexpected expenses, and such other factors discussed under "Key Information - Risk Factors", "Operating and Financial Review and Prospects" and elsewhere in this Annual Report. We assume no obligation to update or revise any forward-looking information, whether as a result of new information, future events or otherwise. You are cautioned not to place undue reliance on these forward-looking statements which apply only as of the date of this Annual Report.

PART I

ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISORS

Not applicable.

ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE

Not applicable.

ITEM 3. KEY INFORMATION

SELECTED CONSOLIDATED FINANCIAL DATA

The selected consolidated financial data for the years ended December 31, 2004, 2005 and 2006, and the selected consolidated financial data as of December 31, 2005 and 2006, set forth below, are derived from our audited consolidated financial statements included herein, and should be read in conjunction with, and are qualified in their entirety by reference to, these consolidated financial statements, including the notes to these consolidated financial statements and "Item 5. Operating and Financial Review and Prospects" included elsewhere in this Annual Report on Form 20-F. The selected consolidated

financial data for the years ended December 31, 2002 and 2003 and the selected consolidated financial data as of December 31, 2002, 2003 and 2004, set forth below, are derived from our audited consolidated financial statements and related notes which do not appear in this Annual Report on Form 20-F. Our consolidated financial statements are prepared and presented in accordance with generally accepted accounting principles in the United States of America.

	Year Ended December 31,				
	2002	2003	2004	2005	200
	(in thousands, except per share data)				
Consolidated Statement of Operations Data:					
Net sales	$ 70,187	$ 88,599	$ 92,196	$ 105,552	$ 12
Cost of sales	28,143	38,314	37,403	40,741	5
Gross profit	42,044	50,285	54,793	64,811	6
Operating expenses:					
Research and development	18,965	19,219	20,260	25,421	3
Selling, general and administrative	11,804	13,522	16,348	20,279	2
Patent related litigation	535	3,954	5,334	10,174	1
Stock Exchange of Hong Kong listing expenses	--	--	--	2,460	
Total operating expenses	31,304	36,695	41,942	58,334	7
Income (loss) from operations	10,740	13,590	12,851	6,477	(
Non-operating income - net	1,662	1,437	2,705	2,704	
Income (loss) before income tax	12,402	15,027	15,556	9,181	(
Income tax expense (benefit)	1,673	1,826	1,472	1,034	(
Net income	10,729	13,201	14,084	8,147	
Earnings per share(1):					
Basic	0.0056	0.0069	0.0072	0.0042	0
Diluted	0.0054	0.0066	0.0070	0.0041	0
Shares used to compute basic earnings per share(1):	1,915,000	1,918,700	1,957,800	1,961,168	1,93
Shares used to compute diluted earnings per share(1):	1,979,550	1,986,800	2,005,100	1,997,459	1,94
Earnings per ADS(2):					
Basic	0.28	0.34	0.36	0.21	
Diluted	0.27	0.33	0.35	0.20	
ADS equivalents used to compute basic earnings per ADS(2):	38,300	38,374	39,156	39,223	3
ADS equivalents used to compute diluted earnings per ADS(2):	39,591	39,736	40,102	39,949	3

	December 31,				
	2002	2003	2004	2005	2006
	(in thousands)				
Consolidated Balance Sheet Data:					
Cash and cash equivalents	$ 69,334	$ 66,489	$ 56,320	$ 46,375	$ 45,438
Short-term investments	42,675	53,923	63,768	55,653	19,697
Working capital	120,793	130,510	132,713	117,942	90,865
Total assets	145,836	169,293	185,196	199,655	197,020
Long-term liabilities, excluding current portion	--	--	--	--	455
Net assets	135,148	154,727	170,781	175,896	173,511
Ordinary shares and additional paid-in capital	126,232	137,115	139,620	138,275	140,262

(1) All share information has been adjusted retroactively to reflect the 50-for-1 share split effected on November 25, 2005.

(2) Fifty ordinary shares equal one American Depositary Share ("ADS").

CAPITALIZATION AND INDEBTEDNESS

Not applicable.

REASONS FOR THE OFFER AND USE OF PROCEEDS

Not applicable.

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RISK FACTORS

We wish to caution readers that the following important factors, and those important factors described in other reports submitted to, or filed with, the Securities and Exchange Commission, among other factors, could affect our actual results and could cause our actual results to differ materially from those expressed in any forward-looking statements made by us or on our behalf and that such factors may adversely affect our business and financial status and therefore the value of your investment:

If the markets for consumer electronics, computers, industrial or communications products do not grow substantially or even decrease, our net sales may be harmed.

Our business focuses on designing, developing and marketing high performance integrated circuits for manufacturers of products for the consumer electronics, computer, industrial and communications markets. As many of the leading sellers of these products have an intermediary manufacture their products or those portions of their products containing our components, we currently derive substantially all of our product revenues from sales to these intermediaries or their suppliers. We also have targeted and are designing products for applications such as LCD monitors, LCD televisions, notebook computers, Internet security, mobile phones, GPS and portable media players, such as portable DVD players. We believe that the important factors driving growth in these markets have been the growing popularity of thinner displays,

mobile computing and portable devices, and the emergence and continued development of the Internet and wireless communications networks. If demand for products using LCDs or other devices using our products declines, or does not grow as quickly as we anticipate, our customers may experience lower demand for their products that use our products, which may cause our net sales to suffer. We cannot be certain that the markets for these products will continue to grow as rapidly as they have in the past or that a significant slowdown in these markets will not occur.

Fluctuations in our quarterly operating results due to factors such as changes in the demand for electronic devices that utilize our products could adversely affect the trading price of our ordinary shares and/or our ADSs.

We believe that quarter-to-quarter comparisons of our financial results are not necessarily meaningful indicators of our future results of operations, and they should not be relied upon as an indication of our future performance. If our quarterly operating results fail to meet the expectations of securities analysts, the trading price of our ordinary shares and/or our ADSs could be adversely affected. Our quarterly operating results have varied substantially in the past and may vary substantially in the future depending upon a number of factors described below and elsewhere in this Risk Factors section, including many factors that are beyond our control. These factors include changes in demand for devices that use our products; market conditions in the semiconductor industry and the economy as a whole; the timing and cancellation of customer orders; the level of orders received that can be shipped in a quarter; the availability of third party semiconductor foundry, assembly and test capacities; fluctuations in manufacturing yields; delays in the introduction of new products; changes in the mix of sales of higher margin products and lower margin products; seasonal changes in demand during the year-end holiday season for devices that use our products; and the amount of legal and other expenses incurred in a particular quarter.

In addition, the trading price of our ordinary shares and/or our ADSs may be affected by factors such as: significant price and volume fluctuations in our ordinary shares and/or our ADSs and financial markets in the U.S. and other countries, as well as relatively thin trading volume of our ordinary shares and/or our ADSs on Nasdaq and the HKSE, respectively. Further, the trading markets for our ordinary shares and/or our ADSs are affected by the research reports that securities or industry analysts publish about us or our business. We do not have control over such coverage. If one or more analysts were to downgrade our ordinary shares and/or our ADSs, the price of our ordinary shares and/or our ADSs may decline. If one or more analysts cease coverage of our company or does not regularly publish reports on us, we may lose visibility in the financial markets, which could cause the price of our ordinary shares and/or our ADSs or trading volume to decline.

If orders for our products are cancelled or deferred, our net sales, operating margins and net income could be substantially reduced.

Orders for our products can be cancelled or deferred with little notice from and without significant penalty to our customers. A significant portion of our net sales in any financial reporting period depends on orders booked and shipped in that period. If a large amount of orders placed is cancelled or deferred, our net sales in that period could be substantially reduced. Since we do not have significant non-cancellable backlog, we typically plan our production and inventory expenses based on internal forecasts of customer demand, which are highly unpredictable and can fluctuate substantially. In particular, in response to anticipated lengthy lead times, which in the past have been as much as ten weeks or more, to obtain inventory and materials from

our suppliers, we place orders with these suppliers in advance of anticipated customer demand, which can result in excess inventory if the expected orders fail to materialize. We also expect to increase our expenses for personnel and new product development. It is difficult for us to reduce our production, inventory, personnel and new product development expenses quickly in response to any shortfalls in net sales resulting from cancelled or deferred orders. As a result, any cancellation or deferral of orders would not only harm our net sales, it would also likely have a disproportionately adverse effect on our operating margins and net income.

We depend on third parties to manufacture, assemble and test our products and, if they are unable to do so, our ability to ship products and our business and results of operations will be harmed.

We do not own or operate the integrated circuit fabrication facilities that manufacture the products we design. Three foundries, SMIC, TSMC and X-FAB, manufactured most of the integrated circuit products that we sold in 2006. These foundries manufacture integrated circuit products for us according to purchase orders. We do not have a guaranteed level of production capacity at any of these foundries, and any one or more could raise prices without notice. Although we provide the foundries with rolling forecasts of our production requirements, the ability of each foundry to provide wafers to us is limited by the foundry's available capacity. The term "wafers" refers to slices of silicon used to manufacture integrated circuits, and it is one of the principal raw materials in our products. These foundries could choose to prioritize capacity for other customers, particularly larger customers, reduce or eliminate deliveries to us on short notice or increase the prices they charge us. Accordingly, we cannot be certain that these foundries will allocate sufficient capacity, if any, to satisfy our requirements particularly during any industry-wide capacity shortages. In addition, if any of these foundries were unable to continue manufacturing our products in the required volumes at acceptable quality, yields and costs or in a timely manner, our business and results of operations would be seriously harmed.

There are other significant risks associated with our reliance on these foundries, including the disruption in our ability to ship products caused by the length of time, as much as 12-to-18 months, required for us to find alternative foundries for existing or new products; the reduction or elimination of deliveries to us by these outside foundries caused by a sudden increase in demand for semiconductor devices or a sudden reduction or elimination of manufacturing capacity by any existing manufacturers of semiconductor devices; the unavailability of, or delays in obtaining access to, key process technologies used by these foundries; and the susceptibility of our outside foundries to production interruptions resulting from natural disasters, such as the interruptions experienced in Taiwan in the past due to earthquake activity. Any of these events could cause these foundries to reduce or eliminate deliveries to us and cause disruption in our ability to ship products to our customers which could negatively affect our business and results of operations.

We also rely on independent subcontractors to assemble and test most of our integrated circuit products. We do not have long-term agreements with any of these subcontractors but obtain services from them primarily on a purchase order basis. Our reliance on these subcontractors involves risks such as reduced control over delivery schedules, quality assurance and costs. These risks could result in product shortages or

increase our costs of manufacturing, assembling or testing our products. If these subcontractors were unable or unwilling to continue to provide assembly and test services and deliver products at acceptable quality, yields and costs

or in a timely manner, our business would be seriously harmed. We would also have to identify and qualify substitute subcontractors, which would be time consuming and costly and could result in unforeseen operational difficulties.

If we cannot compete effectively against new and existing competitors, our net sales and gross margins could be harmed.

Our ability to compete successfully in the market for integrated circuit products depends on factors both within and outside our control, including: our success in designing and subcontracting the manufacture of new products that implement new technologies and satisfy our customers' needs; the performance of our products across a variety of parameters such as reliability and cost efficiency; the price of our products and those of our competitors; our ability to control production costs; and the features of our competitors' products.

We believe our principal competitors include Intersil Corporation, Linear Technology Corporation, Maxim Integrated Products, Inc., Microsemi Corporation, Monolithic Power Systems, Inc., Ricoh Company, Ltd., Rohm Co., Ltd and Texas Instruments Incorporated. There is also competition from the internal integrated circuit design and manufacturing capabilities of some of our existing and potential customers, such as Toshiba and Fujitsu. In addition to these competitors, other integrated circuit companies may decide to enter the market with mixed-signal integrated circuit products that compete with our products or incorporate functions similar to those provided by our products.

Some of our competitors, such as Texas Instruments, have greater name recognition, their own manufacturing capabilities, significantly greater financial and technical resources, and the sales, marketing and distribution strengths that are normally associated with large multinational companies. These competitors may also have pre-existing relationships with our customers or potential customers. These competitors may be able to introduce new technologies more quickly, address customer requirements more rapidly and devote greater resources to the promotion and sale of their products than we do. Further, in the event of a manufacturing capacity shortage, these competitors may be able to manufacture products themselves or obtain third-party manufacturing capability when we are unable to do so.

If we do not develop and introduce new products in a timely manner, our net sales and gross margins could be harmed.

Our success depends upon our ability to develop and introduce new products selected for design into products for the consumer electronics, computer, industrial and communications markets. If we are unable to develop new products in a timely manner, our net sales will suffer. In addition, because our gross margins typically decline over the life cycle of our products as a result of competitive pressures and voluntary pricing arrangements, any failure to develop new products in a timely manner will likely cause our gross margins to decline. The development of our new products is highly complex, and from time to time we have experienced delays in the introduction of new products of as much as eight-to-twelve weeks or more. Successful product development and introduction of new products depend on a number of factors, including accurate new product definition; timely completion of new product designs; achievement of manufacturing yields; timely and cost-effective production of new products; and timely delivery of new third-party supplied products used as key components in devices that incorporate our products. We often incur significant expenditures in the development of a new product without any assurance that it will be selected for design into our customers' products. If we incur such expenditures but fail to be selected, our results of operations will be adversely affected and may fluctuate significantly from period to period. Furthermore, even if our products were selected for design into our customers' products, we cannot be certain that these products will be commercially successful or that we will

benefit from any associated sales.

It is difficult to evaluate our future prospects, and we cannot assure you that we will not incur future losses.

Our past results cannot be relied upon to predict our future performance. We incurred net losses in each year prior to the year ended December 31, 1999. We then experienced significant quarter-to-quarter sales growth in each of the years ended December 31, 2001, 2002 and 2003. However, since the first quarter ended March 31, 2004, we have experienced fluctuations in net sales compared to the previous quarter. Our net sales are subject to fluctuation from quarter to quarter, our previous overall growth may not continue, and we may not be able to sustain or increase profitability in the future. We anticipate that our expenses will increase substantially in the foreseeable future as we continue to develop our technology, protect our technology, expand our product offerings and expand our capabilities. These efforts may prove more expensive than we currently anticipate, and we may not succeed in increasing our net sales sufficiently to offset our increased expenses. If we fail to increase our net sales to keep pace with our increased expenses, we may again experience net losses in future periods, which could cause the trading price of our ordinary shares and/or our ADSs to decline.

If we fail to protect our intellectual property rights, competitors may be able to use our technology or trademarks, and this could weaken our competitive position, increase our costs, reduce our margins and reduce our net sales.

Our success is heavily dependent upon our proprietary technology. We rely primarily on a combination of patent, copyright and trademark laws, trade secrets, confidentiality procedures and contractual provisions to protect our proprietary technology and prevent competitors from using our technology in their products. These laws and procedures provide only limited protection. Our patents may not provide sufficiently broad protection or they may not prove to be enforceable in actions against alleged infringement.

Our ability to sell our products and prevent competitors from misappropriating our proprietary technology and trade names is dependent upon protecting our intellectual property. Despite the precautions we take, unauthorized third parties may copy aspects of our current or future products or obtain and use information that we regard as proprietary. Additionally, our competitors may independently develop similar or superior technology. Policing unauthorized use of software, circuit design or semiconductor design is difficult and some countries' laws do not protect our proprietary rights to the same extent as the laws of the United States, Hong Kong and other developed countries. We have in the past and currently have initiated litigation to protect our intellectual property rights. Litigation may be necessary in the future to enforce our intellectual property rights, to protect our trade secrets or to determine the validity and scope of the proprietary rights of others. Litigation could result in substantial costs and diversion of resources, and could also result in a decision that our intellectual property is invalid or unenforceable and, could adversely affect our business, future results of operations and financial condition. See the section headed "Business Overview--Intellectual Property".

If we cannot adapt our product offerings to respond to rapid technological changes, our net sales will be harmed.

The markets for consumer electronics, computer, industrial and communications products, and the components used in these products, are

characterized by rapidly changing technology and very frequent new product introductions by our direct customers and our competitors. For example, the microprocessor, display and battery technologies with which our products inter-operate change very rapidly. Although our products integrate analog and mixed-signal circuits and therefore have substantially longer life-cycles than digital integrated circuits, we must still update our products or introduce new ones on a regular basis. If we do not respond in a timely manner to technological changes and new product introductions by our direct customers and competitors, we will be unable to maintain and grow our product sales. In addition, the emergence of significantly more efficient or cost-effective microprocessor, display and battery technologies could lessen the need for the power management functionality of our products, which would harm our net sales.

Defects in our products could result in significant costs and could impair our ability to sell our products.

Detection of any significant defects in our products may result in, among other things, loss of or delay in market acceptance and sales of our products, diversion of development resources, injury to our reputation and increased service and warranty costs. Because our products are complex, they may contain defects that can be detected at any point in a product's life cycle. These defects could harm our reputation, which could result in significant costs to us and could impair our ability to sell our products. The costs we may incur in correcting any product defects may be substantial and could materially adversely affect our results of operations. While we continually test our products for defects and work with customers through our customer support services to identify and correct problems, defects in our products may be found in the future. Testing for defects is complicated in part because it is difficult to simulate the highly complex environments in which our customers may use our products. In the past, we have discovered defects in our products and have experienced delays in the shipment of our products. These delays have principally related to new product update releases. To date, none of these delays has materially affected our business. However, product defects or delays in the future could be material, and could adversely affect our reputation and our ability to sell our products.

We have substantial operations outside of the United States that expose us to risks specific to our international operations that could harm our net sales and net income.

As of December 31, 2006, a substantial portion of our operations, most of our employees, and most of the third parties we use to manufacture, assemble and test our products were located in Japan, Korea, China, Singapore and Taiwan. In addition, sales outside the United States as a percentage of net sales were almost 100% in the years ended December 31, 2002, 2003, 2004, 2005 and 2006. We expect our non-U.S. operations to grow and non-U.S. sales to continue to account for a substantial percentage of our net sales.

We are subject to risks specific to our international business operations, including: the risk of supply disruption, production disruption or other disruption arising from the outbreak of any severe communicable disease or other widespread health problems; the risk of potential conflict and further instability in the relationship between Taiwan and China; risks related to international political instability and to the recent global economic turbulence and adverse economic circumstances in Asia, such as in Japan and Korea; unpredictable consequences on the economic conditions in the U.S. and the rest of the world arising from terrorist attacks, such as the attacks of September 11, 2001 in the U.S. and other military or security operations, particularly with regard to the conflicts in the Middle East involving Iraq; unexpected

changes in regulatory requirements or legal uncertainties regarding tax regimes, such as the change to the tax code of Taiwan in 2001 that resulted in a higher income tax rate on our retained earnings; tariffs and other trade barriers, including current and future import and export restrictions; difficulties in staffing and managing international operations; adverse effects of changes in foreign currency exchange rates on our results of operations; limited ability to enforce agreements and other rights in foreign countries; changes in labor conditions; longer payment cycles and greater difficulty in collecting accounts receivables; burdens and costs of compliance with a variety of foreign laws; expropriation of private enterprises; and reversal of the current policies (including favorable tax and lending policies) encouraging foreign investment or foreign trade by our host countries. In addition, the geographical distances between Asia, the U.S., the Cayman Islands and Europe also create a number of logistical and communication challenges. Although we have not experienced any serious harm in connection with our international operations, we cannot assure you that such problems will not arise in the future.

In addition, our reporting currency is the U.S. dollar. However, a significant portion of our operating expenses is denominated in currencies other than the U.S. dollar, primarily the New Taiwan dollar and the Chinese Renminbi. As a result, appreciation or depreciation of other currencies in relation to the U.S. dollar could result in material transaction or translation gains or losses that could adversely affect, or cause fluctuations in, our results of operations. We do not currently engage in currency hedging activities.

We will need to recruit and retain qualified personnel to grow our business successfully.

Our future success will depend on our ability to attract and retain experienced sales, research and development, marketing, customer support and management personnel. If we do not attract and retain these personnel, our ability to grow our business, sell our products, enter new markets and increase our share of existing markets could be harmed. There can be no assurance that we will be successful in hiring for these positions in the near future. Our sales strategy requires that we hire additional direct sales persons and independent sales representatives in our major markets. Moreover, our independent sales representatives and direct sales personnel must market our products effectively and be qualified to provide timely and cost-effective customer support and service. If they are unable to do so or if we are unable to expand these organizations, this could harm our ability to increase our net sales and limit our ability to sell our products or expand our market share. Competition for qualified personnel in digital, analog and mixed-signal integrated circuit design is intense. In the past, we have experienced difficulty in recruiting qualified personnel, especially technical and sales personnel. As we intend to expand the scope of our international operations, this will require us to attract experienced management, research and development, marketing, sales and customer support personnel for our international offices. We expect competition for qualified personnel to remain intense, and we may not succeed in attracting or retaining such personnel. In addition, new employees generally require substantial training in our design methodology, design flow and technology, which in turn requires significant resources and management attention. There is a risk that, even if we invest significant resources in attempting to attract, train and retain qualified personnel, we will not be successful in our efforts. In that event, our costs of doing business would increase without a corresponding increase in net sales.

Our success will depend to a significant extent on the continued service of our executive officers, including Sterling Du, our chief executive officer and chairman of our board, and other key employees, including key sales,

consulting, technical, marketing and legal personnel. If we lose the services of one or more of our executives or key employees, our business and ability to implement our business objectives successfully could be harmed, particularly if one or more of our executives or key employees decide to join a competitor or otherwise compete directly or indirectly with us.

A substantial portion of our net sales is generated by a small number of customers. If any of these customers delays or reduces its orders, our net sales and earnings may be harmed.

Historically, a relatively small number of customers has accounted for a significant portion of our net sales in any particular period. We have no long-term volume purchase commitments from any of our significant customers. We cannot be certain that our current customers will continue to place orders with us, that orders by existing customers will continue at the levels of previous periods or that we will be able to obtain orders from new customers. In addition, some of our customers, acting as intermediary manufacturers, supply products to end-market purchasers, and any of these end-market purchasers could choose to reduce or eliminate orders for our customers' products. This would in turn lower our customers' orders for our products.

In 2006, no customer accounted for 10% or more of net sales. In 2005, no customer accounted for 10% or more of net sales. In 2004, one customer accounted for 17.5% of our net sales. The variations in sales to these customers as a percentage of our total net sales have been caused by a number of factors, some of which were outside our control. We anticipate that sales of our products to a relatively small number of customers will continue to account for a significant portion of our net sales. The reduction, delay or cancellation of orders from one or more of our significant customers would have a disproportionately negative impact on our results of operations.

Our ability to manage growth will affect our ability to achieve and maintain profitability.

Our ability to maintain profitability will depend in part on our ability to implement and expand operational, customer support and financial control systems and to train and manage our employees. We may

not be able to augment or improve existing systems and controls or implement new systems and controls in response to future growth, if any. In addition, we will need to expand our facilities to accommodate the growth in our personnel. Any failure to manage growth could divert management attention from executing our business plan and adversely affect our ability to expand our business successfully. Our historical growth has placed, and any further growth is likely to continue to place, a significant strain on our resources. In order to grow successfully, we will need to maintain close coordination among our executive, engineering, accounting, finance, marketing, sales, operations and customer support organizations, particularly in light of the internationally dispersed nature of our operations.

Third parties have asserted, and in the future could assert, that our products infringe their intellectual property rights. These claims could harm our ability to sell our products and expose us to litigation.

As is typical in the semiconductor industry, we have from time to time received communications from third parties asserting patents that cover certain of our technologies or products and alleging infringement of certain of their intellectual property rights. We may receive similar communications in the future. In the event any third party were to make a valid claim against us or

our customers, we could be enjoined from selling selected products such as our inverter or power products or could be required to pay royalties to third parties. Third-party infringement claims, with or without merit, have been and could continue to be time consuming, result in substantial diversion of our resources and potentially significant litigation costs, including costs related to any damages we may owe, cause product shipment delays or require us to enter into license agreements. Such license agreements may not be available on acceptable terms, or at all. Any such event could seriously harm our business and our results of operations. We expect that semiconductor companies will increasingly be subject to infringement claims as the number of products and competitors in the semiconductor industry grows. See the section headed "Business Overview--Intellectual Property."

From time to time, in the normal course of business, we agree to indemnify third parties with whom we enter into contractual relationships, including customers and parties to other transactions with us, with respect to certain matters. We have agreed, under certain conditions, to hold these third parties harmless against specified losses, such as those arising from a breach of representations or covenants, other third-party claims that our products when used for their intended purposes infringe the intellectual property rights of such other third parties or other claims made against certain parties. It is not possible to determine the maximum potential amount of liability under these indemnification obligations due to our limited history of prior indemnification claims and the unique facts and circumstances that are likely to be involved in each particular claim. To date, we have not made any payments under these obligations.

Until all outstanding litigation is resolved, we will continue to incur substantial legal expenses that vary with the level of activity in the legal proceedings. This level of activity is not entirely within our control as we may need to respond to legal actions. Consequently, we may find it difficult to predict the legal expenses for any given period, which will impair our ability to forecast our results of operations for that period. It is likely that these expenses will remain significant leading up to and during our trials scheduled for July 2007 and February 2008.

Given the inherent uncertainties in litigation, there cannot be any assurance that we will prevail in any particular litigation matter, and we cannot predict the outcome of any such litigation. If any party were to prevail in its claims against us, our rights to certain patents and results of operations could be materially adversely affected. In any litigation arising from claims that we infringe on the intellectual property rights of others, an adverse result could involve an injunction to prevent the sales of a material portion of our products, and a reduction or the elimination of the value of related inventories, any of which could have a material adverse effect on our net sales, results of operations and financial condition. See the section headed "Business Overview--Intellectual Property."

We may be subject to lawsuits from third parties.

We are a defendant or plaintiff in actions that arise in the normal course of business as well as actions that arose as counterclaims in response to our patent infringement actions, including actions for antitrust, unfair competition and interference. While we currently believe the amount of ultimate liability, if any, with respect to these actions will not materially affect our financial position, overall trends in results of operations, or liquidity, the ultimate outcome of any litigation or claim is uncertain, and the impact of an unfavorable outcome could be material to us.

Sales of our products could decline if our products fail to support evolving industry standards.

Our net sales are derived from sales of integrated circuit products that are components of electronic devices built to industry standards and widely accepted specifications. For example, the bus interconnect specifications of most notebook computers for attaching integrated peripherals are currently Peripheral Component Interconnect (PCI), Universal Serial Bus (USB) and Low Pin Count (LPC) and the software used to control the power management functions of many notebook computers conforms to the industry's Advanced Configuration Power Interface specification. Our products must be designed to conform to these standards and specifications in order to achieve market acceptance. Technology standards and specifications continually evolve, and we may not be able to successfully design and manufacture new products in a timely manner that conform to these new standards or specifications. Additionally, new products we develop to conform to new specifications may not be accepted in the market.

We have incurred, and continue to incur, significant costs with respect to corporate governance and financial reporting compliance.

The Sarbanes-Oxley Act of 2002, or the Sarbanes-Oxley Act, as well as new rules subsequently implemented by the Securities and Exchange Commission, or the SEC, and adopted by the Nasdaq in response to the Sarbanes-Oxley Act, have increased and will continue to increase the scope, complexity and costs of our financial reporting, securities disclosure and corporate governance practices. These new or revised rules, regulations, and listing requirements are subject to varying interpretations in many cases and their application in practice may evolve over time as new guidance is provided by regulatory and governing bodies. As a result, we may incur further legal and financial compliance costs and be required to make unanticipated changes to our reporting, disclosure and governance practices. These rules may divert management time and resources, make it more difficult for us to attract and retain qualified executive officers and members of our board, and make it more costly to obtain liability insurance coverage for our officers and directors which could prove disruptive to our business. In particular, the Sarbanes-Oxley Act requires that, among other things: our chief executive officer and chief financial officer personally certify our annual report on Form 20-F which is filed with the SEC each year, which certification includes statements as to the accuracy and fair presentation of the report's disclosure, the establishment and maintenance of controls and procedures related to our disclosure and issues regarding our internal accounting controls; we refrain from making most types of loans to our officers and directors after the adoption of the Sarbanes-Oxley Act or from making any material modifications to loans that existed prior to the adoption of the Sarbanes-Oxley Act; we furnish a report in certain SEC filings in the future pursuant to Section 404 of the Sarbanes-Oxley Act, as discussed in the following risk factor and our audit committee pre-approve all audit and non-audit services provided by our independent registered public accounting firm except for de minimis services; be directly responsible for the appointment, compensation and oversight of the work of our independent registered public accounting firm; establish procedures for the receipt and treatment of complaints received by us regarding accounting, controls or auditing matters and any confidential submissions by our employees regarding questionable accounting or auditing; comprise independent directors, as defined under the Sarbanes-Oxley Act and applicable Nasdaq rules. If we fail to comply with new or revised rules, regulations, and listing requirements in a timely manner, we may be exposed to liability and public perception of our financial reporting, securities disclosure and corporate governance practices could be negatively affected. As a result, the price of our ordinary shares and/or our ADSs could decline.

Our transfer pricing procedures may be challenged, which may subject us to higher taxes and adversely affect our earnings.

Transfer pricing refers to the prices that one member of a group of affiliated corporations charges to another member of the group for goods, services or the use of intellectual property. If two or more affiliated corporations are located in different countries, the laws or regulations of each country generally will require that transfer prices be the same as those charged by unrelated corporations dealing with each other at arm's length. If one or more of the countries in which our affiliated corporations are located believe that transfer prices were manipulated by our affiliated corporations in a way that distorts the true taxable income of the corporations, the laws of such countries could require us to redetermine transfer prices and thereby reallocate the income of our affiliate corporations in order to reflect such income clearly. Any reallocation of income from one of our corporations in a lower tax jurisdiction to an affiliated corporation in a higher tax jurisdiction would result in a higher overall tax liability to us. Moreover, if the country from which the income is being reallocated does not agree to the reallocation, the same income could be subject to taxation by both countries.

We have adopted transfer pricing agreements with our subsidiaries located in the United States, China, Taiwan, Japan and Singapore to regulate inter-company transfers. A transfer pricing agreement is a contract for the transfer of goods, services or intellectual property from one corporation to a related corporation that sets forth the prices that the related parties believe are those charged by unrelated corporations dealing with each other at arm's length. We have entered into these types of agreements because a portion of our assets, such as intellectual property developed in our U.S. and foreign subsidiaries, is transferred among our affiliated corporations. In such agreements, we have determined transfer prices that we believe are the same as the prices that would be charged by unrelated parties dealing with each other at arm's length. In this regard, we are subject to risks not faced by other companies with international operations that do not create inter-company transfers. If the taxing authorities of any jurisdiction, including Taiwan and the United States, were to challenge these agreements successfully or require changes in our transfer pricing practices, we could become subject to higher taxes and our earnings would be adversely affected. We believe that we operate in compliance with all applicable transfer pricing laws in all of the jurisdictions in which we operate. However, there can be no assurance that we will continue to be found to be operating in compliance with transfer pricing laws, or that such laws will not be modified, which, as a result, may require changes to our transfer pricing practices or operating procedures. Any determination of income reallocation or modification of transfer pricing laws could result in an income tax assessment of the portion of income deemed to be derived from the taxing jurisdiction that so reallocates the income or modifies its transfer pricing laws.

If we fail to maintain an effective system of internal controls, we may not be able to report our financial results accurately. As a result, we may fail to meet our reporting obligations and current and potential holders of ADSs and/or ordinary shares could lose confidence in our financial reporting, which could adversely affect the trading price of our ADS and/or ordinary shares.

Effective internal controls are necessary for us to provide reliable financial reports. If we cannot provide reliable financial reports or prevent fraud, our results of operations could be misstated, our reputation may be harmed and the trading price of our ADSs and/or ordinary shares could be adversely affected. In connection with the audit of our financial statements for the years ended December 31, 2002, 2003 and 2004, in May 2005 our independent registered public accounting firm reported to our audit committee a matter that was a "reportable condition" in our internal controls as defined in standards

established by the American Institute of Certified Public Accountants at that time. In general, reportable conditions are significant deficiencies in a company's internal controls that, in the auditor's judgment, could adversely affect the ability to record, process and report financial data consistent with the assertions of management in the financial statements. During 2005, we devoted significant resources to remediate and improve our internal controls. We believe that these efforts have remediated the concerns that gave rise to the "reportable condition." However, we cannot be certain that our controls over our financial processes and reporting will continue to be adequate in the future. Any failure of our internal controls over financial reporting could result in a material misstatement in financial statements.

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In addition, under Section 404 of the Sarbanes-Oxley Act, beginning with our annual report on Form 20-F for the fiscal year ended December 31, 2006, we are required to furnish a report by our management on our internal control over financial reporting. Such a report will contain, among other matters, an assessment of the effectiveness of our internal control over financial reporting as of the end of our fiscal year, including a statement as to whether or not our internal control over financial reporting is effective. This assessment must include disclosure of any material weaknesses in our internal control over financial reporting identified by management. Beginning with our annual report on Form 20-F for the fiscal year ending December 31, 2007, the report by our management on our internal control over financial reporting must also contain a statement that our independent auditors have issued an attestation report on management's assessment of such internal controls.

During this process, if our management identifies one or more material weaknesses in our internal control over financial reporting, we may be unable to assert that such internal control is effective. If we were unable to assert that our internal control over financial reporting is effective (or if our independent auditors were unable to attest that our management's report is fairly stated or they are unable to express an opinion on the effectiveness of our internal controls), we could lose investor confidence in the accuracy and completeness of our financial reports, which could have an adverse effect on the price of our ordinary shares and/or our ADSs.

Changes in accounting standards for stock option plans may impact our results of operations and our ability to use stock options to recruit, retain and motivate employees.

The Financial Accounting Standards Board published revisions to Statement of Financial Accounting Standards No. 123, or SFAS 123R, that required all public entities to treat the value of stock options granted to employees as an expense. As a public entity subject to SFAS 123R, we were required to record, as of the first annual reporting period beginning after June 15, 2005, in our case, beginning January 1, 2006, a compensation expense equal to the value of each stock option granted. This expense would be recognized over the vesting period of the stock option. The requirement to expense stock option grants reduced the attractiveness of granting stock options because the additional expense associated with these grants may adversely affect our results of operations. Accordingly, we may not be able to attract and retain key personnel if any future adverse effects on our profitability resulting from the application of SFAS 123R compel us to reduce the scope of our employee stock option plans. In addition, as a result of the requirement to adopt SFAS 123R to expense stock option grants beginning with the first fiscal year after June 15, 2005, our future profitability may be reduced.

We have never declared or paid dividends on our ordinary shares or other

securities and do not anticipate paying dividends in the foreseeable future.

We have not declared or paid dividends on our ordinary shares or other securities since our incorporation of the company. We do not anticipate declaring any dividend in the foreseeable future. Future dividends, if any, will be at the discretion of our board and will depend upon our future results of operations, capital requirements, general financial condition, legal and contractual restrictions and other factors our board may deem relevant.

Provisions in our Memorandum and Articles of Association may discourage potential acquisition bids for us and prevent changes in our management that our shareholders may favor.

Provisions in our Memorandum and Articles of Association could discourage potential acquisition proposals and could delay or prevent a change in control transaction that our shareholders favor. These provisions could have the effect of discouraging others from making offers for our ordinary shares. As a result, these provisions may prevent the market price of our ordinary shares or ADSs from reflecting the effects of actual or rumored takeover attempts and may prevent shareholders from reselling their ordinary shares or ADSs at or above the price at which they purchased their ordinary shares or ADSs. These provisions may also prevent changes in our management that our shareholders may favor. Our Memorandum and Articles do not permit shareholders to act by written consent, do not permit shareholders to call a general meeting and provide for a classified board of directors, which means shareholders can only elect a limited number of our directors in any given year. Furthermore, our board has the authority to issue up to 250,000,000 preference shares in one or more series. Our board can fix the price, rights, preferences, privileges and restrictions of such preference shares without any further vote or action by our shareholders but subject to any direction that may be given by the shareholders in a general meeting. The issuance of preference shares may delay or prevent a change in control transaction without further action by our shareholders or make removal of management more difficult.

As we are a Cayman Islands company, it could be difficult for investors to effect service of process on and recover against us or our directors and officers and our shareholders may face difficulties in protecting their interest.

We are a Cayman Islands company, and many of our officers and directors are residents of various jurisdictions outside the United States. A substantial portion of our assets and the assets of our officers and directors, at any one time, are and may be located in jurisdictions outside the United States. Although we have irrevocably agreed that we may be served with process in Santa Clara, California with respect to actions arising out of or in connection with United States federal securities laws relating to offers and sales of our ordinary shares and/or our ADSs, it could be difficult for investors to effect service of process within the United States on our directors and officers who reside outside the United States or to recover against us or our directors and officers on judgments of the United States courts predicated upon the civil liability provisions of the United States federal securities laws.

Our corporate affairs are governed by our charter documents, consisting of our Memorandum and Articles of Association, and by the companies law and common law of the Cayman Islands. The rights of our shareholders and the fiduciary responsibilities of our directors are governed by Cayman Islands law, which are not as clearly established as under statutes or judicial precedent in jurisdictions such as the United States. While there is some case law in the Cayman Islands on these matters, it is not as developed as, for example, in the

United States. In addition, the laws of the Cayman Islands relating to the protection of the interests of minority shareholders differ in some respects from those established under statutes or judicial precedent in existence in the United States. Such differences may mean that our minority shareholders may have less protection than they would have under the laws of the United States. Due to the less protective nature of such laws in the Cayman Islands, our shareholders may have more difficulty in protecting their interests in the face of actions by our management or directors than would shareholders of a corporation incorporated in some other jurisdictions.

We may become a passive foreign investment company, which could result in adverse U.S. tax consequences to U.S. investors.

We may be classified as a passive foreign investment company by the U.S. Internal Revenue Service for U.S. federal income tax purposes. Such characterization could result in adverse U.S. tax consequences to you if you are a U.S. investor. For example, if we are a passive foreign investment company, our U.S. investors will become subject to increased tax liabilities under U.S. tax laws and regulations and will become

subject to burdensome reporting requirements. The determination of whether or not we are a passive foreign investment company will be made on an annual basis and will depend on the composition of our income and assets, including goodwill, from time to time. Specifically, we will be classified as a passive foreign investment company for U.S. tax purposes if, after the application of look-through rules, either (a) 75% or more of our gross income in a taxable year is passive income, or (b) the average percentage of our assets (by value) in a taxable year that produce or are held for production of passive income is at least 50%. Our judgment is not binding on the Internal Revenue Service. In the future, the valuation of our intangible assets will be based in part on the then market value of our ADSs and ordinary shares which is subject to change. We cannot assure you that we will not be a passive foreign investment company for the current or any future taxable year. See "Taxation--United States Federal Income Taxation--Passive Foreign Investment Company."

Holders of ADSs may not be able to exercise their right to vote.

Holders of our ADSs may instruct the depositary of our ADSs to vote the ordinary shares underlying their ADSs but only if we ask the depositary to ask for instructions. Otherwise, they will not be able to exercise their right to vote unless they withdraw the ordinary shares underlying the ADSs they hold. However, they may not know about the meeting sufficiently enough in advance to withdraw those ordinary shares. If we ask for instructions, the depositary will notify the holders of the upcoming vote and arrange to deliver our voting materials to them. We cannot assure you that holders will receive the voting materials in time to ensure that they can instruct the depositary to vote their ordinary shares. In addition, the depositary and its agents are not responsible for failing to carry out voting instructions or for the manner of carrying out voting instructions. This means that holders may not be able to exercise their right to vote, and there is no guarantee that the ordinary shares underlying your ADSs would be voted as requested.

The depositary for our ADSs may give us a discretionary proxy to vote the ordinary shares underlying your ADSs if holders of ADSs do not vote at shareholders' meetings which could adversely affect their interests.

Under the deposit agreement for the ADSs, the depositary will give us a discretionary proxy to vote the ordinary shares underlying ADSs at shareholders' meetings if the holder of the ADSs did not vote, unless we notify the depositary

that we do not wish to receive a discretionary proxy, we think there is substantial shareholder opposition to the particular question, or we think the particular question would have a material adverse impact on our shareholders.

The effect of this discretionary proxy is that holders of ADSs cannot prevent the ordinary shares underlying their ADSs from being voted, absent the situation described above, and it may make it more difficult for shareholders to influence the management of our company. Holders of our ordinary shares are not subject to a discretionary proxy.

Holders of ADSs may not receive distributions on ordinary shares or any value for them if it is illegal or impractical to make them available.

The depositary of our ADSs has agreed to pay to ADS holders the cash dividends or other distributions it or the custodian for our ADSs receives on ordinary shares or other deposited securities after deducting its fees and expenses. Holders of our ADSs will receive these distributions in proportion to the number of ordinary shares the ADSs represent. However, the depositary is not responsible if it decides that it is unlawful or impractical to make a distribution available to any holders of ADSs. We have no obligation to take any other action to permit the distribution of our ADSs, ordinary shares, rights or anything else to holders of our ADSs. This means that ADS holders may not receive the distributions we make on ordinary shares or any value for them if it is illegal or impractical for us to make them available. These restrictions may have a material adverse effect on the value of the ADSs.

Holders of ADSs may be subject to limitations on transfer of ADSs.

ADSs represented by American Depositary Receipts, or ADRs, are transferable on the books of the depositary. However, the depositary may close its books at any time or from time to time when it deems expedient in connection with the performance of its duties. The depositary may refuse to deliver, transfer or register transfers of our ADSs generally when our books or the books of the depositary are closed, or at any time if we or the depositary thinks it is advisable to do so because of any requirement of law or any government or governmental body, or under any provision of the deposit agreement, or for any other reason.

ITEM 4. INFORMATION ON THE COMPANY

HISTORY AND DEVELOPMENT OF THE COMPANY

Our legal name is O2Micro International Limited. We are incorporated in Cayman Islands. Our registered office is located at M&C Corporate Services Limited, P.O. Box 309, Ugland House, South Church Street, George Town, Grand Cayman, Cayman Islands. Our principal executive offices are located at Grand Pavilion Commercial Centre, West Bay Road, P.O. Box 32331 SMB, George Town, Grand Cayman, Cayman Islands. Our telephone number is (345) 945-1110. We have a subsidiary, O2Micro, Inc., which was incorporated as a California corporation in March 1995. In March 1997, O2Micro International Limited was incorporated as a Cayman Islands company. In March 1997, we exchanged our ordinary shares and preference shares for common stock and preferred stock of O2 Micro, Inc. After the exchange, we held all of the outstanding capital stock of O2 Micro, Inc., our wholly owned subsidiary in the United States. On November 25, 2005, we effected a 50-for-1 share split of our ordinary shares and created an ADS program for our ADSs to be quoted on Nasdaq, with each ADS representing 50 ordinary shares. We delisted our ordinary shares from Nasdaq on November 25, 2005 and listed our ADSs on Nasdaq on November 28, 2005, the next trading day. We subsequently listed our ordinary shares on the Main Board of the Stock

Exchange of Hong Kong (the "SEHK") Limited on March 2, 2006 by way of introduction.

Our agent for service of process in the U.S. for the purpose of our securities filings is our chief executive officer, Sterling Du, c/o O2Micro, Inc., 3118 Patrick Henry Drive, Santa Clara, CA 95054.

Since January 1, 2004, our principal capital expenditures were investments in various private companies of approximately $18.8 million in the aggregate, $49.2 million in the purchase of land, property and equipment, and $3.8 million deposited for Taiwan court bonds in connection with preliminary injunction actions in Taiwan.

BUSINESS OVERVIEW

We design, develop and market high performance integrated circuits for power management and security applications, as well as systems security solutions. We focus our product design efforts on integrated circuits for consumer electronics, computer, industrial and communications products, including LCD computer monitors, LCD televisions, notebook computers, Internet security devices, GPS, mobile phones and portable DVD players. Our integrated circuit products manage and provide power for lighting of LCDs, provide connections between notebook computers and external plug-in cards, provide Internet security, control and monitor battery charging and discharging, and select and switch between power sources.

We believe that our focus on these products provides us with an opportunity to participate in large and growing markets. Potential future growth in the LCD television market, especially units with larger-size panels, represents an attractive growth opportunity for us because larger LCD panels require more of our inverters for cold cathode fluorescent lamps, or CCFLs.

Our integrated circuit products use analog, digital or mixed-signal designs that combine analog and digital circuits on a single chip, reducing the number of components needed and allowing our customers to reduce the size, weight, power requirements or cost of their products. We offer a wide range of proprietary application specific standard products as well as customized products. We work closely with our customers to identify their product needs and establish engineering priorities for new product designs and development. We believe that our system-level expertise and extensive experience with power management systems allow us to develop proprietary solutions and foster long-term relationships with our customers.

We sell our products to OEMs, ODMs and module makers. Our integrated circuits have been incorporated into products sold by Acer, Apple Computer, Dell, Fujitsu, Hewlett-Packard, Lenovo, LG Electronics, NEC, Samsung Electronics, Sharp, Sony and Toshiba, among others. We sell our products through our direct sales force, independent sales representatives and distributors in China, Hong Kong, Japan, Korea, Singapore, Taiwan and the United States. We also have design centers in many of our key markets to provide design and engineering support to our customers. We outsource the fabrication of our products to standard, high volume semiconductor foundries. This "fabless" approach allows us to focus on product development, minimize fixed costs and capital expenditures, and access diverse manufacturing technologies.

Our net sales have grown from $92.2 million in 2004 to $105.6 million in 2005 and $124.9 million in 2006. In the three months ended March 31, 2007, our net sales were $35.0 million, an increase of 20.4% as compared with net sales of $29.1 million in the same period in 2006.

Industry Background

The markets for consumer electronics, mobile computing and communications products, such as LCD monitors, LCD televisions, notebook computers, mobile handsets and portable entertainment devices, are large and growing as functionality increases and prices decrease. One of the most significant challenges in these markets remains the efficient management of power. As the number of applications and features available for these products has increased, the number and variety of power loads, or individual subsystems requiring voltage or current regulation, has also grown. Each additional application or feature can require multiple functions and circuits that, in turn, require more individually-regulated and managed power sources. Increasingly, manufacturers are turning to innovative new semiconductor technologies to manage the available power source capacity more efficiently.

Power management integrated circuits deliver power and regulate voltage, controlling the flow of electrical energy among the various power loads and energy sources in a product or system. Power management requires a combination of two distinct technological disciplines: digital integrated circuit design and analog integrated circuit design. Digital circuits, such as microprocessor and memory semiconductors, provide most of the functionality of computer processing. However, digital circuits generally cannot handle significant amounts of current or multiple voltage levels. In contrast, analog circuits use and manipulate continuously varying voltage and current levels. Battery power systems, which have relatively high and continuously varying power levels, are inherently analog systems.

Digital integrated circuit technology can be used to manage power systems more intelligently and efficiently and help to prolong battery life in mobile applications. However, since battery power systems are analog by nature, mixed-signal integrated circuits, or circuits that incorporate both digital and analog technologies, are necessary in order to harness the intelligence provided by digital technology. Designing mixed-signal integrated circuits poses a number of difficulties: analog circuits are more sensitive than digital circuits to the physical layout and electrical characteristics of the circuit; analog circuit designers must have a very high level of circuit design experience; and basic differences in the technologies used in digital and analog circuit design make combining the technologies problematic.

In addition, mixed-signal integrated circuits comprise both digital and analog components, and the trend toward more complex devices has increased the number of components substantially. Integrating the

functions of those components on a single chip, known as a system-on-a-chip, can enable manufacturers to make products smaller, lighter and more reliable. Thus, as mobile computing and communications devices grow in complexity and functionality, there is an increasing need for higher levels of systems integration. In addition, variances in battery designs among manufacturers make it more difficult to design intelligent systems that are optimized for particular power systems.

Most consumer electronics, mobile computing and communications product manufacturers need mixed-signal and analog integrated circuits specifically designed to optimize the power system usage in their devices to enable them to offer new devices with richer functionality and longer battery lives. These semiconductors should also be highly integrated and standards-based to help manufacturers create products that are smaller, lighter, easier to use, more reliable and more cost-efficient to design and produce. In addition, in mobile

device markets where product life cycles can be less than one year, these solutions typically need to be developed using advanced design methodologies to allow manufacturers to achieve rapid time-to-market with their new products.

Several different process technologies are available for designing and fabricating analog and digital integrated circuits. Of these, complementary metal oxide semiconductor, or CMOS, is the most widely used process technology, especially for purely digital integrated circuits. CMOS processes are described in terms of feature size, or geometry, and are measured in microns. One micron equals one millionth of a meter. Currently, the most advanced process technologies achieve feature sizes of 0.13 micron, 0.09 micron, 0.065 micron and smaller. However, small feature size circuits can become damaged when exposed to high voltages and therefore power management integrated circuits are typically fabricated using larger feature sizes. For this reason, older manufacturing facilities, or fabs, having feature sizes of 0.25 micron and 0.80 micron or greater, have traditionally been used in fabricating power management integrated circuits, while the most advanced, and most expensive fabs are used for digital and non-power management analog integrated circuits.

Products

We market power management and cardbus controller components for the Consumer, Computer, Industrial and Communications markets and also market system security solutions. Our power management and cardbus controller products include ICs to provide power for lighting of LCDs and LEDs, control and monitor battery charging and discharging, DC / DC conversion, and provide connections between notebook computers and external plug-in cards including product to select and switch between power sources. Our system security solutions products include VPNs and firewalls which provide security functions for communications between computer systems and networks, including the transmission of data across the Internet. We sell our products into the following four end-markets:

- Consumer electronics market, including desktop monitors, LCD televisions, digital cameras and camcorders and portable media players;

- Computer market, including notebook computers, desktop computers and desktop servers;

- Industrial market, including any product that is specified to operate over an extended temperature range, for instance, beyond the standard commercial operating temperature range of standard semiconductor products of zero degrees to 70 degrees centigrade. Products that operate over an extended temperature range include industrial tools, automobile GPS systems, and other automobile systems; and

- Communications market, including portable GPS systems, data communications security and networking systems, Internet and Internet related systems and mobile phone handsets.

The majority of our revenue is derived from the sale of our products in the consumer and computer markets. Additionally, we have increased our efforts to expand our product portfolio addressing opportunities in the communications and industrial markets.

Marketing, Sales, and Customer Support

Our marketing strategy is focused on the sale of proprietary analog and

mixed-signal integrated circuits to customers in the consumer electronics, computer, industrial and communications markets. These markets tend to be dominated by a small number of major brand name companies. As a result, we focus our resources on the major vendors in each market.

We primarily sell proprietary application specific products to our customers and work with them on new product development. We also design customized products for our customers. We work directly with our customers to create demand for our products by providing them with application specific product information for their system design, engineering and procurement groups. We actively participate in their design processes to introduce them to our products and the target applications our products address. We endeavor to design products that will meet increasingly complex and specific design requirements, but which will also support widespread demand for these future products. We typically undertake a four-to-eight month development process with our customers. If successful, this process culminates in a customer deciding to use our product in its system, which we refer to as a design win. Volume production generally takes an additional three-to-six months after the initial design win confirmation. Once our products are accepted and designed into an application, the customer is likely to continue to use the same power architecture and derivative products in a number of its models, which tends to extend our product life cycles.

We sell our products to OEMs, ODMs and module makers. We market and sell these products through a combination of our direct sales force, independent sales representatives and distributors in Asia, Europe and North America. We sell most of our products through direct sales. We maintain direct sales offices in most of our major markets which include Texas, California, China, Taiwan, Korea and Japan. Additionally, we have sales representatives in China, Hong Kong, Singapore, Taiwan and the United States, as well as two distributors in Japan.

We pay our direct sales force on a salary and performance bonus basis only. Our independent sales representatives are paid on a commission basis, based on a percentage of the actual sales referred by them. For sales through sales representatives, we invoice and deliver our products directly to the customers. We have entered into distributorship arrangements with distributors on a non-exclusive basis for the sale of our products in Japan as a principal at the request of certain of our major end-customers in Japan. For our other customers in Japan, sales are made through our direct sales offices in Japan. In Japan, it is customary practice for OEMs, ODMs and module makers to purchase products like ours through distributors because of the ancillary services provided by them such as inventory storage, payment terms and conditions and just-in-time delivery. We may provide a discount on the prices of the products we sell to our distributors (as compared to the prices we offer to end customers), depending on the term and conditions of the individual purchases. We defer recognition of such sales until the product is sold by the distributors to its end customers. In addition, products held by the distributors are considered part of our inventory and included in our inventory balance. Sales to the distributors are recognized and inventory is adjusted upon shipment to its end-customers as title to inventories generally transfers upon shipment. We receive monthly inventory and sales reports from the distributors in Japan, which we use as part of our overall inventory control. We evaluate our inventory on a quarterly basis and full provision is made for inventory which is over six months old and for which there is not end customer demand based on forecasted product demand and market conditions.

Our marketing efforts include market analysis, participation in industry trade shows and technical conferences, sales training, publication of technical articles, maintenance of our web site and advertising. In addition, we maintain customer support staff in United States, Taiwan, China, Japan and Korea for post order servicing and applications support.

Seasonality

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

Customers

We focus on the major OEMs (or brand owners) in the consumer electronics, computer, industrial and communications markets. Many of these major OEMs use third-party providers, such as ODMs, module makers or other intermediaries, to produce their products or portions of their products containing our components. Hence, the majority of our direct sales are to these third-party providers. We have maintained long-term relationships with our major customers for a number of years.

We have no long-term volume purchase contracts with any of our major customers. The majority of our sales to customers are conducted on the basis of purchase orders, which set out the specific terms for a particular sale. We price our products primarily with reference to the prevailing market conditions, taking into consideration the complexity, technology and features of the product, the order size and the relationship with the customer.

The table below sets forth, for the periods indicated, the dollar amount of our net sales derived from Asia, North America States and other regions:

	Years Ended December 31 (In Thousands)		
Location of customers	2004	2005	2006
Asia	$ 92,105	$ 105,517	$ 124,761
North America	53	29	32
Other regions	38	6	122
	$ 92,196	$ 105,552	$ 124,915

We generally extend to our customers credit terms varying from 45 to 55 days. We may adjust our usual credit terms according to each customer's credit history as well as local market practice. Our customers generally pay us either by direct wire transfer or under letter of credit arrangement. To date, we have not experienced any material problems relating to customer payments or material write-offs of accounts receivable due to uncollectibility.

Manufacturing

We subcontract the manufacture of our products and most of the testing

for our products to semiconductor foundries, assembly and testing service providers. This "fabless" approach allows us to focus on product development, reduce fixed costs and capital expenditures, and access diverse manufacturing technologies.

We use established mainstream processes for the manufacture of our products. This approach reduces our technical risks and minimizes the risks related to production capacity constraints.

Wafer Manufacturing

Wafer manufacturing is a capital intensive and complex operation which takes place at dedicated facilities of semiconductor foundries. After we have designed our integrated circuits, we place orders with a semiconductor foundry to fabricate wafers with our integrated circuits embedded in them. The semiconductor foundry purchases raw

unprocessed wafers, or silicon substrates, and processes them according to our specifications to fabricate the wafers used in our products. Currently, the majority of our wafers are fabricated using 0.25 to 0.80 micron CMOS semiconductor processes, which are the standard semiconductor processes used by semiconductor foundries. The wafer fabrication process generally takes six to 10 weeks. Fabricated wafers are then shipped by the semiconductor foundry, according to our instructions, to either an assembly service provider for electrical wafer sort and assembly or to an electrical wafer sort service provider for electrical wafer sort only.

Our major semiconductor foundry providers are SMIC, TSMC and X-FAB. We do not enter into long-term contracts with our semiconductor foundry providers. They manufacture our products on a purchase-order basis in accordance with our specifications and requirements. In general, the cost charged to us for the foundry services depends on prevailing wafer costs, which, in turn, depends on industry capacity and the state of manufacturing process technologies as well as on the complexity of our product designs, order size, cycle time and foundry capacity utilization.

Assembly and Testing

After the fabricated wafers have been electrically sorted, they are ready for assembly and are either sent to an assembly service provider for assembly or held at our warehouse facilities, or an "inventory hub," for assembly at a later date. An inventory hub is a provider of warehousing services. We often hold inventory of our semi-finished products in the form of electrically sorted wafers because it is at this manufacturing stage that most time has been invested, with the least costs, and we then have the flexibility of choosing the type of packaging into which they are to be assembled. The wafer sort and assembly process generally takes three to six weeks.

Once our integrated circuits are assembled and packaged, they are ready for final electrical testing. We instruct the assembly service provider to send our packaged integrated circuits to either a testing service provider or our testing facilities for final testing or our warehouse facilities (or an inventory hub) for testing at a later date. The electrical testing process generally takes a few days. Once our products have been tested, they are ready for use by our customers.

Finished products may be sent to our customers or their designees such as third party service providers that manufacture their products or a portion of their products containing our integrated circuits. Our customers may request for

our integrated circuits to be shipped in plastic tubes, several to a tube, or use a form of packaging called "tape and reel" that more readily provides for automated assembly of our integrated circuits into their products. If a customer orders "tape and reel" packaging, this is done either at a testing service provider or a "tape and reel" service provider prior to shipment of our products to the customer.

We utilize several assembly and testing service providers in Taiwan and other parts of Asia on a purchase order basis. They assemble and test our products based on our specifications and requirements. In general, the cost charged to us for these assembly and testing services depends on prevailing market rates for these services and our relationship with the service provider. We operate a semiconductor testing facility to test a portion of our products prior to shipment. Typically analog and mixed-signal products have a greater portion of their product cost associated with product testing than digital products.

Our current credit terms with our foundry, assembly and testing service providers vary from 30 to 45 days, depending on our relationships with each of them. We generally pay our service providers by direct wire transfer.

We also have made investments in certain of our current suppliers and potential future suppliers, including software developers, foundries and testing service providers. These investments enable us to enhance our business relationships with these suppliers to ensure the adequacy of foundry capacity allocation and quality of services provided to us. We plan to continue to evaluate additional investment opportunities in our supply chain.

Competition

We compete in the market for analog and mixed-signal integrated circuits based on such factors as product performance, power efficiency, new technologies, functional innovation, reliability, price and availability. We believe our principal competitors include Intersil Corporation, Linear Technology Corporation, Maxim Integrated Products, Inc., Microsemi Corporation, Monolithic Power Systems, Inc., Ricoh Company, Ltd., Rohm Co., Ltd and Texas Instruments Incorporated. There is also competition from internal integrated circuit design and manufacturing capabilities of some of our existing and potential customers, such as Toshiba and Fujitsu. In addition to these competitors, other integrated circuit companies may decide to enter the market with analog and mixed signal integrated products that compete with our products or incorporate functions similar to those provided by our products.

Intellectual Property

Our intellectual property is primarily developed in-house. We do, from time to time, acquire intellectual property from third parties which we believe is instrumental or complementary to our business. We also on occasion license our intellectual property to third parties in exchange for royalties or other consideration.

Our success depends significantly upon our ability to protect our intellectual property. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our products or obtain and use information that we regard as proprietary. Competitors may recruit our employees who have access to our proprietary technologies, processes and operations.

We rely in part on patents to protect our intellectual property. As of

December 31, 2006, we had approximately 103 patents issued in the United States and approximately 170 patents issued in other countries. In addition, we had approximately 184 patent applications pending in the United States Patent and Trademark Office. We also had approximately 345 patent applications pending in various countries other than the United States. These patents may never be issued. Even if these patents are issued, taken together with our existing patents, they may not be sufficiently broad to protect our proprietary rights, or they may prove to be unenforceable. To protect our proprietary rights, we also rely on a combination of copyrights, trademarks, trade secret laws, contractual provisions, licenses and maskwork protection under the Federal Semiconductor Chip Protection Act of 1984 and similar laws in other jurisdictions. We also enter into confidentiality agreements with our employees, consultants and customers and seek to control access to, and distribution of, our proprietary information.

We may from time to time grant rights to third parties for our patents and other intellectual property. In March 2003, we granted a limited non-exclusive license to Ricoh Company, Ltd. for our patents entitled "Integrated PC Card Host Controller for the Detection and Operation of a Plurality of Expansion Cards" (U.S. Patent No. 6,470,284 and Taiwan Patent No. 155891) and their foreign counterparts. In April 2007, we entered into a Memorandum of Agreement with Samsung Electronics Co., Ltd. and its subsidiaries pursuant to which we agreed to certain provisions regarding our intellectual property portfolio including without limitation patents owned by us.

The laws of some foreign countries do not protect our proprietary rights to the same extent as do the laws of the United States, and many companies have encountered substantial infringement problems in these countries, including countries in which we have sold and continue to sell a significant portion of our products. There is a risk that our means of protecting our proprietary rights may not be adequate. For example, our competitors may independently develop similar technology, duplicate our products or design around our patents or our other intellectual property rights. If we fail to protect our intellectual property adequately, it would make it easier for our competitors to sell competing products.

We are involved in a variety of litigation matters involving intellectual property. For example, we have initiated and are pursuing certain patent infringement actions in Taiwan. We have obtained preliminary injunctions and provisional attachment orders against numerous competitors, their customers and users. As of December 31, 2006, we have deposited an amount of New Taiwan dollars equivalent to approximately $14.5 million

with the Taiwan courts for court bonds in connection with the preliminary injunction actions and related provisional attachment actions. The court bonds provide security for the enjoined party to claim damages incurred from the preliminary injunctions, provisional attachments or the provision of a countersecurity against us in the event we do 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.

We are currently in litigation against Microsemi Corporation in the United States District Court in the Northern District of California and the United States District Court in the Eastern District of Texas. In April 2007, we filed a complaint in the United States District Court in the Northern District of California for declaratory judgment that U.S. Patent Numbers 5,615,093, 5,923,129, 5,930,121 and 6,198,234 held by Microsemi Corporation are not infringed by us, invalid and unenforceable. In response, Microsemi Corporation

filed a cross claim in the United States District Court in the Eastern District of Texas alleging that we infringe their U.S. Patent Numbers 5,930,121 and 6,198,234. They are seeking preliminary injunction, permanent injunction, damages, trebling of damages, enhancement, attorneys' fees and costs. On June 4, 2007, the United States District Court in the Northern District of California granted a motion to transfer our declaratory judgment case against Microsemi Corporation to the United States District Court in the Eastern District of Texas. In addition, in May 2007, a jury in the United States District Court in the Northern District of California found Claims 1, 2, 9, 12, 14 and 18 of our U.S. Patent Number 6,396,722 to be invalid. In February 2007, Monolithic Power Systems, Inc. amended its complaint in the Intermediate People's Court in Chengdu, China alleging that two of our customers infringe Chinese Patent Number ZL03140709.9.

We are also involved in several other patent litigation matters in the United States. Given the inherent uncertainties in litigation, there cannot be any assurance that we will prevail in any of the pending litigation, and we cannot predict the outcome of any such litigation. Litigation is costly, time consuming, and may distract management from other important tasks and, in patent litigation where we are the plaintiff, there is a risk that our patents may be held invalid or unenforceable. In addition, in any litigation arising from claims that we infringe on the intellectual property rights of others, an adverse result could involve an injunction to prevent the sales of a material portion of our products, a reduction or the elimination of the value of related inventories, and the assessment of a substantial monetary award for damages related to past sales, any of which could have a material adverse effect on our result of operations and financial condition.

ORGANIZATIONAL STRUCTURE

We are incorporated under the laws of the Cayman Islands and we are the parent company for the various subsidiaries that conduct our business on a worldwide basis. Our significant subsidiaries, all of which are wholly-owned, are:

Significant Subsidiary	Country of Incorporation	Date of I
O2Micro, Inc.	U.S.A.	Marc
O2Micro Electronics, Inc.	Taiwan	Marc
O2Micro International Japan Limited	Japan	Augu
O2Micro PTE Limited-Singapore	Singapore	Septem
Aotu Micro (Wuhan) Co., Ltd.	China	Janua
O2Micro (Beijing) Co., Ltd.	China	Febru
O2Micro (China) Co., Ltd.	China	Apri

O2Micro (Chengdu) Co., Ltd.	China	Jul
OceanOne Semiconductor (Ningbo) Limited	China	Augu

PROPERTY, PLANT AND EQUIPMENT

The table below describes our headquarters and the facilities where the above subsidiaries are located as of December 31, 2006:

Location	Approx. Available Square Feet	Lease Expiration
California, USA................	37,180	not applicable
Taipei, Taiwan.................	33,707	2011
Hsin-Chu, Taiwan...............	23,630	2007
Singapore......................	7,104	2008
Shanghai, China................	30,448	not applicable
Beijing, China.................	16,070	2008
Wuhan, China...................	11,220	2009
Chengdu, China.................	13,552	2007
Grand Cayman, Cayman Islands...	600	2008
Tokyo, Japan...................	1,302	2008
Ningbo, China	5,187	2007

We maintain our Cayman Islands office to process invoices and receive amounts payable. Research and development, marketing, applications and administrative staff are located in California. We also have sales offices in Pfluggerville, Texas and Houston, Texas. Marketing, sales, applications, design, worldwide production support, final inspection and shipping, and general and administrative staff are located in Taiwan. We have offices Japan, Singapore, Korea and China for marketing, sales, design, warehousing and applications. We believe our current facilities are adequate for our needs for the foreseeable future, and that any additional space required will be available to us on commercially reasonable terms.

In May 2004, we purchased a 37,180 square foot building in Santa Clara, California housing our California operations. The purchase price was approximately $4.6 million. In October 2005, we purchased a 30,448 square foot facility in Shanghai, China for approximately $7.1 million. In April 2006, we purchased 29,935 square feet of land in Hsin-Chu, Taiwan for approximately $8.8 million.

ITEM 4A. UNRESOLVED STAFF COMMENTS

None.

ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Overview

We design, develop and market high performance integrated circuits for power management and security applications, as well as systems security solutions. We also license a limited portion of our proprietary intellectual property from and to third parties. Our net sales have been derived primarily

from the sale of analog and mixed-signal integrated circuit products to customers in the consumer electronics, computer, industrial and communications markets.

Our net sales have grown from $92.2 million in 2004 to $105.6 million in 2005 and $124.9 million in 2006. This increase in net sales was due primarily to higher unit shipments of our existing products, expansion of our customer base and the introduction of new products. We have continued to diversify our customer base and market focus by providing new products to the consumer electronics, computer, industrial and communications markets. Our overall gross margin has fluctuated in the past and is likely to fluctuate in the future due to the stages of our products in their life cycles, variations in our product mix, the timing of our product introductions and specific product manufacturing costs. New products typically have higher gross margins than products that are more mature. Gross margins on the products we sell will typically decline over the life of these products due to competitive pressures and volume pricing agreements.

Operating expenses grew from $41.9 million in 2004 to $58.3 million in 2005 and $72.7 million in 2006. Our operating expenses increased primarily from new product development efforts, hiring additional personnel and expanding our operations and recognized stock-based compensation due to adoption of Statement of Financial Accounting Standards ("SFAS") No. 123 (R), "Share-Based Payment."

Our net income was $14.1 million in 2004, $8.1 million in 2005 and $743,000 in 2006. We have been profitable in each quarter since the quarter ended September 30, 1999 except for the quarter ended June 30, 2006. We believe this profitability has been the result of our strategy to make investments to develop new products and grow net sales, while maintaining a high level of fiscal control, product quality and customer satisfaction. Our profitability resulted in retained earnings of $33.9 million at December 31, 2006.

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

We sell our products through a combination of direct sales offices, sales representatives and distributors. We have sales representatives in China, Hong Kong, Singapore, Taiwan and the United States, as well as two distributors in Japan.

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

Critical Accounting Policies--

Revenue Recognition and Accounts Receivable Allowances

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

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

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

Inventories

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

Long-Lived Assets

We evaluate the recoverability of property and equipment in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." We perform periodic reviews to determine whether facts and circumstances exist that would indicate that the carrying amounts of property and equipment might not be fully recoverable. If facts and circumstances indicate that the carrying amount of property and equipment might not be fully recoverable, we compare projected undiscounted net cash flows associated with the related assets over their estimated remaining useful life against their respective carrying amounts. In the event that the projected undiscounted cash flows are not sufficient to recover the carrying value of the assets, the assets are written down to their estimated fair values based on the expected discounted future cash flows attributable to the assets. Evaluation of impairment of

property and equipment requires estimates in the forecast of future operating results that are used in the preparation of the expected future undiscounted cash flows. Actual operating results and remaining economic lives of the property and equipment could differ from the estimates used in assessing the recoverability of these assets. These differences could result in additional impairment charges, which could have a material adverse impact on the results of operations.

Income Taxes

Our income taxes are accounted in accordance with SFAS No. 109, "Accounting for Income Taxes". The provision for income tax represents income tax paid and payable for the current year plus the changes in the deferred income tax assets and liabilities during the years. Deferred income tax assets are primarily the tax effects of the operating loss carryforwards, research and development credit carryforwards and temporary differences. On a periodic basis we evaluate the deferred tax assets balance for realizability. To the extent we believe it is more likely than not that some portion of deferred tax assets will not be recognized, we will increase the valuation allowance against the deferred tax assets. Realization of the deferred tax assets is dependent primarily upon future taxable income, changes in tax laws and other factors. These changes, if any, may require possible material adjustment to the deferred tax assets, resulting in a reduction in net income in the period when such determinations are made. In addition, we recognize liabilities for potential income tax contingencies based on the estimate of whether, and the extent to which, additional taxes may be due. If we determine that payment of these amounts is unnecessary or if the recorded tax liability is less than its current assessment, we may be required to recognize an income tax benefit or additional income tax expense in our consolidated financial statements, accordingly.

Legal Contingencies

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

Stock-based compensation

We grant stock options and other awards to our employees and certain non-employees. Prior to January 1, 2006, we elected to follow 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 our employee stock options. Under APB No. 25, compensation expense is measured based on the difference, if any, on the date of the grant, between the fair value of our ordinary shares and the exercise price of the stock option.

Effective January 1, 2006, we adopted the fair value recognition provisions of SFAS No. 123 (R), "Share-Based Payments," 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.

At the end of June 2005, our board approved the acceleration of the vesting of options with exercise prices greater than $17.00 or $0.34 after taking into account the 50-to-1 stock split on November 25, 2005. Our board evaluated the minimal benefit to our employees of accelerating the remaining vesting on these significantly underwater options against the value to shareholders of not having earnings materially affected and the impact that this may have on our market value. In addition, these options had exercise prices in excess of the then current market values and were not fully achieving their original objectives of incentive compensation and employee retention. Accelerating the vesting of these options accelerated the recognition of any remaining expense associated with these options which is zero under APB No. 25.

Treasury Stock

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

Research and development costs

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

Long-term Investments

Our long-term investments in private companies over which we do not exercise significant influence are accounted for under the cost method of accounting. We evaluate 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 we periodically weigh all quantitative and qualitative factors in determining if any impairment loss exists.

Our 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.

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, 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, 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, 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 believes that the adoption of FIN No.48 does 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 SEC'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.

Operating Results

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

	Year Ended December 31,		
	2004	2005	2006
Consolidated Statement of Operations Data:			
Net sales	100.0%	100.0%	100.0%
Cost of sales	40.6	38.6	45.4
Gross margin	59.4	61.4	54.6
Operating expenses:			
Research and development	22.0	24.1	25.4
Selling, general and administrative .	17.7	19.2	23.4
Patent related litigation	5.8	9.6	8.8
Stock Exchange of Hong Kong listing expenses	-	2.3	0.6
Total operating expenses	45.5	55.2	58.2
Income (loss) from operations	13.9	6.2	(3.6)
Non-operating income-net	2.9	2.5	2.2
Income tax expenses (benefit)	1.6	1.0	(2.0)
Net income	15.2%	7.7%	0.6%

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Years Ended December 31, 2006 and 2005

Net Sales. Net sales consisted of product revenues generated principally by sales of our integrated circuit products. Net sales for the year ended December 31, 2006 were $124.9 million, an increase of $19.4 million or 18.3% from $105.6 million for the year ended December 31, 2005. The increase in net sales resulted primarily from increased unit shipments to our existing customers, expansion of our customer base and the introduction of new products.

Gross Profit. Gross profit represents net sales less cost of sales. Cost of sales primarily consists of the cost of purchasing packaged integrated circuit products manufactured and assembled for us by independent foundries and packaging vendors and other costs associated with the procurement, storage and shipment of these products. Gross profit for the year ended December 31, 2006 was $68.1 million, an increase of $3.3 million or 5.1% from $64.8 million for the year ended December 31, 2005. This increase was primarily due to increased sales of our integrated circuit products. Gross profit as a percentage of net sales for the year ended December 31, 2006 decreased to 54.6% from 61.4% for the year ended December 31, 2005 primarily due to increased sales of our lower

margin products. We expect that our gross profit as a percentage of net sales will continue to fluctuate in the future as a result of the stages of our products in their life cycles, variations in our product mix, the timing of our product introductions and specific product manufacturing costs.

Research and Development Expenses. Research and development expenses consist primarily of salaries and related costs of employees engaged in research, design and development activities and, to a lesser extent, expenses for outside engineering consultants. Research and development expenses for the year ended December 31, 2006 were $31.8 million, an increase of $6.3 million or 24.9% from $25.4 million for the year ended December 31, 2005. As a percentage of net sales, research and development expenses were 25.4% for the year ended December 31, 2006, an increase from 24.1% for the year ended December 31, 2005. Research and development expenses as a percentage of net sales will fluctuate from quarter to quarter depending on the amount of net sales and the success of new product development efforts, which we view as critical to our future growth. At any point in time, we have several research and development projects underway, and we believe that none of these projects is material on an individual basis. We expect to continue the development of innovative technologies and processes for new products and we believe that a continued commitment to research and development is essential in order to maintain the competitiveness of our existing products and to provide innovative new product offerings. Therefore, we expect to continue to invest significant resources into research and development in the future.

Selling, General and Administrative Expenses. Selling, general and administrative expenses consist primarily of employee-related expenses, sales commissions to agents, professional fees, travel and other promotional expenses. Selling, general and administrative expenses for the year ended December 31, 2006 were $29.2 million, an increase of $8.9 million or 44.0% from $20.3 million for the year ended December 31, 2005. This increase was primarily due to additional hiring of sales, operations and administrative personnel, increased promotional expense, increased traveling expense and the stock-based compensation expense recognized due to adoption of SFAS No. 123 (R). As a percentage of net sales, selling, general and administrative expenses were 23.4% for the year ended December 31, 2006, an increase from 19.2% for the year ended December 31, 2005. We expect that selling, general and administrative expenses will continue to increase in absolute dollar terms for the foreseeable future.

Patent Related Litigation Expenses. Patent related litigation expenses consist primarily of fees paid to outside counsel and consultants engaged by outside counsel. Patent related litigation expenses for the year ended December 31, 2006 were $11.0 million, an increase of $788,000 or 7.7% from $10.2 million for the year ended December 31, 2005. This increase was primarily due to increased activity in various litigation matters. As a percentage of net sales, patent related litigation expenses were 8.8% for the year ended December 31, 2006, a decrease from 9.6% for the year ended December 31, 2005. We expect that patent related litigation expenses will continue to fluctuate for the foreseeable future. (Please see also, "Business Overview - Intellectual Property.")

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Stock Exchange of Hong Kong Listing Expenses. The SEHK listing expenses consist primarily of expenses incurred in relation to our SEHK listing activities commencing in 2005. SEHK listing expenses for the year ended December 31, 2006 was $786,000, a decrease of $1.7 million or 68.0% from $2.5 million for the year ended December 31, 2005.

Non-operating Income-net. Non-operating income-net reflects primarily interest earned on cash and cash equivalents and short-term investments,

impairment loss on long-term investments and foreign exchange transaction losses. Non-operating income-net was $2.9 million for the year ended December 31, 2006 increasing from $2.7 million for the year ended December 31, 2005, reflecting increased interest earned on cash and cash equivalents, and short term investments.

Income Tax Expenses (benefit). Income tax benefit was approximately $2.5 million for the year ended December 31, 2006, compared to an income tax expense of $1.0 million for the year ended December 31, 2005. This difference was primarily due to a reversal of an accrual of income tax payable upon the completion of examination of our 2001 tax filing by the Taiwan Tax Authority.

Years Ended December 31, 2005 and 2004

Net Sales. Net sales for the year ended December 31, 2005 were $105.6 million, an increase of $13.4 million or 14.5% from $92.2 million for the year ended December 31, 2004. The increase in net sales resulted primarily from increased unit shipments to our existing customers and expansion of our customer base.

Gross Profit. Gross profit for the year ended December 31, 2005 was $64.8 million, an increase of $10.0 million or 18.3% from $54.8 million for the year ended December 31, 2004. This increase was primarily due to increased sales. Gross profit as a percentage of net sales for the year ended December 31, 2005 increased to 61.4% from 59.4% for the year ended December 31, 2004 primarily due to increased sales of our higher margin products.

Research and Development Expenses. Research and development expenses for the year ended December 31, 2005 were $25.4 million, an increase of $5.1 million or 25.5% from $20.3 million for the year ended December 31, 2004. This increase reflected the increased hiring of design engineers resulting from our increased operations and increased consultancy fees paid to outside consultants in respect of certain research and development projects. As a percentage of net sales, research and development expenses were 24.1% for the year ended December 31, 2005, an increase from 22.0% for the year ended December 31, 2004.

Selling, General and Administrative Expenses. Selling, general and administrative expenses for the year ended December 31, 2005 were $20.3 million, an increase of $4.0 million or 24.1% from $16.3 million for the year ended December 31, 2004. This increase was primarily due to additional hiring of sales, operations and administrative personnel, increased sales commissions relating to higher sales and increased professional fees. As a percentage of net sales, selling, general and administrative expenses were 19.2% for the year ended December 31, 2005, an increase from 17.7% for the year ended December 31, 2004.

Patent Related Litigation Expenses. Patent related litigation expenses consist primarily of fees paid to outside counsel and consultants engaged by outside counsel. Patent related litigation expenses for the year ended December 31, 2005 were $10.2 million, an increase of $4.9 million or 90.7% from $5.3 million for the year ended December 31, 2004. This increase in absolute dollars was primarily due to the MPS trial commencing in June 2005, Taiwan Sumida trial in November 2005, increased litigation activity in other litigation matters and filing of additional litigation by us. As a percentage of net sales, patent related litigation expenses were 9.6% for the year ended December 31, 2005, an increase from 5.8% for the year ended December 31, 2004.

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Stock Exchange of Hong Kong Listing Expenses.. SEHK listing expenses for the year ended December 31, 2005 was $2.5 million, an increase of $2.5

million or 100.0% from $0 for the year ended December 31, 2004.

Non-operating Income-net. Non-operating income-net was $2.7 million for the year ended December 31, 2005 almost unchanged from $2.7 million for the year ended December 31, 2004, reflecting a foreign exchange loss of $443,000 offset by increased interest earned on our cash and cash equivalents and short term investments.

Income Tax Expenses. Income tax expenses were approximately $1.0 million for the year ended December 31, 2005, compared to $1.5 million for the year ended December 31, 2004. This decrease was primarily due to an accrual of approximately $658,000 for Taiwan income tax due on imported products as of December 31, 2004, which was reversed and applied as a credit on our income tax due in the year ended December 31, 2005, and a decrease in our income before income tax as a result of an accrual for Stock Exchange of Hong Kong listing expenses of $2.5 million in December 2005. The accrual and reversal related to our application on May 24, 2004 to the Taiwan Customs Authority for the rectification of the value of the imported goods reported for the period from March 2003 to March 2004. We had mistakenly reported a lower amount to the Taiwan Customs Authority than the correct amount that was reported on our tax return for the years ended December 31, 2003 and 2004. However, a rectification of the Taiwan Customs Authority's records usually cannot be made after six months have elapsed, in which case the understated cost of the imported goods reported to the customs officials would have been deemed to be the actual cost, and thus the taxable income for the years ended December 31, 2003 and 2004 would have been higher. We therefore accrued the provision for income tax of $658,000 based on our estimate of the most probable impact on income tax as at December 31, 2004. As we have addressed the design flaw in the customized report that was submitted to the Taiwan Customs Authority, we have confirmed that there was no need to make a similar accrual for Taiwan income tax in 2005. Adding back the Stock Exchange listing expenses of $2.5 million to our income before income tax and excluding the impact of the reversal of approximately $658,000 on our income tax expenses, our effective income tax rate for 2005 would have been 14.5%. Our effective tax rate was 11.3% for the year ended December 31, 2005, compared to 9.5% for the year ended December 31, 2004.

Liquidity and Capital Resources

Since our inception, we have financed our operations primarily through private sales of securities and through our initial public offering in August 2000 and our public offering in November 2001 as well as cash provided by operating activities in recent years. Cash, cash equivalents and short-term investments were $65.1 million at December 31, 2006 as compared to $102.0 million at December 31, 2005. Our operating activities provided cash in the amount of $3.3 million in the year ended December 31, 2006, $11.0 million in the year ended December 31, 2005, and $14.1 million in the year ended December 31, 2004.

Non-cash charges primarily consist of depreciation of property and equipment, impairment loss of long-term investment, changes of deferred income tax assets and amortization of stock-based compensation from stock options. The working capital components that have a significant impact on our cash flows are accounts receivable, inventory, notes, accounts payable, prepaid expenses and other current assets, income tax payable and accrued liabilities.

Net cash inflows from operations resulted from net income adjusted by changes in accounts receivable, inventory, notes and accounts payable, income tax payable and accrued liabilities.

In 2006, we had a net cash inflow from investing activities of $1.7 million as compared to a net cash outflow of $19.3 million in 2005. This increase in net cash provided by investing activities between 2005 and 2006 was

principally due to an increase of $29.0 million in net sales of short-term investments. This increase was partially offset by an increase of $8.5 million in net acquisitions of property and equipment.

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

Net cash inflow from our financing activities in 2004 was $0.9 million, primarily due to the exercise of stock options and issuance of shares under our Employee Stock Purchase Plan, which was partially offset by the repurchase of our shares under a share repurchase program. Net cash outflow from our financing activities in 2005 was $2.1 million, primarily due to the repurchase of our shares and ADSs under a share repurchase program, which was partially offset by proceeds from the exercise of stock options and warrants and issuance of shares under our Employee Stock Purchase Plan. Net cash outflow from our financing activities in 2006 was $6.2 million, primarily due to the repurchase of $7.6 million of our Shares and American depositary shares under a share repurchase program in 2006 which was partially offset by proceeds from the exercise of stock options and issuance of shares under our existing Employee Stock Purchase Plan for the year. The listing of our ordinary shares on the Main Board of the SEHK may or may not enhance our ability to obtain additional financing in the future.

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

Research and Development, Patents and Licenses, etc.

We believe that the continued introduction of new products in our target markets is essential to our growth. As of December 31, 2006, we had approximately 613 full-time employees world-wide engaged in research and development efforts. Our total expenditures for research and development were $31.8 million for the year ended December 31, 2006, $25.4 million for the year ended December 31, 2005, and $20.3 million for the year ended December 31, 2004. We believe that our research and development staffing will increase in the next 12 months primarily due to the expansion of our existing design centers. We intend to continue to expand our research and development operations, including increasing the number of design engineers.

We employ designers who are experienced in system architecture, analog, digital, mixed signal and software design and development. We also utilize independent contractors from time-to-time for specific research and development projects. Our internal research and development personnel thoroughly review the external development processes and the design of these products as part of our quality assurance process. All development is carried out using ISO 9001 certified design processes, and our design tools are continuously enhanced to improve design, fabrication and verification of our products.

Our research and development activities are a constantly evolving process which reflects the results of our ongoing projects, our expectations regarding market developments and changes in customer demand and industry specifications. We commence new projects or alter the scope or direction of existing projects on a regular basis under the guidance of our management and senior research personnel.

We work with our customers to monitor the performance of our product designs and to provide support at each stage of customer product development. Due to the complexity of our products, we maintain a significant direct applications support staff for customer technical support in our key markets including in Japan, Taiwan, China, Korea and the United States. These direct applications engineering personnel assist with supporting existing products at key customers. Additionally, we work closely with our customers to develop highly efficient power management products for specific applications.

Trend Information

See "Risk Factors" and "Operating and Financial Review and Prospects" above.

Off-Balance Sheet Arrangements

There are no off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors.

Tabular Disclosure of Contractual Obligations

The table below describes our contractual obligations as of December 31, 2006:

Contractual Obligations	Payments due by period				
	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
	(in thousands)				
Operating Lease Obligations	$3,189	$1,670	$1,088	$ 431	$ --
Purchase Obligations	502	502	--	--	--
Licenses, Maintenance and Support	983	785	198	--	--
Pension	455	--	--	--	455
Total	5,129	2,957	1,286	431	455

ITEM 6 DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES

Directors and Senior Management

Our executive officers and directors and their ages as of December 31, 2006, were as follows:

Name	Age	Position
Sterling Du......................	47	Chief Executive Officer, Class I Director and Chairm Board
Chuan Chiung "Perry" Kuo.........	47	Chief Financial Officer, Joint Secretary and Class I
James Keim.......................	62	Class II Director and Head of Marketing and Sales
Michael Austin...................	71	Independent Non-executive Director, Class III Direct member of Compensation Committee
Geok Ling Goh....................	65	Independent Non-executive Director, Class I Director of Audit Committee
Lawrence Lin.....................	56	Independent Non-executive Director, Class II Directo of Audit Committee and Compensation Committee
Keisuke Yawata...................	72	Independent Non-executive Director, Class III Direct Chairman of Audit Committee
Xiaolang Yan.....................	60	Independent Non-executive Director and Class III Dir
Ivan Chang.......................	44	Vice-President, Finance
Johnny Chiang....................	49	Vice-President, Logistics and Backend
Jane Liang.......................	38	Qualified Accountant

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Our Class I Directors have held office from the date of the annual general meeting in 2005 for a three year term until 2008; our Class II Directors have held office from the date of the annual general meeting in 2006 for a three year term until 2009; and our Class III Directors are currently holding office and have been nominated for re-election at the annual general meeting that will be held in June 2007 and if re-elected will hold office for a three year term until 2010.

Executive Directors

Sterling Du has served as our chief executive officer and chairman of our board of directors since March 1997 and as a Class I Director since June 2001. He also served as our chief financial officer from March 1997 to March 1999. From May 1995 to March 1997, Mr. Du was president and chief executive officer of O2Micro, Inc., our predecessor entity. From October 1993 to April 1995, Mr. Du was vice president of engineering at GreenLogic, Inc., a semiconductor design company, which he co-founded. Mr. Du received a B.S. in chemical engineering from National Taiwan University and an M.S. in electrical engineering from the University of California, Santa Barbara.

Chuan Chiung "Perry" Kuo has served as our general manager of Taiwan operations since January 1997, as chief financial officer and a director since March 1999, as secretary since October 1999 and as a Class I director since June 2001. From February 1992 to December 1996, he was executive vice president of Pac Net Group, a holding company with investments in chemicals, electronics and real estate. From July 1983 to February 1992, he held various positions at Formosan Rubber Group, a rubber manufacturer, including product design engineer, plant manager, research and development director, and vice president. Mr. Kuo received a B.S. in chemical engineering from National Taiwan University and an M.B.A. from the Rotterdam School of Management, Erasmus University in The

Netherlands.

James Keim has served as a director since March 1999 and as Head of Marketing and Sales since December 2001 and a Class II director since June 2001. He also served as our chief operating officer from June 1998 to June 2001. From March 1995 to June 1998, Mr. Keim was a principal in Global Marketing Associates, an international consulting firm. Prior to March 1995, he had been vice president of sales at Alliance Semiconductor Corporation, vice president of marketing at Performance Semiconductor Corporation and worldwide linear marketing manager at Fairchild Semiconductor Corporation. Mr. Keim received a B.S. in engineering from Iowa State University, an M.S. in electrical engineering and an M.B.A. from the University of Illinois.

Independent Non-Executive Directors

Michael Austin has served as a director since October 1997 and as a Class III director since June 2001. He currently serves on the compensation committee and nominating committee. Mr. Austin is a resident of the Cayman Islands and is a Chartered Accountant. Mr. Austin was admitted as an Associate of the Institute of Chartered Accountants in England and Wales in 1964 and as a Fellow in 1974. Mr. Austin is also an Associate Member of The Chartered Institute of Taxation, a Member of the Society of Trust and Estate Practitioners, and a Notary Public of the Cayman Islands. Mr. Austin served as the managing partner of the Cayman Islands office of KPMG Peat Marwick, an international accounting firm, for 23 years. Since retiring in July 1992, Mr. Austin has been a consultant and currently serves as a non-executive director on several company boards, including those of a number of mutual funds, trust and insurance companies. He serves as a director of Scottish Re,

a public company. Mr. Austin served as a director of the Cayman Islands Monetary Authority from January 1997, and was appointed Chairman of the Board in January 2003, a position he held until his retirement on July 31, 2004. He has also served on a variety of other government committees and government related boards, including the Cayman Islands Agricultural and Industrial Development Board, as Chairman; the Stock Exchange Committee; and the Government/Private Sector Consultative Committee. In 1990 Mr. Austin was awarded an M.B.E. by Her Majesty the Queen in recognition of services to the public and business community.

Geok Ling Goh has served as a director since January 2000, as a member of the audit committee since August 2000 and as a Class I director since June 2001. From October 1998 to October 1999, he was the managing director of Micron Semiconductor Asia Pte Ltd. From June 1970 to October 1998, he held various positions at Texas Instruments Singapore Pte Ltd, including Vice-President of Marketing and in 1993, the first local managing director of Texas Instruments Singapore Pte Ltd. He serves as a director on the boards of Sembcorp Industries Ltd., Venture Corporation Ltd., DBS Group Holdings Ltd. and DBS Bank Ltd. He is also the chairman of Sembcorp Marine Ltd. and serves as a trustee of Nanyang Technology University. He received a bachelor of engineering degree from Sydney University.

Lawrence Lin has served as a Class II Director and a member of the audit committee since June 2003. He currently also serves as Chairman of the Compensation Committee. He is a Certified Public Accountant in Taiwan. Since 1990, Mr. Lin has been a partner of L&C Company, Certified Public Accountants, which is a member firm of Urbach Hacker Young International, and a director of Urbach Hacker Young International from October 1994 to October 1998. Prior to L&C Company, he was a partner at T N Soong & Co. Mr. Lin serves as an independent non-executive director and chairman of the audit committee for Yageo

Corporation and corporate supervisor for Tex Year Industries Inc., both of which are Taiwan public companies. He graduated from Taipei Vocational Commercial School in 1969.

Keisuke Yawata has served as a director since October 1999, as a member of the audit committee since August 2000, as Chairman of the audit committee since July 2001 and as a Class III director since June 2001. Mr. Yawata has been a partner and director of Start-up101, a venture capital firm, since 1999 and is the Chief Executive Officer of The Future International, a consulting firm he founded in 1997. From 1995 to 1997, he was the president and chief executive officer of Applied Materials Japan and a senior vice president of Applied Materials, Inc. From 1985 to 1994, he was at LSI Logic KK, serving as president and chief executive officer from 1985 to 1992, and as chairman of the board from 1993 to 1994. From 1958 to 1984, he was employed by NEC Corporation and its subsidiaries where he held various positions, the last position being president and chief executive officer of NEC Electronics, Inc. from 1981 to 1984. In addition, Mr. Yawata was a vice president of the Semiconductor Industry Association Japan Chapter from 1989 to 1994. Mr. Yawata serves as a director on the boards of U10 Networks, DigiPub Japan, Sequence Design KK and NanoGeometry Research. He received a B.S. in electrical engineering from Osaka University in Osaka, Japan and an M.S. in electrical engineering from Syracuse University.

Xiaolang Yan has served as a Class III Director since July 2005 and currently serves on the nominating committee. Mr. Yan is a professor and Dean of the Electrical Engineering College, Dean of the Information Science & Engineering College and Director of Institute of VLSI Design at Zhejiang University in China. He is also the Director of China's National Integrated Circuit Talent Education Program and Vice President of China Semiconductor Industry Association. From May 2002 to October 2006, he was the Director of the Strategic Expert Committee for VLSI Design of the China State High Technology Program (863 Program). From May 1994 to March 1999, he was Professor and Dean of Hangzhou Institute of Electronic Engineering and Director of its ICCAD Research Institute. From September 1993 to May 1994, he was a visiting scholar at Stanford University. From March 1990 to September 1993, he was Executive Vice-President and Chief Engineer at Beijing IC Design Center in Beijing, China. Mr. Yan received his bachelor of science and master of science degrees in electrical engineering from Zhejiang University in Hangzhou, China.

Senior Management

Ivan Chang has served as our Vice-President, Finance since February 2003. He also served as our Controller from July 1999 until February 2003. From August 1996 to July 1999, he was Finance Manager at Siemens Limited in Taiwan. Mr. Chang received a B.S. in Accounting from Soochow University and an M.S. in Accounting Information from University of Maryland, College Park.

Johnny Chiang has served as our Vice-President, Logistics and Backend since February 2003. He also served as our Director of Operations from March 1999 to February 2003 and our Operations Manager from November 1997 to March 1999. Mr. Chiang received a B.S. in Industrial Engineering from Chung Yung University.

Jane Liang has served as our Qualified Accountant since November 2005. She is a fellow of the Association of Chartered Certified Accountants and a member of the Chinese Institute of Certified Public Accountants. From July 2000 to October 2003, she was senior finance manager at Bausch & Lomb (Shanghai) Trading Co. From August 1999 to June 2000, she was an accounting supervisor at Exxon Chemical (Shanghai) Trading Co. Ms. Liang received her bachelors and masters degree in Philosophy from Fudan University.

There are no family relationships among any of our directors or executive officers. There are no arrangements or understandings with major shareholders, customers, suppliers or others, pursuant to which any person referred to above was selected as a director or member of senior management.

Compensation

We paid an aggregate amount of compensation during 2006 to our directors and members of our administrative, supervisory or management bodies as a group equal to approximately $2,750,000. All of our officers and directors are eligible to participate in our employee benefit plans except non-employee directors are not eligible to participate in our ESPP plan.

Share Ownership of Directors and Senior Management

As of December 31, 2006, the aggregate number of ordinary shares beneficially owned by our directors and members of our administrative, supervisory or management bodies was 247,097,750. This number includes options to purchase an aggregate of 105,467,050 ordinary shares under our 1997 Stock Plan, 1999 Stock Plan and 2005 Share Option Plan exerciseable within 60 days of December 31, 2006.

Employee Benefit Plans

1997 Stock Plan. Our 1997 stock plan was adopted by our board of directors and approved by our shareholders in 1997. The 1997 stock plan provides for the granting to our employees of incentive stock options within the meaning of Section 422 of the United States Internal Revenue Code, and for the granting to employees and independent contractors of nonstatutory stock options and stock purchase rights. Our board of directors and our shareholders authorized a total of 3,700,000 ordinary shares for issuance pursuant to the 1997 stock plan, as amended or 185,000,000 ordinary shares after taking into account the 50-to-1 stock split on November 25, 2005. As of December 31, 2006, options outstanding and exercisable under the 1997 stock plan were 17,520,850. No more grants have been made under this plan after the consummation of our initial public offering on August 23, 2000. Our 1997 stock plan was terminated effective on March 2, 2006, the date of the listing of our ordinary shares on the Hong Kong Stock Exchange; provided that options granted under the plan remain outstanding in accordance with their terms.

1999 Stock Incentive Plan. Our 1999 stock plan was adopted by our board of directors in October 1999 and was approved by our shareholders prior to the consummation of our initial public offering in August 2000. The 1999 stock plan provides for the granting to employees of incentive stock options within

the meaning of Section 422 of the Internal Revenue Code and the granting of nonstatutory stock options, stock appreciation rights, dividend equivalent rights, restricted stock, performance units, performance shares and other equity-based rights to our employees, directors and consultants. Initially, we have reserved 3,000,000 ordinary shares for issuance under the 1999 stock plan or 150,000,000 ordinary shares after taking into account the 50-to-1 stock split on November 25, 2005. Commencing January 1, 2001, the number of ordinary shares of stock reserved for issuance under the 1999 stock plan will be increased annually by a number equal to 4% of the fully-diluted number of ordinary shares outstanding as of December 31 of the immediately preceding calendar year or a lesser number determined by the administrator. However, the maximum number of ordinary shares available for issuance as incentive stock options will be increased by the least of 4% of the fully-diluted number of ordinary shares

outstanding on December 31 of the immediately preceding calendar year, 1,500,000 ordinary shares (or 75,000,000 ordinary shares after taking into account the 50-to-1 stock split on November 25, 2005) or a smaller number as determined by the administrator. In the year ended December 31, 2006, the number of shares reserved under the 1999 stock plan was not increased. Where an award agreement permits the exercise or purchase of the award for a specified period of time following the recipient's termination of service with us, or the recipient's disability or death, the award will terminate to the extent not exercised or purchased on the last day of the specified period or the last day of the original term of the award, whichever occurs first. As of December 31, 2006, options outstanding under the 1999 stock plan were 272,942,250, of which 221,683,400 were exercisable. Our 1999 stock plan was terminated effective on March 2, 2006, the date of the listing of our ordinary shares on the Hong Kong Stock Exchange; provided that options granted under the plan remain outstanding in accordance with their terms.

1999 Employee Stock Purchase Plan. Our 1999 purchase plan was approved by our board of directors in October 1999, was approved by our shareholders prior to the consummation of our initial public offering in August 2000 and is intended to qualify as an "employee stock purchase plan" under Section 423 of the Internal Revenue Code and to provide our employees with an opportunity to purchase ordinary shares or ADSs through payroll deductions. In May 2005, our board of directors adopted certain amendments to the 1999 purchase plan and in October 2005 our board of directors adopted and approved an amendment and restatement of 1999 purchase plan to amend various administrative terms in anticipation of our listing on the Hong Kong Stock exchange. We have reserved 50,000,000 ordinary shares for issuance under our 1999 purchase plan, subject to adjustment upon certain changes in our capitalization. The number of ordinary shares which shall be made available for sale under the 1999 purchase plan, any share options granted pursuant to our 2005 share option plan and any other plan (but not including our 2005 share incentive plan) will not exceed 10% of the number of ordinary shares to be issued and outstanding immediately following the listing of our ordinary shares on the Hong Kong Stock Exchange. In no event may an option be granted under our 1999 purchase plan if such grant would result in the total aggregate number of ordinary shares subject to all then outstanding purchase rights granted by us pursuant to our 1999 purchase plan, any share option granted pursuant to our 2005 share option plan or any other plan (but not including our 2005 share incentive plan) to exceed 30% of the issued and outstanding ordinary shares from time to time. As of December 31, 2006, 34,148,050 shares had been issued under the 1999 purchase plan.

Our board of directors or a committee designated by our board of directors, referred to as the "plan administrator", administers our 1999 purchase plan. All of our employees who are regularly employed for more than five months in any calendar year and work more than 20 hours per week are eligible to participate in our 1999 purchase plan, subject to a 10 day waiting period after hiring. Non-employee directors, consultants and employees subject to the rules or laws of a non-U.S. jurisdiction that prohibit or make impractical their participation in the plan will not be eligible to participate. Our 1999 purchase plan designates offer periods, purchase periods and exercise dates. Offer periods are periods of three months commencing in February, May, August and November. Purchase periods will generally be three month periods. Exercise dates are the last day of each purchase period. In the event of a corporate transaction, the plan administrator may elect to shorten the offer periods then in progress and set a new exercise date for the purchase of ordinary shares or ADSs.

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On the first day of each offer period, a participating employee will be granted a purchase right. A purchase right is a form of option to be

automatically exercised on the forthcoming exercise dates within the offer period during which authorized deductions are to be made from the pay of participants and credited to their accounts under our 1999 purchase plan. When the purchase right is exercised, the participant's withheld salary is used to purchase the ordinary shares or ADSs. The price per share at which the ordinary shares or ADSs are to be purchased under our 1999 purchase plan during any purchase period will be expressed as a percentage not less than the lower of (a) 90% of the fair market value of the ordinary shares or ADSs on the date of grant of the purchase right (which is the commencement of the offer period) or (b) 90% of the fair market value of the ordinary shares or ADSs on the date the purchase right is exercised. Purchase rights may not be assigned, transferred, pledged or otherwise disposed of in any way by the participant, other than by will or the laws of descent and distribution.

Payroll deductions may range from 1% to 10% in whole percentage increments of a participant's regular base pay. The maximum number of ordinary shares or ADSs that any employee may purchase under our 1999 purchase plan during a purchase period is 100,000 ordinary shares or 2,000 ADSs. In addition, Section 423 of the U.S. Internal Revenue Code imposes a US$25,000 limit on the maximum amount of ordinary shares or ADSs that may be purchased under a tax-qualified employee stock purchase plan during any calendar year. The US$25,000 limit is determined at the fair market value of the ordinary shares or ADSs at the time such option is granted for each calendar year in which such option is outstanding.

The plan administrator has the authority to amend or terminate our 1999 purchase plan. The plan administrator may terminate any offer period on any exercise date if the plan administrator determines that the termination of the offer period is in the best interests of our company and its shareholders.

2005 Share Option Plan. Our 2005 share option plan was adopted by our board of directors in August 2005, was approved by our shareholders in November 2005 and took effect on March 2, 2006. The 2005 share option plan provides for the granting to employees of incentive stock options within the meaning of Section 422 of the Internal Revenue Code and the granting of nonstatutory stock options to our employees, directors and consultants. Initially, the maximum aggregate number of shares reserved for issuance pursuant to all options (including incentive stock options) under the 2005 share option plan is 100,000,000 ordinary shares after taking into account the 50-to-1 stock split on November 25, 2005 and such number of shares shall not, when added to the remaining number of ordinary shares available for the grant of options under any other plan or employee share purchase plan, be greater than 10% of the number of ordinary shares outstanding as of the date of adoption of the 2005 share option plan. The maximum number of shares that may be issued upon exercise of all outstanding (and unexercised) options under the 2005 share option plan and any other plan of ours and any purchase rights granted by us pursuant to any employee share repurchase plan must not, in aggregate, exceed 30% of the number of ordinary shares outstanding from time to time. Where an award agreement permits the exercise or purchase of the award for a specified period of time following the recipient's termination of service with us, or the recipient's disability or death, the award will terminate to the extent not exercised or purchased on the last day of the specified period or the last day of the original term of the award, whichever occurs first. As of December 31, 2006, 16,279,900 options were outstanding under the 2005 share option plan.

2005 Share Incentive Plan. Our 2005 share incentive plan was adopted by our board of directors in August 2005, was approved by our shareholders in November 2005 and took effect on March 2, 2006. The 2005 share incentive plan provides for the granting to our employees, directors and consultants of restricted shares, cash dividend equivalent rights, restricted share units or stock appreciation rights or similar right with a fixed or variable price related to the fair market value of our ordinary shares and with an exercise or

conversion privilege related to the passage of time, the occurrence of one or more events, or the satisfaction of performance criteria or other conditions. Initially, the maximum aggregate number of shares which may be issued pursuant the 2005 share incentive plan is 75,000,000 ordinary shares after taking into account the

50-to-1 stock split on November 25, 2005. In addition, a right entitling a grantee to compensation measured by dividends paid with respect to ordinary shares shall be payable solely in cash and shall not be deemed to reduce the maximum aggregate number of shares which may be issued under our 2005 share incentive plan. Where an award agreement permits the exercise or purchase of the award for a specified period of time following the recipient's termination of service with us, or the recipient's disability or death, the award will terminate to the extent not exercised or purchased on the last day of the specified period or the last day of the original term of the award, whichever occurs first. As of December 31, 2006, 7,914,750 shares were outstanding under the 2005 share incentive plan.

Board Practices

Duties of Directors

Under Cayman Islands law, our directors have a duty of loyalty to act honestly in good faith with a view to promoting our best interests. Our directors also have a duty of care to exercise the care, diligence and skills that a reasonably prudent person would exercise in comparable circumstances. In fulfilling their duty of care to us, our directors must ensure compliance with our memorandum and articles of association and the class rights vested under our memorandum and articles of association in the holders of the shares.

Terms of Directors and Officers

Our articles of association provide for not less than five nor more than nine directors although the holders of a majority of our shares may increase or reduce such limits. Our articles of association provide for our board of directors to be divided into three classes, designated Class I, Class II and Class III, with each class consisting of an equal number of directors or as nearly equal in number as the then total number of directors permits. The directors of each class have been elected for terms of three years ending in consecutive years. At each annual general meeting, successors to the class of directors whose terms expire at that annual general meeting are elected for new three year terms. If the number of directors is changed, any increase or decrease is apportioned among the classes so as to maintain the number of directors in each class as nearly equal as possible and any additional directors of any class elected to fill a vacancy resulting from an increase in such class shall hold office for a term that shall coincide with the remaining term of that class, but in no case will a decrease in the number of directors shorten the term of any incumbent directors. The term of executive officers is determined by our board of directors. There are no provisions of Cayman Islands law which require the term of executive officers to be for a particular period.

Our board of directors has the power at any time and from time to time to appoint any person to be a director, either to fill a casual vacancy or as an additional to the existing directors provided that the appointment does not cause the number of directors to exceed any number fixed by or in accordance with the articles of association as a maximum number of directors. Any director so appointed shall hold office only until one next annual general meeting and is then eligible for re-election at that meeting.

Our shareholders may by special resolution remove any directors before the expiration of his period of office notwithstanding anything in the articles of association or in any agreement we have entered into with such director (but without prejudice to any claim for damages under any such agreement).

There is no shareholding qualification for directors. Subject to any retirement rules, statutes or provisions provided by applicable law, any individual who reaches the age of seventy-five (75) years or older at the time of election or re-election will not be eligible for recommendation for nomination to our board. Subject to any retirement rules, statutes or provisions provided by applicable law, upon reaching seventy-five (75) years of age, any existing director will be allowed to complete his or her term in office but will not be eligible for recommendation for nomination to our board for a subsequent term.

Committees of the Board of Directors

We have an audit committee, a compensation committee and a nominating committee. Each of our audit committee members qualifies as an "independent" director for purposes of the rules and regulations of Nasdaq. The audit committee is established by the Board primarily for the purpose of overseeing the accounting and financial reporting processes of the Company and audits of the financial statements of the Company. The Committee's responsibilities include (1) the appointment, retention, compensation and oversight of the work of our independent auditors, and for review of its qualifications, and (2) review of our system of internal controls. The Committee also maintains procedures for the receipt, retention and treatment of complaints received by the Company regarding accounting, internal controls, or auditing matters and for the confidential, anonymous submission by employees of the company of concerns regarding accounting or auditing matters. The audit committee meets at least four times per year, and also meets separately with the representatives of management at least annually. The audit committee held seven meetings in 2006. Currently, Messrs. Yawata, Goh and Lin serve on the audit committee.

The compensation committee establishes remuneration levels for our officers, performs the functions that are provided under our employee benefit programs and administers our long-term incentive, compensation and equity plans including our 1999 stock incentive plan, our 1999 employee stock purchase plan, our 2005 share incentive plan and 2005 share option plan. Currently, Messrs. Lin and Austin serve on the compensation committee.

The nominating committee assists our board of directors in selecting nominees for election to our board of directors and makes recommendations to our board of directors from time to time, or whenever it shall be called upon to do so, regarding nominees for our board of directors. Currently, Messrs. Austin and Yan serve on the nominating committee

Compensation Committee Interlocks and Insider Participation

No member of our compensation committee serves as a member of the board of directors or the compensation committee of any entity that has one or more executive officers serving as a member of our board of directors or our compensation committee.

Employees

As of December 31, 2006, we had 1,001 full-time employees, 116 of which were based in the United States, 850 in Asia, 32 in Europe and 3 in Cayman Islands. Our employees are not represented by any collective bargaining

agreements, and we have never experienced a work stoppage. We believe our employee relations are good.

ITEM 7. MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS

MAJOR SHAREHOLDERS

The following table sets forth information known to us with respect to the beneficial ownership of our ordinary shares, as of March 31, 2007, by each shareholder known by us to own beneficially more than 5% of our ordinary shares based on SEC filings as of March 31, 2007.

Name of Beneficial Owner	Shares Beneficially Owned	
	Number	Percent
Wasatch Advisors, Inc.	356,712,650	18.73%
Wellington Management Co. LLP	187,601,500	9.85%
Capital Research & Management Co.	152,750,000	8.02%
RS Investment Management Co	116,456,350	6.11%
Directors and members of our administrative, supervisory or management bodies	247,097,750	12.97%

None of the major shareholders listed above have differing voting rights with respect to the ordinary shares of the Company. We do not know of any arrangements the operation of which may at a subsequent date result in a change in control of the Company. To our knowledge, we are not directly or indirectly owned or controlled by another corporation, by a foreign government or any other natural or legal person.

RELATED PARTY TRANSACTIONS

Loans

In 2001, James Keim, one of our 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, we entered into a term loan agreement with Mr. Keim in February 2002, under which we made an interest free, unsecured loan in the amount of $400,000 to Mr. Keim. The loan is repayable in February 2007 and was repaid in full in December 2006.

In February 2000, we loaned $750,000 to 360(degree) Web Ltd (360(degree) Web). The loan accrued interest at a rate of USD-LIBOR + 1% and was to be paid semiannually until the loan was fully repaid or until the loan was converted into up to 2,083,333 shares of Series B preference shares of 360(degree) Web. The conversion price was $0.36 per share, convertible at any time before February 1, 2005 or before 360(degree) Web offers its shares in an initial public offering. In February 2002, we made an additional loan of $1.0 million to 360(degree) Web on terms similar to the February 2000 loan. The February 2002 loan was also convertible, into a maximum of 1,000,000 Series B2 preference shares of 360(degree) Web at a conversion price of $1.00 per share. On January 3, 2003, we exercised our option to convert both the February 2000 and February 2002 loans (aggregate principal of $1,750,000) into 2,083,333 Series B preference shares at $0.36 per share and 1,000,000 Series B2 preference shares at $1.00 per share. After the conversion, we owned a 35.18% interest in 360(degree) Web. We did not participate in 360(degree) Web's additional financing rounds during 2003, and our ownership was diluted to 29.33% as of

December 31, 2003. In March 2004, we sold 1,000,000 shares of our stock in 360(degree) Web and recognized a gain of $340,000. In January 2005, we purchased 180,769 Series D preference shares of 360(degree) Web at $1.30 per share. As of December 31, 2006, we held 19.52% ownership of 360(degree) Web. From time to time, we may make additional loans to 360(degree) Web on similar terms.

Executive Severance and Change of Control Agreements

In April 2007, we entered into an Executive Severance and Change of Control Agreement with Sterling Du, our chief executive officer and chairman of our board, pursuant to which Mr. Du would be entitled to, among other things, two times his base salary and annual target bonus and immediate vesting of 50% of his unvested equity awards if terminated under certain circumstances. In addition, Mr. Du would be entitled to, among other things, three times his base salary and annual target bonus and immediate vesting of 100% of his unvested equity awards if terminated under certain circumstances within twenty-four months of a change of control of our company.

In April 2007, we entered into an Executive Severance and Change of Control Agreement with Chuan Chiung "Perry" Kuo, our chief financial officer, pursuant to which Mr. Kuo would be entitled to,

among other things, one times his base salary and annual target bonus and immediate vesting of 50% of his unvested equity awards if terminated under certain circumstances. In addition, Mr. Kuo would be entitled to, among other things, one and a half times his base salary and annual target bonus and immediate vesting of 50% of his unvested equity awards if terminated under certain circumstances within twelve months of a change of control of our company.

In April 2007, we entered into an Executive Severance and Change of Control Agreement with James Keim, our head of marketing and sales, pursuant to which Mr. Keim would be entitled to, among other things, one times his base salary and annual target bonus and immediate vesting of 50% of his unvested equity awards if terminated under certain circumstances. In addition, Mr. Keim would be entitled to, among other things, one and a half times his base salary and annual target bonus and immediate vesting of 50% of his unvested equity awards if terminated under certain circumstances within twelve months of a change of control of our company.

ITEM 8 FINANCIAL INFORMATION

CONSOLIDATED STATEMENTS AND OTHER FINANCIAL INFORMATION

Consolidated Financial Statements

Our financial statements set forth in the accompanying index to Consolidated Financial Statements included in this Annual Report following Part IV beginning on page F-1 are hereby incorporated in this Annual Report. Our Consolidated Financial Statements are filed as part of this Annual Report.

DIVIDEND POLICY

We have never declared or paid any cash dividends on our ordinary shares or other securities and do not anticipate paying cash dividends in the foreseeable future.

ITEM 9 THE OFFER AND LISTING

ADS AND ORDINARY SHARE PRICES AND RELATED MATTERS

Our ADSs are quoted and traded on the Nasdaq Global Select Market and the Cayman Islands Stock Exchange. Our ordinary shares are listed on the SEHK and the Cayman Islands Stock Exchange.

Ordinary Shares Prior to Close of Trading on November 25, 2005 and ADSs After Commencement of Trading on November 28, 2005

The following table sets forth for the periods indicated the high and low last reported sales prices per ordinary share prior to the close of trading on November 25, 2005 and the high and low last reported sales prices per ADS after the commencement of trading on November 28, 2005 as furnished by the Nasdaq Global Select Market.

(a) Annual high and low market prices

	High	Low
January 1, 2002 through December 31, 2002	$25.28	$5.30
January 1, 2003 through December 31, 2003	$25.29	$8.01
January 1, 2004 through December 31, 2004	$24.98	$9.04
January 1, 2005 through December 31, 2005	$17.72	$8.74
January 1, 2006 through December 31, 2006	$13.55	$5.07

(b) Quarterly high and low market prices

First Quarter 2005	$10.95	$8.74
Second Quarter 2005	$14.72	$9.35
Third Quarter 2005	$17.72	$14.10
Fourth Quarter 2005	$15.83	$9.24
First Quarter 2006	$13.55	$9.95
Second Quarter 2006	$10.98	$7.20
Third Quarter 2006	$7.87	$5.07
Fourth Quarter 2006	$8.64	$6.40
First Quarter 2007	$8.65	$7.12

(c) Monthly high and low market prices

December 2006	$8.64	$7.49
January 2007	$8.43	$7.12
February 2007	$8.65	$7.68
March 2007	$8.11	$7.33
April 2007	$10.67	$7.80
May 2007	$10.98	$9.72

Ordinary Shares After Commencement of Trading On March 2, 2006

The following table sets forth for the periods indicated the high and low last reported sales prices per ordinary share in Hong Kong dollars (HK$) as furnished by the Hong Kong Stock Exchange. Our ordinary shares commenced trading on the Hong Kong Stock Exchange on March 2, 2006

(a) Quarterly high and low market prices

	High	Low
Second Quarter 2006	HK$1.70	HK$1.11
Third Quarter 2006	HK$1.16	HK$0.84
Fourth Quarter 2006	HK$1.31	HK$0.94
First Quarter 2007	HK$1.32	HK$1.05

(b) Monthly high and low market prices

	High	Low
December 2006	HK$1.31	HK$1.00
January 2007	HK$1.28	HK$1.05
February 2007	HK$1.32	HK$1.14
March 2007	HK$1.24	HK$1.16
April 2007	HK$1.64	HK$1.16
May 2007	HK$1.64	HK$1.51

ITEM 10 ADDITIONAL INFORMATION

The following are summaries of material provisions of our memorandum and articles of association and the Companies Law (2004 Revision). The summary is qualified in its entirety by reference to our memorandum and articles of association (see Item 19-Exhibit 1).

Registered Office

The Company has been assigned registration number CR-72204 by the registrar of companies in the Cayman Islands. The registered office is located at the offices of M&C Corporate Services Limited, P.O. Box 309, Ugland House, South Church Street, George Town, Grand Cayman, Cayman Islands. The telephone number at that location is (345) 949-8066.

Objects and Purposes

Paragraph 3 of the memorandum of association provides that the objects and purposes of the Company are unlimited and the Company may perform all corporate activities not prohibited by any law as provided by the Companies Law.

Directors

Article 117 of the articles of association of the Company provides that a director will not be disqualified by his office from contracting with the Company notwithstanding such director's interest and that such an interested director will not be liable to the Company for any profit realized through such contract or arrangement, provided, the interested director declares such interest at the earliest meeting of the board. Article 127 provides that directors' compensation shall from time to time be determined by the Company in general meeting or by the board in accordance with the articles of association. Article 136 provides that the directors may exercise all the powers of the Company to borrow money and to mortgage or charge its undertaking, property and uncalled capital or any part thereof and to issue debentures, debenture stock and other securities whether outright or as security for any debt, liability or obligation of the Company or of any third party.

Ordinary Shares

General. The Company's articles of association authorize the issuance of 4,750,000,000 ordinary shares with a par value of US $0.00002. All the outstanding ordinary shares are fully paid and nonassessable and accordingly no further capital may be called for by the Company from any holder of the ordinary shares outstanding. Certificates representing the ordinary shares are issued in registered form. The ordinary shares are not entitled to any sinking fund or pre-emptive or redemption rights. Under Cayman Islands Law, non-residents may freely hold, vote and transfer ordinary shares in the same manner as Cayman Islands residents, subject to the provisions of the Companies Law and the articles of association. No Cayman Islands laws or regulations restrict the export or import of capital or affect the payment of dividends to non-residents holders of the ordinary shares.

Dividends. The holders of our ordinary shares are entitled to receive the dividends that are declared by the board of directors. Dividends may be paid only out of profits, which include net earnings and retained earnings undistributed in prior years, and out of share premium, a concept analogous to paid-in-surplus in the United States, subject to a statutory solvency test.

Voting Rights. Each ordinary share is entitled to one vote on all matters upon which the ordinary shares are entitled to vote, including the election of directors. Voting at any meeting of shareholders is by show of hands unless a poll is demanded. A poll may be demanded by the chairman of the meeting or any shareholder present in person or by proxy, before or on the declaration of the result of the show of hands.

A quorum required for a meeting of shareholders consists of at least a number of shareholders present in person or by proxy and entitled to vote representing the holders of not less than a majority of our issued voting share capital. Shareholders' meetings are held annually and may be convened by the board of directors on its own initiative. Advanced notice of at least twenty-one days in the case of annual general meetings or any meeting at which the passing of a special resolution is to be considered and fourteen days in all other cases is required for the convening of shareholders' meetings.

Any ordinary resolution to be made by the shareholders requires the affirmative vote of a simple majority of the votes attaching to the ordinary shares and preference shares, if any, cast in a general meeting, while a special resolution requires the affirmative vote of two-thirds of the votes cast attaching to the ordinary shares and preference shares, if any. Holders of ordinary shares, which are currently the only shares, carrying the right to vote at our general meetings, have the power, among other things, to elect directors, appoint auditors and make changes in the amount of our authorized share capital.

Material issues that require a special resolution of the shareholders under the Companies Law include resolutions to alter the memorandum of association with respect to any objects, powers or other matters specified therein, any alteration of the articles of association, any reduction of capital, any change of name, the appointment of an inspector for examining into the affairs of the company, requiring the company to be wound up by a court, any voluntary winding up, delegating to creditors the power of appointing liquidators, making binding arrangements between the company and its creditors, and sanctioning the transfer of the business or property of the company being wound up to another company whether established in the Cayman Islands or in any other jurisdiction.

Liquidation. If we are to be liquidated, the liquidator may, with the approval of the shareholders, divide among the shareholders in cash or in kind the whole or any part of our assets, in a manner proportionate to their

shareholdings, and may vest the whole or any part of those assets in trustees of those trusts for the benefit of the shareholders that the liquidator, with the approval of the shareholders, thinks fit, provided that, in practice, a shareholder may not be compelled to accept any shares or other assets that would subject that shareholder to liability.

Preference Shares

The articles of association authorizes the issuance of 250,000,000 preference shares with a par value of $0.00002 per share. Pursuant to our articles of association, the board of directors has the authority, without further action by the shareholders, to issue preference shares in one or more series. It also has the authority to fix the designations, powers, preferences, privileges and relative participating, optional or special rights and the qualifications, limitations or restrictions of those shares, including dividend rights, conversion rights, voting rights, terms of redemption and liquidation preferences, any or all of which may be greater than the rights of the ordinary shares. The board of directors, without shareholder approval, can issue preference shares with voting, conversion or other rights that could harm the voting power and other rights of the holders of ordinary shares. Subject to the directors' duty of acting in our best interest, preference shares can be issued quickly with terms calculated to delay or prevent a change in control or make removal of management more difficult. Additionally, the issuance of preference shares may have the effect of decreasing the market price of the ordinary shares, and may harm the voting and other rights of the holders of ordinary shares. We have confirmed that as long as our ordinary shares or preference shares are listed on the SEHK, we will comply with the listing rules of the SEHK and any preference shares issued or to be issued shall carry the same voting rights as the ordinary shares.

Anti-takeover Effects of Provisions in Our Charter Documents

Provisions in our charter documents could discourage potential acquisition proposals and could delay or prevent a change in control transaction that our shareholders favor. These provisions could have the effect

of discouraging others from making tender offers for our shares. As a result, these provisions may prevent the market price of our ordinary shares from reflecting the effects of actual or rumored takeover attempts and may prevent shareholders from reselling their shares at or above the price at which they purchased their shares. These provisions may also prevent changes in our management that our shareholders may favor. Our charter documents do not permit shareholders to act by written consent, do not permit shareholders to call a general meeting and provide for a classified board of directors, which means shareholders can only elect, or remove, a limited number of our directors in any given year. Furthermore, as discussed above, our board of directors have the authority to issue up to 250,000,000 preference shares in one or more series. Our board of directors can fix the price, rights, preferences, privileges and restrictions of such preference shares without any further vote or action by our shareholders. The issuance of preference shares may delay or prevent a change in control transaction without further action by our shareholders or make removal of management more difficult.

Differences in Corporate Law

The Companies Law of the Cayman Islands is modeled after that of England but does not follow recent United Kingdom statutory enactments and differs from laws applicable to United States corporations and their

shareholders. The following paragraphs are a summary of the significant differences between the provisions of the Companies Law applicable to us and the laws applicable to companies incorporated in the United States and to their shareholders.

Mergers and Similar Arrangements. Cayman Islands law does not provide for mergers as that expression is understood under United States corporate law. However, there are statutory provisions that facilitate the reconstruction and amalgamation of companies, provided that the arrangement in question is approved by a majority in number of each class of shareholders and creditors with whom the arrangement is to be made, and who must in addition represent three-fourths in value of each class of shareholders or creditors, as the case may be, that are present and voting either in person or by proxy at a meeting or meetings convened for that purpose. The convening of the meetings and subsequently the arrangement must be sanctioned by the Grand Court of the Cayman Islands. While a dissenting shareholder would have the right to express to the court the view that the transaction ought not to be approved, the court can be expected to approve the arrangement if it satisfies itself that:

- the parties have complied with the statutory provisions regarding majority vote;

- the shareholders have been fairly represented at the meeting in question;

- the arrangement is one that a businessman would reasonably approve; and

- the arrangement is not one that would more properly be sanctioned under some other provision of the Companies Law.

When a take-over offer is made and accepted by holders of 90% of the shares within four months, the offeror may, within a two-month period require the holders of the remaining shares to transfer these shares on the terms of the offer. An objection can be made to the Grand Court of the Cayman Islands but this is unlikely to succeed unless there is evidence of fraud, bad faith or collusion.

If the arrangement and reconstruction is approved, the dissenting shareholder would have no rights comparable to appraisal rights, which would otherwise ordinarily be available to dissenting shareholders of United States corporations, providing rights to receive payment in cash for the judicially determined value of the shares.

Shareholders' Suits. Maples and Calder has advised us that no significant or major reported class action or derivative action has been brought in a Cayman Islands court. In principle, we will normally be the proper plaintiff and a derivative action may not be brought by a minority shareholder. However, based on

English authorities, which would in all likelihood be of persuasive authority in the Cayman Islands, exceptions to the foregoing principle apply in circumstances in which:

- a company is acting or proposing to act illegally or outside of its powers;

- the act complained of, although not outside of its powers, could be effected only if authorized by more than a simple majority vote;

- the individual rights of the plaintiff shareholders have been infringed or are about to be infringed; or
- those who control the company are perpetrating a "fraud on the minority."

Indemnification

Cayman Islands law does not limit the extent to which a company's articles of association may provide for indemnification of officers and directors, except to the extent that a provision may be held by the Cayman Islands courts to be contrary to public policy, such as to provide indemnification against civil fraud or the consequences of committing a crime. Our articles of association provide for indemnification of officers and directors for losses, damages, costs and expenses incurred in their capacities as such, except if they acted in a willfully negligent manner or defaulted in any action against them.

Insofar as indemnification for liabilities arising under the Securities Act may be permitted to our directors, officers or persons controlling us pursuant to these provisions, we have been informed that, in the opinion of the Securities and Exchange Commission, this indemnification is against public policy as expressed in the Securities Act and therefore is unenforceable.

Enforceability of Civil Liabilities

We are a Cayman Islands company. We incorporated in the Cayman Islands because of the following benefits associated with being a Cayman Islands company:

- political and economic stability;
- an effective judicial system;
- unlike some jurisdictions which impose taxes on worldwide income, no taxation of companies based upon profits, income, gains or appreciation;
- the absence of exchange control or currency restrictions; and
- the availability of professional and support services.

However, the Cayman Islands has a less developed body of securities laws than the United States and provides less protection for investors. For example, the remedies of shareholders and fiduciary responsibilities of our directors are governed by Cayman Islands law and are not as clearly established as under statutes or judicial precedent in existence in jurisdictions in the United States. While there is some case law in the Cayman Islands on these matters, it is not as developed as, for example, English law. However, we believe that English case law, although not binding in the courts of the Cayman Islands, would be regarded as persuasive. Based on English case law, we believe under Cayman Islands law, our directors have a duty of loyalty to act honestly in good faith with a view to promoting our best interests. Our directors also have a duty of care to exercise the care, diligence and skills that a reasonably prudent person would exercise in comparable circumstances. In fulfilling their duty of care to us, our directors must ensure compliance with our memorandum and articles of association and the class rights vested under our memorandum and articles of association in the holders of the shares.

A substantial majority of our assets are located outside the United States. In addition, a majority of our directors and officers are nationals and/or residents of countries other than the United States, and all or a substantial portion of our assets and the assets of our directors and officers are located outside the United States. As a result, it may be difficult to effect service of process within the United States upon us or our directors and officers or to enforce against us or against them judgments obtained in United States courts, including judgments predicated upon the civil liability provisions of the securities laws of the United States or any state thereof.

Maples and Calder, our counsel as to Cayman Islands law, has advised us that there is uncertainty regarding whether the courts of the Cayman Islands would (1) recognize or enforce judgments of United States courts obtained against us or our officers and directors predicated upon the civil liability provisions of the securities laws of the United States or any state thereof or (2) be competent to hear original actions brought in their jurisdiction against us or our officers and directors predicated upon the securities laws of the United States or any state thereof.

There is no statutory enforcement in the Cayman Islands of judgments obtained in the United States. Instead, such a judgment must be enforced by action at common law. Maples and Calder have advised us that a final and conclusive judgment in a federal or state court of the United States under which a sum of money is payable, other than a sum payable in respect of taxes, fines, penalties or similar charges, may be subject to enforcement proceedings as a debt in the Courts of the Cayman Islands under the common law doctrine of obligation.

Material Contracts

Other than the contracts listed under Item 19--Exhibits and the Executive Severance and Change of Control Agreements described in "Related Party Transactions - Executive Severance and Change of Control Agreements", in the past two years we have not entered into any material contracts other than contracts entered into in the ordinary course of business.

Exchange Control

Our articles of association authorizes us to issue an aggregate of 4,750,000,000 ordinary shares with a par value of $0.00002 per share. Of those 4,750,000,000 authorized ordinary shares, 1,906,969,950 shares were issued and outstanding as of December 31, 2006, all of which are fully paid or credited as fully paid. We may not call for any further capital from any holder of ordinary shares outstanding. Under Cayman Islands law, non-residents of the Cayman Islands may freely hold, vote and transfer ordinary shares in the same manner as Cayman Islands residents, subject to the provisions of the Companies Law and our articles of association. No Cayman Islands laws or regulations restrict the export or import of capital, or affect the payment of dividends to non-resident holders of ordinary shares.

TAXATION

Cayman Islands Taxation

The Cayman Islands currently levy no taxes on individuals or corporations based upon profits, income, gains or appreciation and there is no taxation in the nature of inheritance tax or estate duty. There are no other taxes likely to be material to us levied by the Government of the Cayman Islands except for stamp duties that may be applicable on instruments executed in, or after execution brought within, the jurisdiction of the Cayman Islands. The Cayman Islands are not party to any double tax treaties. There are no exchange

control regulations or currency restrictions in the Cayman Islands.

No stamp duties are payable on the issue or transfer of shares. An agreement to transfer shares may be subject to stamp duty if the agreement is executed in the Cayman Islands or, if executed outside the Cayman Islands, subsequently brought into the Cayman Islands. The Stamp Duty Law (2005 Revision) does not provide who is liable to pay stamp duty on any document but, in practice, the person who seeks to rely on the document in any civil court proceedings will be required to pay stamp duty in order to have the document admitted in evidence.

United States Federal Income Taxation

The following discussion addresses the material United States federal income tax consequences of the ownership and disposition of ordinary shares or ADSs held as a capital asset by a "U.S. Investor" (as defined below). This summary does not provide a complete analysis of all potential tax consequences. This summary is based on the Internal Revenue Code of 1986, as amended (the "Code"), final, temporary and proposed Treasury Regulations thereunder, and administrative and judicial interpretations thereof, all as in effect as of the date hereof, and all of which are subject to change at any time (possibly on a retroactive basis) by legislative, judicial or administrative action, and to differing interpretations. There can be no assurance that the Internal Revenue Service (the "IRS") will not take a contrary view. This summary does not discuss state, local or foreign tax consequences of the ownership and disposition of ordinary shares or ADSs.

This summary is directed solely to U.S Investors that hold ordinary shares or ADSs as capital assets within the meaning of Section 1221 of the Code, which generally means as property held for investment. For purposes of this discussion, a "U.S. Investor" means a beneficial owner of ordinary shares or ADSs who is any of the following:

- a citizen or resident of the United States or someone treated as a U.S. citizen or resident for U.S. federal income tax purposes;
- a corporation or other entity taxable as a corporation for U.S. federal income tax purposes created or organized in or under the laws of the United States or any political subdivision thereof, including the District of Columbia;
- an estate the income of which is subject to U.S. federal income taxation regardless of its source;
- a trust that is subject to the primary supervision of a court within the United States and one or more U.S. persons have the authority to control all of its substantial decisions;
- a trust in existence on August 20, 1996 that has a valid election in effect under applicable U.S. Treasury regulations to be treated as a U.S. person; or
- a person that is otherwise subject to U.S. federal income taxation on its net income.

If a partnership (including for this purpose any entity treated as a partnership for U.S. federal income tax purposes) is a beneficial owner of ordinary shares or ADSs, the U.S. federal income tax consequences to a partner in the partnership will generally depend on the status of the partner and the

activities of the partnership. A holder of ordinary shares or ADSs that is a partnership and partners in such partnership should consult their individual tax advisors about the U.S. federal income tax consequences of holding or disposing of the ordinary shares or ADSs.

This summary does not address the United States federal income tax treatment of investors having a special legal status, including without limitation the following types of investors, who may be subject to tax rules that differ significantly from those summarized below:

- life insurance companies;
- tax-exempt investors;
- banks and financial institutions;
- dealers in securities or foreign currencies;
- traders in securities that elect to use a mark-to-market method of accounting for their securities holdings;
- persons liable for alternative minimum tax;
- U.S. investors who or that actually or constructively hold 10% or more of our voting shares or ADSs;
- investors who hold our ordinary shares or ADSs as part of straddles, hedging or integrated or conversion transactions; or
- persons whose "functional currency" is not the U.S. dollar.

This summary is not a comprehensive description of all of the tax considerations that may be relevant with respect to your ownership of ordinary shares or ADSs. You are advised to consult your own tax adviser with respect to your particular circumstances and with respect to the effects of federal, state, local or foreign tax laws to which you may be subject. The United States does not have an income tax treaty with the Cayman Islands.

As relates to the ADSs, this discussion is based in part upon the representations of the depositary and the assumption that each obligation in the deposit agreement and any related agreement will be performed in accordance to its terms.

Generally, a holder of ADSs will be treated as the owner of the underlying ordinary shares represented by those ADSs for U.S. federal income tax purposes. Accordingly, no gain or loss will be recognized if the holder exchanges ADSs for the underlying ordinary shares represented by those ADSs. The holder's adjusted tax basis in the ordinary shares will be the same as the adjusted tax basis of the ADSs surrendered in exchange therefor, and the holding period for the ordinary shares will include the holding period for the surrendered ADSs.

Dividends and Other Distribution on Ordinary Shares or ADSs. Subject to the discussion in "Passive Foreign Investment Company Status" below, in the event that a U.S. Investor receives a distribution on the ordinary shares or ADSs, the U.S. Investor will be required to include the distribution in gross income as a taxable dividend on the date of receipt by the depositary, in the case of ADSs, or by the U.S. Investor, in the case of ordinary shares, but only to the extent that a distribution is paid from our current or accumulated

earnings and profits as determined for United States federal income tax principles. Dividends paid by us will not be eligible for the corporate dividends received deduction. For taxable years beginning before January 1, 2011, "qualified dividend income" paid to a noncorporate U.S. Investor will be subject to tax at the rates applicable to long-term capital gains (which are currently taxed at the maximum rate of 15%) if (1) our ordinary shares or ADSs are readily tradable on an established securities market in the United States, (2) we are not a passive foreign investment company (as discussed below) for either our taxable year in which the

dividend was paid or the preceding taxable year and (3) certain holding period requirements must be met. It is expected that our ADSs will satisfy the "readily tradable" requirement as a result of being traded on the Nasdaq Global Select Market. However, any U.S. Investor that exchanges its ADSs for ordinary shares, or that holds only ordinary shares, may not be eligible for the reduced rate of taxation on dividends if the ordinary shares are not readily tradable on an established securities market in the United States. In order for dividends to constitute "qualified dividend income," a U.S. Investor generally must have held the ADSs for more than 60 days during the 121-day period beginning 60 days before the ex-dividend date; however, because the holding period rules are intricate and because an owner's holding period is reduced for periods during which the risk of loss is diminished, U.S. Investors should consult their own advisors concerning the calculation of their holding periods. Moreover, a dividend will not be treated as a qualified dividend income to the extent that the taxpayer is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property. U.S. Investors should consult their own tax advisers regarding the availability of the lower rate for dividends paid with respect to our ADSs or ordinary shares.

The Company has the right to pay dividends in any currency. If dividends are paid in a currency other than the U.S. dollar, the dividends will be included in a U.S. Investor's income as a U.S. dollar amount based on the exchange rate in effect on the date that the U.S. Investor receives the dividend, regardless of whether the payment is in fact converted into U.S. dollars. If the U.S. Investor does not receive U.S. dollars on the date the dividend is distributed, the U.S. Investor will be required to include either gain or loss in income when the U.S. Investor later exchanges the foreign currency for U.S. dollars. The gain or loss will be equal to the difference between the U.S. dollar value of the amount that the U.S. Investor includes in income when the dividend is received and the amount that the US. Investor receives on the exchange of the foreign currency for U.S. dollars. The gain or loss generally will be ordinary income or loss from U.S. sources. If we distribute as a dividend non-cash property, the U.S. Investor will generally include in income an amount equal to the U.S. dollar equivalent of the fair market value of the property on the date that it is distributed.

Dividends will constitute foreign source income for foreign tax credit limitation purposes. The limitation on foreign taxes eligible for credit is calculated separately with respect to specific classes of income. Under current law, for taxable years beginning after December 31, 2006, dividends distributed by us with respect to ordinary shares or ADSs would generally constitute "passive category income" but could, in the case of certain U.S. Investors, constitute "general category income." Special rules apply to individuals whose foreign source income during the taxable year consists entirely of "qualified passive income" and whose creditable foreign taxes paid or accrued during the taxable year do not exceed $300 ($600 in the case of a joint return). Further, in particular circumstances, a U.S. Investor that (i) has held the ordinary shares or ADSs for less than a specified minimum period during which it is not

protected from risk of loss, (ii) is obligated to make payments related to the dividends, or (iii) holds the ordinary shares or ADSs in arrangements in which the U.S. Investor's expected economic profit, after non-U.S. taxes, is insubstantial, will not be allowed a foreign tax credit for foreign taxes imposed on dividends paid on the ordinary shares or ADSs.

The U.S. Treasury has expressed concerns that parties to whom ADSs are pre-released may be taking actions that are inconsistent with the claiming of foreign tax credits by U.S. Investors of ADSs. Such actions would also be inconsistent with the claiming of the preferential tax rates applicable to qualified dividend income, as defined above. Accordingly, the creditability of foreign withholding taxes and the availability of such preferential tax rates could be affected by future actions that may be taken by the U.S. Treasury or parties to whom ADSs are pre-released.

Distributions in excess of our current and accumulated earnings and profits will be treated as a nontaxable return of capital to the extent of the U.S. Investor's basis in the ordinary shares or ADSs and thereafter as gain from the sale or exchange of a capital asset. We do not generally intend to calculate our earnings and profits under U.S. federal income tax principles. Therefore a U.S. Investor should expect that a distribution will generally be treated as a dividend even if that distribution would otherwise be treated as a nontaxable return of capital or as capital gain under the rules described above.

Distributions to a U.S. Investor of new ordinary shares or ADSs or rights to subscribe for new ordinary shares or ADSs that are received as part of a pro rata distribution to all our shareholders will not be subject to U.S. federal income tax. The adjusted tax basis of the new ordinary shares or ADSs or rights so received will be determined by allocating the U.S. investor's adjusted tax basis in the old ordinary shares or ADSs between the old ordinary shares or ADSs and the new ordinary shares or ADSs or rights received, based on their relative fair market values on the date of distribution. However, the adjusted tax basis of the new ordinary shares or ADSs or rights will be zero if the fair market value of the new rights is less than 15% of the fair market value of the old ordinary shares or ADSs at the time of distribution and the U.S. Investor does not make an election to determine the adjusted tax basis of the rights by allocation as described above. A U.S. Investor's holding period in the new ordinary shares or ADSs or rights will generally include the holding period of the old ordinary shares or ADSs on which the distribution was made.

Dispositions of ordinary shares or ADSs. Subject to the discussion in "Passive Foreign Investment Company Status" below, gain or loss realized by a U.S. Investor on the sale or other disposition of the ordinary shares or ADSs will be subject to United States federal income tax as capital gain or loss in an amount equal to the difference between the amount realized on the disposition and that U.S. Investor's basis in the ordinary shares or ADSs. The capital gain or loss will be long-term capital gain or loss if the U.S. Investor has held the ordinary shares or ADSs for more than one year at the time of the sale or exchange. A noncorporate U.S. investor will be eligible for reduced rates of taxation (currently, at a maximum rate of 15% for sales occurring in taxable years beginning before January 1, 2011) on long-term capital gain. The deductibility of capital losses is subject to limitations. Any gain or loss recognized by a U.S. Investor will generally be treated as U.S. source income or loss for U.S. foreign tax credit purposes.

U.S. Investors should consult their own tax advisor regarding the U.S. federal income tax consequences if the U.S. Investor receives currency other than U.S. dollars upon the disposition of ordinary shares or ADSs.

Passive Foreign Investment Company Status. We believe that we are not a passive foreign investment company and do not expect to become a passive foreign investment company in the future. We will be classified as a passive foreign investment company if for a taxable year, after the application of "look through" rules, either (a) 75% or more of the gross income of the company in a taxable year is passive income, or (b) the average percentage of assets by value of the company in a taxable year that produce or are held for the production of passive income (which includes cash) is at least 50%, the income or assets test. Whether or not we are a passive foreign investment company will be determined annually based upon the composition of our income and assets including goodwill, from time to time. In determining that we are not a passive foreign investment company, we are relying on the current valuation of our assets, including goodwill. In calculating goodwill, we have valued our total assets based on our total market value determined using the then market price of our ordinary shares and ADSs and have made a number of assumptions regarding the amount of this value allocable to goodwill. Because the determination of goodwill will be based on the price of our ordinary shares and ADSs, it is subject to change. We believe our valuation approach is reasonable. However, it is possible that the Internal Revenue Service will challenge the valuation of our goodwill, which may result in our being classified as a passive foreign investment company. In addition, the composition of our income and assets will be affected by how we spend the cash we have raised, which is a passive asset for purposes of the passive foreign investment company asset test discussed above. We intend to use the cash we have raised in the past and conduct our business activities in an effort to reduce the risk of our classification as a passive foreign investment company. Because the passive foreign investment company determination is made at the end of each taxable year, we cannot determine in advance whether we will be considered a passive foreign investment company for any future taxable year. If we determine that we have become a passive foreign investment company, we will notify the Bank of New York and all U.S. investors who have been record holders of our ordinary shares or ADSs during any period in which we determine that we are a passive foreign investment company, within 60 days of the end of our taxable year for which we make such determination. If we are a passive foreign investment company for any year during which a U.S. Investor holds ordinary shares or ADSs, we generally will continue to be treated as a passive foreign investment company for all succeeding years during which the U.S. Investor holds ordinary shares or ADSs.

Special U.S. tax rules apply to U.S. Investors of interests in a passive foreign investment company. Subject to the discussion of the market-to-market election and qualified electing fund election below, if we were a passive foreign investment company for any taxable year during which a U.S. Investor held ordinary shares or ADSs, the U.S. Investor would be subject to special tax rules regardless of whether we meet the income or assets test for any other year with respect to:

- any "excess distribution" by us to the U.S. Investor, which means any distributions received by the U.S. Investor on the ordinary shares or ADSs in a taxable year that are greater than 125% of the average annual distributions received by the U.S. Investor in the three preceding taxable years, or, if shorter, the U.S. Investor's holding period for the ordinary shares or ADSs; and

- any gain realized on the sale or other disposition, including a pledge, of ordinary shares or ADSs.

Under these special tax rules:

- the excess distribution or gain would be allocated ratably over the

U.S. Investor's holding period for the ordinary shares or ADSs;

- the amount allocated to the current taxable year and any taxable year prior to the first taxable year in which we are a passive foreign investment company would be treated as ordinary income;

- the amount allocated to each of the other years would be taxed as ordinary income at the highest tax rate in effect for that year; and

- the interest charge applicable to underpayments of tax would be imposed with respect to the resulting tax attributable to each prior year in which we were a passive foreign investment company to recover the deemed benefit from the deferred payment of the tax attributable to each prior year.

In addition, dividends that a U.S. Investor receives from us will not be eligible for the special tax rates applicable to "qualified dividend income" (see "-- United States Federal Income Taxation --- Dividends") if we are a passive foreign investment company either in the taxable year of the distribution or the preceding taxable year, but will instead be taxable at rates applicable to ordinary income.

If we are a passive foreign investment company in any year, a U.S. Investor would be required to file an annual return on Internal Revenue Service Form 8621 regarding distributions received with respect to the ordinary shares or ADSs and any gain realized on the disposition of the ordinary shares or ADSs.

A U.S. Investor in a passive foreign investment company is allowed to make a mark-to-market election with respect to the stock of the passive foreign investment company, provided that the stock of the passive foreign investment company is "marketable" within the meaning of the Code. The ordinary shares will be "marketable" as long as they remain listed on the Nasdaq Global Select Market and are "regularly traded." The ordinary shares or ADSs will be considered "regularly traded" for any calendar year during which the ordinary shares or ADSs are traded, other than in de minimis quantities, on at least fifteen days during each calendar quarter. If the election is made, a U.S. Investor would be required to mark the ordinary shares or ADSs to market each taxable year and recognize ordinary income for any increase in market value for that taxable year and would be allowed to recognize an ordinary loss for any decrease in that market value to the extent that prior gains exceed prior losses. The adjusted basis in the ordinary shares or ADSs would be adjusted to reflect that gain or loss. The mark-to-market election will be effective for the taxable year for which the election is made and all subsequent taxable years, unless the ordinary shares cease to be marketable or the Internal Revenue Service consents to the revocation of the election.

Alternatively, for each year we meet the income or assets test, a U.S. Investor can make an election to include in income annually its pro rata share of our earnings and net capital gains. This election is referred to as a qualified electing fund election. To make a qualified electing fund election, a U.S. Investor will need to have an annual information statement from us documenting the earnings and capital gain for the year. If we were to become a passive foreign investment company, we would furnish the passive foreign investment company annual information statement to any shareholder or former shareholder who requested it. In general, a U.S. Investor must make a qualified electing fund election on or before the due date for filing its income tax return for the first year to which the qualified electing fund election will apply. U.S. Investors are permitted to make retroactive elections in particular

circumstances, including if the U.S. Investor had a reasonable belief that the foreign corporation was not a passive foreign investment company and filed a protective election. As discussed above, we will notify investors if we determine that we have become a passive foreign investment company. This notice will provide U.S. Investors on a calendar tax year with sufficient time to make the qualified electing fund election. U.S. Investors (in particular those with a tax year other than the calendar year) should consult their own tax advisors as to the consequences of making a protective qualified electing fund election or other consequences of the qualified electing fund election.

If we are a passive foreign investment company in any year, U.S. Investors should consult with their tax advisers regarding whether to make a mark-to-market or qualified electing fund election.

Information Reporting and Backup Withholding. In general, information reporting requirements will apply to dividends in respect of our ordinary shares or ADSs or the proceeds received on the sale, exchange or redemption of our ordinary shares or ADSs paid within the United States (and, in certain cases, outside the United States) to U.S. Investors other than certain exempt recipients, such as corporations, and a backup withholding tax (currently at a rate of 28%) may apply to such amounts if the U.S. Investor fails to provide an accurate taxpayer identification number or to report interest and dividends required to be shown on its U.S. federal income tax returns. U.S. Investors who are required to establish their exempt status generally must provide such certification on IRS Form W-9.

Backup withholding is not an additional tax. Amounts withheld as backup withholding from a payment to a U.S. Investor may be allowed as a credit against the U.S. Investor's U.S. federal income tax liability and the U.S. Investor may obtain a refund of any excess amounts withheld by filing the appropriate claim for refund with the IRS and furnishing any required information in a timely manner.

DOCUMENTS ON DISPLAY

We file annual reports on Form 20-F and furnish current reports on Form 6-K with the SEC. You may read and copy this information at the SEC's Public Reference Room at Judiciary Plaza, 100 F Street N.E., Washington, D.C. 20549, and at the regional offices of the SEC located at 233 Broadway, New York, New York 10279 and Citicorp Center, 500 West Madison Street, Suite 1400, Chicago, Illinois 60661. You can also request copies of the documents, upon payment of a duplicating fee, by writing to the Public Reference Section of the SEC. Please call the SEC at 1-800-SEC-0330 for further information on the operation of the Public Reference Room. Certain of our SEC filings are also available to the public from the SEC's website at http://www.sec.gov.

ITEM 11 QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market risk is the risk of loss related to adverse changes in market prices, including interest rates and foreign exchange rates, of financial instruments. In the normal course of business, our financial position is routinely subject to a variety of risks, including market risk associated with interest rate movements and currency rate movements on non-U.S. dollar denominated assets and liabilities, as well as collectibility of accounts receivable.

We regularly assess these financial instruments and their ability to address market risk and have established policies and business practices to protect against the adverse effects of these and other potential exposures.

Interest Rate Risk

Our major market risk exposure is changing interest rates. Our exposure to market risk for changes in interest rates relates primarily to our investments in government and corporate bonds.

We maintain an investment portfolio consisting mainly of fixed income securities, including time deposits and government bonds. These securities are subject to interest rate risk and will fall in value if market interest rates increase. If market rates were to increase immediately and uniformly by 10.0% from the levels at December 31, 2006, the fair value of our investment portfolio would decline by an immaterial amount. We presently intend to treat our fixed income investments as available for sale, and therefore we do not expect our results of operations or cash flows to be affected to any significant degree by a sudden short-term change in market interest rates. We have not purchased and do not currently hold any derivative financial instruments for hedging or trading purposes.

The table below provides information about our financial instruments whose maturity dates are greater than three months as of December 31, 2006.

	2007	2008	2009	2010	2011	Thereafter
Time Deposit:						
Fixed rate (US$)....	$14,132	29	-	-	-	-
Government Bonds						
Fixed rate (US$)....	6,273	-	1,580	-	-	-

Foreign currency risk

Fluctuations in exchange rates may adversely affect our financial results. The functional currency for each of our foreign subsidiaries is the local currency. As a result, certain of our assets and liabilities, including certain bank accounts, accounts receivable, restricted assets, short-term investments and accounts payable, exist in non-US dollar-denominated currencies, which are sensitive to foreign currency exchange rate fluctuations. If exchange rates were to change immediately and uniformly from the levels at December 31, 2006, the fair value of such assets and liabilities would change by an immaterial amount beyond the change reflected by the exchange rates. As of December 31, 2006, we held approximately $23.3 million in government bonds, certificates of deposits and bank demand accounts denominated in foreign currencies.

We have not engaged in hedging techniques to mitigate foreign currency exposures and may experience economic losses as a result of foreign currency exchange rate fluctuations. We will monitor currency exchange fluctuations periodically. For the year ended December 31, 2006, we experienced a foreign exchange loss of approximately $261,000 due to foreign currency exchange fluctuations, which are reflected in our results of operations.

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ITEM 12. DESCRIPTION OF SECURITIES OTHER THAN EQUITY SECURITIES

Not applicable.

PART II

ITEM 13. DEFAULTS, DIVIDEND ARREARAGES AND DELINQUENCIES

There are no defaults, dividend arrearages or delinquencies that are required to be disclosed.

ITEM 14. MATERIAL MODIFICATIONS TO THE RIGHTS OF SECURITY HOLDERS AND USE OF PROCEEDS.

RIGHTS OF SECURITY HOLDERS

Effective March 2, 2006, upon the listing of our ordinary shares on the Stock Exchange of Hong Kong, certain amendments to our Memorandum and Articles of Association became effective. A summary of material provisions of our Memorandum and Articles of Association is included in Item 10 above.

USE OF PROCEEDS

As of December 31, 2006, the net proceeds from our initial public offering in August 2000 and our public offering in November 2001 were primarily used for general working capital and investment in interest income producing financial instruments. None of the net proceeds from our initial public offering were paid, directly or indirectly, to any of our directors, officers or general partners or any of their associates, or to any person owning ten percent or more of any class of our equity securities, or any of our affiliates.

PART III

ITEM 15T. CONTROLS AND PROCEDURES

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports filed pursuant to the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to the management, including the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives. In addition, the design of any control system is based in part upon certain assumptions about the likelihood of future events. Our disclosure controls and procedures are designed to provide reasonable assurance of achieving their objectives.

As of December 31, 2006, we carried out an evaluation, under the supervision and with the participation of the management, including the Chief Executive Officer and the Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures. Based on the foregoing, the Chief Executive Officer and the Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective.

Management is responsible for establishing and maintaining adequate internal control over financial reporting for the company. Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America. Our company's

internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of our company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America, and that receipts and expenditures of our company are being made only in accordance with authorizations of management and directors of our company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of our company's assets that could have a material effect on the financial statements. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate. Management conducted an evaluation of the effectiveness of internal control over financial reporting based on the framework in Internal Control--Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this evaluation, management concluded that our company's internal control over financial reporting was effective as of December 31, 2006. This Annual Report does not include an attestation report of our registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by our registered public accounting firm pursuant to temporary rules of the Securities and Exchange Commission that permit us to provide only management's report in this Annual Report.

There has been no change in our internal control over financial reporting that occurred during our fiscal year 2006 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

ITEM 16. Not applicable.

ITEM 16A. AUDIT COMMITTEE FINANCIAL EXPERT

The Board of Directors has determined that Mr. Lawrence Lin is an "audit committee financial expert" as defined in Item 16A of Form 20-F. We believe Mr. Lin is "independent" as defined in Rule 4200(a)(15) of the Marketplace Rules of the Nasdaq Stock Market.

ITEM 16B. CODE OF ETHICS

We have adopted the O2Micro International Limited Code of Business Conduct and Ethics ("Code of Conduct"), a code of business conduct and ethics that applies to our employees, officers and non-employee directors, including our principal executive officer, principal financial officer, principal accounting officer or controller and persons performing similar functions. It is publicly available on our website at www.o2micro.com. If we make any substantive amendments or grant any waiver from a provision of the Code of Conduct to our directors or executive officers, we will disclose the nature of such amendment or waiver on that website or in a report on Form 6-K or in the next annual report on Form 20-F.

ITEM 16C. PRINCIPAL ACCOUNTANT FEES AND SERVICES

Deloitte & Touche has served as the Company's independent registered public accounting firm for each of the fiscal years in the two-year period ended December 31, 2006. The appointment of the independent registered public accounting firm is subject to approval and ratification by the Company's shareholders at the annual general meeting of shareholders. The following table presents the aggregate fees for professional services and other services

rendered by Deloitte & Touche in each of the years ended December 31, 2005 and 2006.

	Year ended December 31, 2006	Year ended December 31, 2005
Audit Fees	$436,200	$322,300
Audit-related Fees	10,002	9,599
Tax Fees	74,066	85,761
All Other Fees	463,766	475,695
Total	$984,034	$893,355

Audit Fees. This category includes the audit of our annual financial statements, review of quarterly financial statements and services that are normally provided by Deloitte & Touche in connection with statutory and regulatory filings or engagements for those fiscal years.

Audit-related Fees. This category consists of assurance and related services by Deloitte & Touche that are related to the performance of audit or review of our financial statements and are reported above under "Audit Fees."

Tax Fees. This category consists of professional services rendered by Deloitte & Touche for tax compliance and tax consultation. The services for fees disclosed under this category include tax return preparation advice and technical tax consultation.

All Other Fees: This category consists primarily of fees in connection with the Stock Exchange of Hong Kong listing and Sarbanes-Oxley Act readiness preparation.

The audit committee pre-approves all audit and permissible non-audit services provided by the independent registered public accounting firm. These services may include audit services, audit-related services, tax services and other services. During the year ended December 31, 2006, the audit committee pre-approved all audit and non-audit-fees of Deloitte & Touche.

ITEM 16D. EXEMPTION FROM THE LISTING STANDARDS FOR AUDIT COMMITTEE

Not applicable.

ITEM 16E. PURCHASES OF EQUITY SECURITIES BY THE ISSUER AND AFFILIATED PERSONS

Period	Total Number of Shares Purchased (2)	Average Price Paid per Share (2)	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (1) (2) (3)	M S B t P

January 4, 2006 to January 12, 2006	595,000	0.2205	595,000	8
April 18, 2006	1,000,000	0.2126	1,000,000	1
May 11, 2006 to May 31, 2006	4,000,000	0.1845	4,000,000	1
June 2, 2006 to June 27, 2006	3,445,000	0.1659	3,445,000	1
July 7, 2006 to July 31, 2006	12,640,000	0.1303	12,640,000	1
August 2, 2006 to August 29, 2006	36,767,450	0.1146	36,767,450	1

(1) In May 2002, we announced a share repurchase program to repurchase up to 3,000,000 shares of our ordinary shares or 150,000,000 shares after taking into account the 50-to-1 stock split on November 25, 2005. There is no expiration date for the share repurchase program.

(2) All share and price per share numbers reflect the 50-for-1 stock split which occurred on November 25, 2005

(3) On November 14, 2005, our shareholders adopted a general mandate (the "Repurchase Mandate") to exercise all the powers of our company to repurchase such number of Ordinary Shares not exceeding 10% of the total nominal amount of the share capital of our company in issue and to be issued. The Repurchase Mandate was to only become effective if and when our Ordinary Shares were listed for trading on the SEHK, which occurred on March 2, 2006. On March 2, 2006, the maximum number of shares that may yet be purchased was 198,049,435 shares.

(4) On June 15, 2006, our shareholders renewed the Repurchase Mandate to exercise all the powers of the Company to repurchase such number of Ordinary Shares not exceeding 10% of the total nominal amount of the share capital of the Company in issue and to be issued. On June 15, 2006, the maximum number of shares that may yet be purchased was 195,576,295 shares.

PART IV

ITEM 17. FINANCIAL STATEMENTS

The Company's Consolidated Financial Statements have been prepared in accordance with Item 18 hereof.

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ITEM 18. FINANCIAL STATEMENTS

The Company's financial statements set forth in the accompanying Index to Consolidated Financial Statements included in this Annual Report on Form 20-F following Part IV beginning on page F-1 are hereby incorporated herein by this reference. Such consolidated financial statements are filed as part of this Annual Report on Form 20-F.

Report of Independent Registered Public Accounting Firm

Consolidated Balance Sheets as of December 31, 2005 and 2006

Consolidated Statements of Operations and Comprehensive Income for the years ended December 31, 2004, 2005 and 2006

Consolidated Statements of Shareholders' Equity for the years ended December 31, 2004, 2005 and 2006

Consolidated Statements of Cash Flows for the years ended December 31, 2004, 2005 and 2006

Notes to Consolidated Financial Statements

ITEM 19. EXHIBITS

1. Memorandum and Articles of Association, as amended, of the registrant.

4.1 Standard NNN Lease dated July 29, 1999 by and between Limir Realty Corp. #17 as landlord and O2Micro, Inc. as tenant (incorporated by reference from Exhibit 10.5 to the Registration Statement on Form F-1 (File No. 333-12386) filed by the registrant)

4.2 Lease dated October 16, 1997 by and between Hung Kuo Development Corp. as landlord and O2Micro, Inc. as tenant (incorporated by reference from Exhibit 10.6 to the Registration Statement on Form F-1 (File No. 333-12386) filed by the registrant)

4.3 Agreement dated October 1, 1999 by and between PSA Corporation Limited as landlord and O2Micro, Inc. as tenant (incorporated by reference from Exhibit 10.8 to the Registration Statement on Form F-1 (File No. 333-12386) filed by the registrant)

8.1 List of registrant's subsidiaries

12.1 Certification of Chief Executive Officer of the Company, pursuant to Section 302 of the Sarbanes-Oxley Act.

12.2 Certification of Chief Financial Officer of the Company, pursuant to Section 302 of the Sarbanes-Oxley Act.

13. Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act.

15.1 Consent of Deloitte & Touche, independent registered public accounting firm.

SIGNATURES

Pursuant to the requirements of Section 12 of the Securities Exchange Act of 1934, the registrant hereby certifies that it meets all of the requirements for filing on Form 20-F and that it has duly caused and authorized the undersigned to sign this Annual Report on its behalf.

O2MICRO INTERNATIONAL LIMITED

Date: June 18, 2007

By: /s/ STERLING DU

Name: Sterling Du
Title: Chief Executive Officer

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O2 MICRO INTERNATIONAL LIMITED

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O2Micro 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

The Board of Directors and the Shareholders
O2Micro International Limited

We have audited the accompanying consolidated balance sheets of O2Micro 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 each of the years 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 audit 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 O2Micro International Limited and subsidiaries as of December 31, 2005 and 2006, and the results of their operations and their cash flows for each of 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."

April 16, 2007

O2MICRO INTERNATIONAL LIMITED AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS
(In Thousand U.S. Dollars, Except Per Share Amounts)

December

ASSETS	2005	
CURRENT ASSETS		
Cash and cash equivalents	$ 46,375	$
Restricted cash	5,605	
Short-term investments	55,653	
Accounts receivable, net	11,460	
Inventories	15,943	
Prepaid expenses and other current assets	6,665	
Total current assets	141,701	
LONG-TERM INVESTMENTS	16,898	
PROPERTY AND EQUIPMENT, NET	23,319	
RESTRICTED ASSETS	14,492	
OTHER ASSETS	3,245	
TOTAL	$ 199,655	$
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES		
Notes and accounts payable	$ 5,760	$
Income tax payable	3,907	
Accrued expenses and other current liabilities	14,092	
Total current liabilities	23,759	
ACCRUED RETIREMENT BENEFIT COSTS	-	
Total liabilities	23,759	
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	
Treasury stock - 15,030,000 shares and 0 nil as of December 31, 2005 and 2006, respectively	(3,296)	
Additional paid-in capital	141,532	
Retained earnings	38,739	
Accumulated other comprehensive loss	(1,118)	

Total shareholders' equity	175,896	
TOTAL	$ 199,655	$

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

O2MICRO INTERNATIONAL LIMITED AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME
(In Thousand U.S. 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	15,556	9,181	(1,707)
INCOME TAX EXPENSE (BENEFIT)	1,472	1,034	(2,450)

NET INCOME	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)

O2MICRO INTERNATIONAL LIMITED AND SUBSIDIARIES

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

	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
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.

(Concluded)

O2MICRO INTERNATIONAL LIMITED AND SUBSIDIARIES

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

	Ordinary Shares		Additiona
			Ordinary
	Shares	Amount	Shares
BALANCE, JANUARY 1, 2004	1,951,630,800	$ 39	$ 136,077
Issuance of:			
Shares issued for exercise of stock options	7,858,350	-	1,359
Shares issued for 1999 Purchase Plan	5,923,950	-	1,032
Acquisition and retirement of treasury stock	(6,010,000)	-	(422
Options granted to nonemployees	-	-	-
Net income for 2004	-	-	-
Foreign currency translation adjustments	-	-	-
Unrealized loss on available-for-sale securities	-	-	-
BALANCE, DECEMBER 31, 2004	1,959,403,100	39	138,046
Issuance of:			
Shares issued for exercise of stock options	7,422,050	-	1,203
Shares issued for 1999 Purchase Plan	6,389,200	-	1,110
Acquisition of treasury stock - 20,420,000 shares	-	-	-
Retirement of treasury stock	(5,390,000)	-	(380
Options granted to nonemployees	-	-	-
Net income for 2005	-	-	-
Foreign currency translation adjustments	-	-	-
Unrealized loss on available-for-sale securities	-	-	-
BALANCE, DECEMBER 31, 2005	1,967,824,350	39	139,979
Issuance of:			
Shares issued for exercise of stock options	5,643,000	-	396
Shares issued for 1999 Purchase Plan	6,980,050	-	985
Acquisition of treasury stock - 58,447,450 shares	-	-	-
Retirement of treasury stock	(73,477,450)	(1)	(5,240
Options granted to nonemployees	-	-	-
Stock-based compensation	-	-	-
Net income for 2006	-	-	-
Foreign currency translation adjustments	-	-	-
Unrealized loss on available-for-sale securities	-	-	-
BALANCE, DECEMBER 31, 2006	1,906,969,950	$ 38	$ 136,120

	Treasury Stock	Accumulated Other Comprehensive Income (Loss): Unrealized Investment Gain (Loss)	Accumulated Other Comprehensive Income (Loss): Cumulative Translation Adjustment
BALANCE, JANUARY 1, 2004	$ -	$ 149	$ (670)
Issuance of:			
Shares issued for exercise of stock options	-	-	-
Shares issued for 1999 Purchase Plan	-	-	-
Acquisition and retirement of treasury stock	-	-	-
Options granted to nonemployees	-	-	-
Net income for 2004	-	-	-
Foreign currency translation adjustments	-	-	714
Unrealized loss on available-for-sale securities	-	(303)	-
BALANCE, DECEMBER 31, 2004	-	(154)	44
Issuance of:			
Shares issued for exercise of stock options	-	-	-
Shares issued for 1999 Purchase Plan	-	-	-
Acquisition of treasury stock - 20,420,000 shares	(4,355)	-	-
Retirement of treasury stock	1,059	-	-
Options granted to nonemployees	-	-	-
Net income for 2005	-	-	-
Foreign currency translation adjustments	-	-	(238)
Unrealized loss on available-for-sale securities	-	(770)	-
BALANCE, DECEMBER 31, 2005	(3,296)	(924)	(194)
Issuance of:			
Shares issued for exercise of stock options	-	-	-
Shares issued for 1999 Purchase Plan	-	-	-
Acquisition of treasury stock - 58,447,450 shares	(7,550)	-	-
Retirement of treasury stock	10,846	-	-
Options granted to nonemployees	-	-	-
Stock-based compensation	-	-	-
Net income for 2006	-	-	-
Foreign currency translation adjustments	-	-	695
Unrealized loss on available-for-sale securities	-	(205)	-
BALANCE, DECEMBER 31, 2006	$ -	$ (1,129)	$ 501

	Retained Earnings	Total Shareholders' Equity
BALANCE, JANUARY 1, 2004	$ 18,133	$ 154,727
Issuance of:		
Shares issued for exercise of stock options	-	1,282

Shares issued for 1999 Purchase Plan	-	1,032
Acquisition and retirement of treasury stock	(946)	(1,368)
Options granted to nonemployees	-	613
Net income for 2004	14,084	14,084
Foreign currency translation adjustments	-	714
Unrealized loss on available-for-sale securities	-	(303)
BALANCE, DECEMBER 31, 2004	31,271	170,781
Issuance of:		
Shares issued for exercise of stock options	-	1,185
Shares issued for 1999 Purchase Plan	-	1,110
Acquisition of treasury stock - 20,420,000 shares	-	(4,355)
Retirement of treasury stock	(679)	-
Options granted to nonemployees	-	36
Net income for 2005	8,147	8,147
Foreign currency translation adjustments	-	(238)
Unrealized loss on available-for-sale securities	-	(770)
BALANCE, DECEMBER 31, 2005	38,739	175,896
Issuance of:		
Shares issued for exercise of stock options	-	354
Shares issued for 1999 Purchase Plan	-	985
Acquisition of treasury stock - 58,447,450 shares	-	(7,550)
Retirement of treasury stock	(5,605)	-
Options granted to nonemployees	-	4
Stock-based compensation	-	2,589
Net income for 2006	743	743
Foreign currency translation adjustments	-	695
Unrealized loss on available-for-sale securities	-	(205)
BALANCE, DECEMBER 31, 2006	$ 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 U.S. Dollars)

	Years Ended December 31		
	2004	2005	2006
OPERATING ACTIVITIES			
Net income	$ 14,084	$ 8,147	$
Adjustments to reconcile net income to net cash provided by operating activities:			

Depreciation and amortization	2,692	3,684	4,
Amortization of stock options granted for services	386	264	
Stock-based compensation	-	-	2,
Gain on sale of long-term investments	(340)	-	
Gain on sale of short-term investments	-	(10)	
Deferred income taxes	(68)	527	(
Impairment loss on long-term investments	-	-	
Loss on sale/disposal of property and equipment	3	18	
Reversal of income tax payable	(375)	(658)	(2,
Changes in operating assets and liabilities:			
Accounts receivable, net	363	(2,029)	(7,
Inventories	(1,618)	(4,712)	1,
Prepaid expenses and other current assets	(1,278)	(2,721)	(
Notes and accounts payable	(2,699)	2,125	4,
Income tax payable	1,274	814	(
Accrued expenses and other current liabilities	1,705	5,570	
Accrued retirement benefit costs	-	-	
Net cash provided by operating activities	14,129	11,019	3,
INVESTING ACTIVITIES			
Receivables from employees	116	-	
Acquisition of:			
Property and equipment	(8,354)	(14,870)	(23,
Long-term investments	(4,861)	(5,819)	(8,
Short-term investments	(166,045)	(151,562)	(98,
(Increase) decrease in:			
Restricted assets	(1,945)	306	
Restricted cash	5	(3,718)	(2,
Other assets	(187)	(1,750)	(
Proceeds from:			
Sale of short-term investments	155,021	158,132	134,
Sale of long-term investments	1,020	-	
Sale of property and equipment	2	-	
Net cash provided by (used in) investing activities	(25,228)	(19,281)	1,

(Continued)

O2MICRO INTERNATIONAL LIMITED AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS
(In Thousand U.S. Dollars)

	Years Ended December 31		
	2004	2005	2006
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)
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.

(Concluded)

O2MICRO INTERNATIONAL LIMITED AND SUBSIDIARIES

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

1. GENERAL

Business

O2Micro, 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, O2Micro International Limited (the "Company") was formed in the Cayman Islands and all authorized and outstanding common stock, preferred stock and stock options of O2Micro, Inc. were exchanged for the Company's ordinary shares, preference shares and stock options with identical rights and preferences. O2Micro, Inc. became the Company's subsidiary after the share exchange.

The Company has incorporated various wholly-owned subsidiaries, including (among others) O2Micro Electronics, Inc. ("O2Micro-Taiwan"), O2Micro International Japan Ltd. ("O2Micro-Japan"), O2Micro Pte Limited-Singapore

("O2Micro-Singapore") and O2Micro (China) Co., Ltd ("O2Micro-China"). O2Micro-Taiwan is engaged in operations. O2Micro-Japan is engaged in trading. O2Micro-Singapore, O2Micro-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, O2Micro International Limited - Taiwan Branch ("O2Micro-Taiwan Branch") to engage in marketing and customer support related services. Due to the duplicated functions between O2Micro-Taiwan Branch and O2Micro-Taiwan, the Board of Directors ("Board") determined to dissolve O2Micro-Taiwan Branch on October 31, 2002. The dissolution process of O2Micro-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 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 SEHK; 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 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 Taiwan 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 are classified 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. 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 U.S. 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 such asset is separately identifiable and is less than the carrying value. If impairment occurs, a loss based on the excess of 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 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 expenditures 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 a decrease of $0.0013 both to basic and diluted earnings per share. Total stock-based compensation includes the impacts 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 have 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 3	
	2004	2005
Net income as reported (in thousands)	$ 14,084	$
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)	(
Pro forma net income (loss)	$ 7,144	$
Pro forma shares used in calculation - basic (in thousands)	1,957,800	1,9
Pro forma earnings (loss) per share - basic	$ 0.0036	$ (
Earnings per share - basic as reported	$ 0.0072	$
Pro forma shares used in calculation - diluted (in thousands)	2,005,100	1,9
Pro forma earnings per share - diluted	$ 0.0036	$
Earnings per share - diluted as reported	$ 0.0070	$

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 U.S. dollar. Accordingly, the financial statements of the foreign subsidiaries are translated into U.S. 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 out 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

In February, 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	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	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, 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, 2005 and 2006.

(In Thousands)

December 31		
2005		
Less Than 12 Months	12 Months or Greater	Total

	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unreal Loss
Corporate bonds	$24,642	$ 11	$ -	$ -	$24,642	$
Investment in CSMC (Note 8)	-	-	3,580	968	3,580	
	$24,642	$ 11	$ 3,580	$ 968	$28,222	$

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 changes in the allowances are summarized as follows:

	(In Thousands) Years Ended December 31 2004	2005	2006
Allowances for doubtful receivables			
Balance, beginning of the year	$ 86	$ 90	$
Additions	4	-	
Reversal and Write-off	-	(56)	(
Balance, end of the year	$ 90	$ 34	$
Allowances for sales returns and discounts			
Balance, beginning of the year	$ 315	$ 317	$ 3
Additions	252	587	8
Write-off	(250)	(588)	(8
Balance, end of the year	$ 317	$ 316	$ 3

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 specialized 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 managed by 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 of 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 HK$0.50 per share for continuous 12 months and recognized an impairment loss of $756,000 based on the quoted market price of HK$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		
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
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, 2004, 2005 and 2006 were approximately $2,391,000, $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 land in Hsin-Chu, Taiwan for a future facility for a total purchase price of approximately $8,789,000 (NT$286,421,000).

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 (5,600,000 Renminbi) of which $215,000 (1,680,000 Renminbi) 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. 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

12. INCOME TAX

Income (loss) before income taxes consisted of:

	(In Thousands)		
	Years Ended December 31		
	2004	2005	2006
Cayman Islands	$ 15,496	$ 6,226	$ (3,3
Foreign	60	2,955	1,6
	$ 15,556	$ 9,181	$ (1,7

Income tax expense (benefit) consisted of:

	(In Thousands)		
	Years Ended December 31		
	2004	2005	2006
Current	$ 1,540	$ 507	$ (1,6
Deferred	(68)	527	(8
Income tax expense (benefit)	$ 1,472	$ 1,034	$ (2,4

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%	
Foreign in excess of statutory rate	7.09%	15.69%	35.2
Research and development credits	(6.08%)	(9.56%)	(20.8
Adjustments to prior years' taxes	3.49%	(9.11%)	(190.2
Change in valuation allowance	4.59%	9.74%	35.6
Others	0.37%	4.50%	(3.2

Effective tax rate	9.46%	11.26%	(143.5

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	$ 10	$ 31
Other assets	62	295
Accrued expenses and other current liabilities	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, O2 Micro, Inc. had U.S. federal and state research and development credit carryforwards of approximately $3,300,000 and $2,253,000, respectively. The U.S. 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 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 form 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 and an income tax benefit was recognized in 2005.

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13. RETIREMENT AND PENSION PLANS

The Company has a savings plan for that qualifies under Section 401(k) of the U.S. 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%

14. 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 numbers of options outstanding and exercisable were 17,520,850 and 17,520,850, respectively, under the 1997 Stock Plan, and 272,942,250 and 221,683,400, respectively, 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 BOD 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 Option Shares	Weighted-average Exercise Price	Weight avera Remain Contractu
Outstanding options at 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 at December 31, 2006	306,743,000	$ 0.2344	6.8
Vested or expected to vest options at December 31, 2006	286,332,400	$ 0.2350	6.7

Exercisable options at December 31, 2006	240,858,450	$	0.2354	6.6

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

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

Range of Exercise Prices	Options Outstanding Number Outstanding	Weighted-average Remaining Contractual Life		Weighted-average Exercise Price	Opt Exe an
$0.0017-$0.0010	2,758,300	1.99	$	0.0087	
$0.0790-$0.1198	8,149,050	3.38	$	0.0945	
$0.1292-$0.1948	63,871,700	5.73	$	0.1672	
$0.2013-$0.2994	178,082,000	7.54	$	0.2310	
$0.3076-$0.4836	53,881,950	6.38	$	0.3577	
Balance, December 31, 2006	306,743,000	6.80	$	0.2344	

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 Shares		Weighted-average Grant-Date Fair Value
Granted	8,085,250	$	0.1736
Vested	-	$	-
Forfeited	(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 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 U.S. 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 Sto	
	Years Ended December 31			Years Ende	
	2004	2005	2006	2004	2005
Risk-free interest rate	3.54%	4.06%	4.45%-5.10%	-	2.20%-3
Expected life	5-7 years	5-7 years	5-7 years	-	0.26-0.51
Volatility	65%	65%	67%-71%	-	38%-7
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

15. 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 3	
	2004	2005
Net income (in thousands)	$ 14,084	$ 8,147
Weighted average thousand shares outstanding - basic	1,957,800	1,961,168
Effect of dilutive securities:		
Options (in thousands)	47,300	36,291
Weighted average thousand shares outstanding - diluted	2,005,100	1,997,459
Earnings per share - basic	$ 0.0072	$ 0.0042
Earnings per share - diluted	$ 0.0070	$ 0.0041

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.

16. 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

17. 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 US$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 U.S. District Court in the Eastern District of Texas, the U.S. 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.

18. 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.

19. 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	
	2005	2006
Taiwan	$ 7,795	$ 21,261
PRC	8,244	13,015
U.S.A.	6,804	6,669
Singapore	274	335
Others	202	147
	$ 23,319	$ 41,427

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