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O2MICRO INTERNATIONAL LTD  
Form 20-F  
June 20, 2005

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, 2004

or

[ ] Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the transition period from \_\_\_\_\_ to \_\_\_\_\_.

Commission file number: 0-30910

O2 MICRO 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 ----- Registered -----
Ordinary Shares, par value \$0.001 per share	Nasdaq National Market 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.

39,188,062 Ordinary Shares

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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  No

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

Item 17  Item 18

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### Certain Definitions and Conventions

In this annual report on Form 20-F (the "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 ability to develop products in a timely manner to meet customer demands, our ability to take advantage of cost-efficiencies associated with the "fabless" semiconductor business model, our future gross profits, continued expansion of our engineering, research and development resources, our efforts to reduce costs and expenses, our expectations regarding outcome of litigation matters, our expectation that our existing facilities will be adequate to meet our needs, 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.

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## 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, 2002, 2003 and 2004, and the selected consolidated financial data as of December 31, 2003 and 2004, 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

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elsewhere in this annual report on Form 20-F. The selected consolidated financial data for the years ended December 31, 2000 and 2001 and the selected consolidated financial data as of December 31, 2000, 2001 and 2002, 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.

	Year Ended December 31,				
	2000	2001	2002	2003	2004
	(in thousands, except per share data)				
Consolidated Statement of Operations Data:					
Net sales .....	\$ 40,356	\$ 45,819	\$ 70,187	\$ 88,599	\$ 92,
Cost of sales .....	15,687	16,465	28,143	38,314	37,
Gross profit .....	24,669	29,354	42,044	50,285	54,
Operating expenses:					
Research and development .....	9,682	14,320	18,935	19,219	20,
Selling, general and administrative .....	8,714	9,561	11,790	13,522	16,
Patent litigation .....	0	348	535	3,954	5,
Stock-based compensation .....	458	166	44	-	
Total operating expenses .....	18,854	24,395	31,304	36,695	41,
Income from operations .....	5,815	4,959	10,740	13,590	12,

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Non-operating income - net .....	1,056	1,827	1,662	1,437	2,
	-----	-----	-----	-----	-----
Income before income tax .....	6,871	6,786	12,402	15,027	15,
Income tax expense .....	227	1,152	1,673	1,826	1,
	-----	-----	-----	-----	-----
Net income .....	6,644	5,634	10,729	13,201	14,
	=====	=====	=====	=====	=====
Earnings per share:					
Basic .....	0.34	0.17	0.28	0.34	0
Diluted .....	0.21	0.16	0.27	0.33	0
Shares used to compute basic earnings per share: .....	19,419	34,020	38,300	38,374	39,
	=====	=====	=====	=====	=====
Shares used to compute diluted earnings per share: .....	32,260	35,576	39,591	39,736	40,
	=====	=====	=====	=====	=====

	December 31,				
	2000	2001	2002	2003	2004
	-----	-----	-----	-----	-----
	(in thousands)				
Consolidated Balance Sheet Data:					
Cash and short term investments ...	\$ 37,448	\$ 118,950	\$ 112,009	\$ 120,412	\$ 120,
Working capital .....	44,072	122,990	120,793	130,510	132,
Total assets .....	54,607	136,419	145,836	169,293	185,
Long-term debt, excluding current portion .....	13	7	-	-	
Net assets .....	47,928	128,424	135,148	154,727	170,
Ordinary shares and additional paid-in capital .....	55,104	130,235	126,232	137,115	139,

CAPITALIZATION AND INDEBTEDNESS

Not applicable.

REASONS FOR THE OFFER AND USE OF PROCEEDS

Not applicable.

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RISK FACTORS

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

Our business focuses on designing, developing and marketing high performance integrated circuits for manufacturers of products for the computer, consumer electronics, industrial and communications markets. Because many of the leading suppliers 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. We also have targeted and are designing products for other

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computer, consumer electronics, industrial and communications applications such as internet security, mobile phones, global positioning systems, portable DVD players, liquid crystal display (LCD) monitors and LCD television sets. 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. We believe that an important factor driving growth in these markets has been the growing popularity of mobile computing, the growing popularity of thinner displays, and the emergence and continued development of the Internet and wireless communications networks. If mobile computing does not continue to grow in popularity and the demand for notebook computers declines, or does not grow as quickly as we expect, our intermediaries or original equipment manufacturer customers will experience lower demand for notebook computers that use our products, and our net sales will suffer. If the growth in the use of the Internet and wireless communications networks declines, or does not grow as quickly as we anticipate, our customers may experience lower demand for the electronic devices that use our products, and our sales will suffer. If demand for products using LCDs declines, or does not grow as quickly as we anticipate, our customers may experience lower demand for those systems that use our products, which may cause our sales to suffer.

In addition, we have experienced, and may experience in the future, shortages of LCDs and semiconductors caused by industry market trends or by natural disasters, such as earthquakes, that are outside of our control. These shortages may increase the costs of components used in those products containing our products. This may cause an increase in the cost of such products, thus constraining their more widespread market acceptance.

Finally, the semiconductor industry has historically been highly cyclical and, at various times, has experienced significant downturns and wide fluctuations in supply and demand. This has caused significant variances in product demand, production capacity and rapid erosion of average selling prices. Industry-wide fluctuations in the future could result in pricing pressure on our products as well as lower demand for our products. If such fluctuations were to occur, it could materially adversely affect our operating margins and net sales.

Fluctuations in our quarterly operating results due to factors such as changes in the demand for electronic devices that can utilize our products could depress our stock price.

We believe that quarter-to-quarter comparisons of our financial results are not necessarily meaningful indicators of our future operating results, 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 could be negatively 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 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 introductions 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 may be

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affected by factors such as: significant price and volume fluctuations in the stock and financial markets in the U.S. and other countries, as well as relatively thin trading volume of our stock on the Nasdaq National Market. In addition, the trading market for our stock is affected by the research and 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 stock, our stock price may decline. In addition, if one or more analysts cease coverage of the Company or does not regularly publish reports on us, we may lose visibility in the financial markets, which could cause our stock price or trading volume to decline.

If orders for our products are deferred or cancelled, our quarterly 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 quarter depends on orders booked and shipped in that quarter. If a large amount of orders placed is cancelled or deferred, our net sales in that quarter could be substantially reduced. Since we do not have significant non-cancelable 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 expenses 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 lower than expected, cancelled or deferred orders. As a result, any significant downturn in orders would not only harm our net sales, it would likely have a disproportionately adverse effect on our operating margins and net income.

A substantial portion of our net sales is generated by a small number of large customers. If any of these customers delays or reduces its orders, our net sales and earnings will 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 2004, one customer accounted for 10% or more of our net revenues (17.54%). In 2003, one customer accounted for 10% or more of our net revenues (13.5%). In 2002, two customers accounted for 10% or more of our net revenues (18.6% and 15.9%, respectively). The variations in sales to these customers as a percentage of our total revenue 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.

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

Our ability to compete successfully in the market for semiconductor or 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 Linear Technology, Maxim Integrated Products Texas Instruments, Ricoh Company, Ltd. and Monolithic Power Systems. In addition to these competitors, other integrated circuit companies may decide to enter the market with mixed signal integrated products that compete with ours or incorporate functions similar to those provided by our products. We also face competition from in-house integrated circuit design and manufacturing groups at some of our existing and potential customers, such as Toshiba Corporation.

Many 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 timely, our net sales and gross margins will be harmed.

Our success depends upon our ability to develop and introduce new products selected for design into products for the computer, consumer electronics, 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 the following: accurate new product definition; timely completion of new product designs; achievement of manufacturing yields; timely and cost-effective production of new products; and delays in the introduction 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-in to such products. If we incur such expenditures but fail to be selected, our operating results will be adversely affected, and may cause significant fluctuations from period to period. Furthermore, even if we were selected for design-in, we cannot be assured that these systems will be commercially successful or that we will benefit from any associated revenue.

It is difficult to evaluate our future prospects, and we cannot assure you that



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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 experienced significant quarter to quarter sales growth in the years ended December 31, 2001, 2002 and 2003. However, in the first quarter ending March 31, 2004,

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in the third quarter ending September 30, 2004 and in the first quarter ending March 31, 2005, we experienced a decrease in 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 and protect our technology and expand our product offerings. 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 would cause the value of our stock to decline.

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

The markets for computer, consumer electronics, 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 interoperate change very rapidly, and the product life cycles for products in the computer, consumer electronics, industrial and communications markets that use our power management and security technologies are often less than one year. If we do not respond in a timely manner to technological changes and new product introductions by our direct customers and competitors by developing new products and enhancing our existing products, we will be unable to maintain and grow our product sales. In addition, the emergence of significantly more efficient or cost-effective battery, display or microprocessor technologies could lessen the need for the power management functionality of our products, which would harm our net sales.

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 net sales and gross margins will be harmed.

We do not own or operate the integrated circuit fabrication facilities that manufacture the products we design. Three foundries, United Microelectronics Corporation, or UMC, Taiwan Semiconductor Manufacturer Company Limited, or TSMC, and X-FAB Semiconductor Foundries AG, or X-FAB, manufactured most of the semiconductor devices that we sold in 2004. These suppliers manufacture integrated circuit semiconductors for us according to purchase orders. We do not have a guaranteed level of production capacity at any of our suppliers, and any one or more could raise prices without notice. We provide the suppliers with rolling forecasts of our production requirements; however, the ability of each supplier to provide wafers to us is limited by the supplier's available capacity. Our suppliers 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 our suppliers will allocate sufficient capacity, if any, to satisfy

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our requirements particularly during any industry-wide capacity shortages. In addition, if any of our suppliers were to become unable to continue manufacturing our products in the required volumes at acceptable quality, yields and costs or in a timely manner, our business and operating results would be seriously harmed.

There are other significant risks associated with our reliance on outside suppliers, including: the disruption in our ability to ship products caused by the length of time, as much as six to twelve months, required for us to qualify alternative suppliers for existing or new products; the reduction or elimination of deliveries to us by our foundries caused by a sudden demand for an increased amount of 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 suppliers; and the susceptibility of our third-party suppliers 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 our foundries to either reduce or eliminate deliveries to us, and a disruption in our ability to ship products to our customers could negatively affect our business and results of operations.

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We also rely on independent subcontractors to assemble and test substantially all of our semiconductor products. We do not have long-term agreements with any of these subcontractors and typically obtain services from them 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 are 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.

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

Our net sales are derived from sales of semiconductor products that are components of electronic devices built to industry standards and widely accepted specifications. For example, the hardware specification for the voltage of most notebook computers is currently either 3.3 or 5.0 volts and the software used to control the power management functions of many notebook computers conforms to the 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 conforms to these new standards. Additionally, new products we develop to conform to new specifications may not be accepted in the market.

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.

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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 decrease our profit margins. 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 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, 2004, a substantial portion of our operations, approximately 68% of our employees, and most of the third parties we use to manufacture, assemble and test our products were located in Japan, Korea, the People's Republic of 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, December 31, 2003 and December 31, 2004. 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 Severe Acute Respiratory Syndrome; the risk of potential conflict and further instability in the relationship between Taiwan and the People's Republic of 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

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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, such as Singapore, the People's Republic of China and Taiwan; risks that changes in foreign currency exchange rates will make our products comparatively more expensive; 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; limitation on imports or exports and 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, America, 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.

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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 reduce our operating results. We do not currently engage in currency hedging activities.

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 hurt 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.

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 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 rights 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 infringers.

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 precautions that we take, it may be possible for unauthorized third parties to copy aspects of our current or future products or to obtain and use information that we regard as proprietary. In particular, we may provide our customers with access to our proprietary information underlying our products. Additionally, our competitors may independently develop similar or superior technology. Policing unauthorized use of software, circuit design or semiconductor design is difficult and some foreign laws do not protect our proprietary rights to the same extent as United States laws. We have in the past and have currently 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 harm our business, future operating results and financial condition. See "Information on the Company--Business Overview--Intellectual Property".

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, this could harm our ability to grow our business, sell our products, enter new markets and increase our share of existing markets. 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 or independent sales representatives internationally and in the United States. 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 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 semiconductor design is intense. In the past, we have experienced difficulty in recruiting qualified personnel, especially technical and sales personnel. Moreover, we intend to expand the scope of our international operations, which 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 this case, our costs of doing business would increase without the expected 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 the board of directors, 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 decided to join a competitor or otherwise compete directly or indirectly with us.

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 related 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 believes that transfer prices were manipulated by our affiliate corporations in a way that distorts the true taxable income of the corporations, the laws of countries where our affiliated corporations are located could require us to redetermine transfer prices and thereby reallocate the income of our affiliate corporations in order to clearly reflect such income. 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, the People's Republic of China, Taiwan, Japan and

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Singapore to regulate intercompany transfers. A transfer pricing agreement is a contract for the transfer of goods, services or intellectual property from one corporation

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to a related corporation that sets forth the prices that the related parties believe are 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 United States Internal Revenue Service or the taxing authorities of any other jurisdiction were to successfully challenge these agreements 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 these jurisdictions. 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 can 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.

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 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 one of such events could seriously harm our business and our operating results. 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 "Information on the Company--Business Overview--Intellectual Property".

From time to time, in the normal course of business, we 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

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unique facts and circumstances that are likely to be involved in each particular claim. Historically, payments made by us under these obligations have not been material.

Until our litigations are 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 quarter, which will impair our ability to forecast our results of operations for that quarter. It is likely that these expenses will increase leading up to and during our trials scheduled for June 2005, for September 2005, and for December 2005.

Monolithic Power Systems, Inc. ("MPS") has alleged that our OZ960, OZ961, OZ969A and OZ970 products infringe on one of their patents and a continuation of that patent. On May 28, 2004, the U.S. District Court for the Northern District of California granted our motion for summary judgment that MPS lacked evidence of damages. As the case currently stands, MPS will not be able to recover damages at

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trial but may only attempt to seek injunctive relief and attorneys' fees. However, 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 was to prevail in its claims against us, our operating results 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 revenues, net sales, result of operations and financial condition. This risk factor only summarizes the legal proceedings in which we are involved and related events. You are advised to read the descriptions of our litigation in "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 the 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. We believe that the ultimate disposition of these matters will not have a material adverse effect on our business, financial condition or results of operations.

Provisions in our charter documents may discourage potential acquisition bids for us and prevent changes in our management that our shareholders may favor.

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

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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, our board of directors have the authority to issue up to 5,000,000 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.

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

To comply with the requirements of the Sarbanes-Oxley Act of 2002, as well as new rules subsequently implemented by the SEC and adopted by Nasdaq in response to Sarbanes-Oxley, we have made changes to our financial reporting, securities disclosure and corporate governance practices. We may incur increased legal and financial compliance costs due to these new or revised rules, regulations, and listing requirements and management time and resources may be re-directed to implement our compliance initiatives. These rules may make it more difficult for us to attract and retain qualified executive officers and members of our board of directors, as well as make it more costly to obtain liability coverage for our officers and directors.

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If we fail to maintain an effective system of internal controls, we may not be able to accurately report our financial results. As a result, current and potential stockholders could lose confidence in our financial reporting, which would harm our business.

Effective internal controls are necessary for us to provide reliable financial reports. If we cannot provide reliable financial reports or prevent fraud, our operating results could be misstated, our reputation may be harmed and the trading price of our stock could be negatively affected. In connection with the audit of our financial statements for the three years ended December 31, 2004, in May 2005 our independent registered public accounting firm reported to our audit committee a matter that was a "reportable condition" in our internal controls as defined in standards established by the American Institute of Certified Public Accountants. In general, reportable conditions are significant deficiencies in our internal controls that, in our auditor's judgment, could adversely affect our ability to record, process and report financial data consistent with the assertions of management in the financial statements. In 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 cause us to fail to meet our reporting obligations.

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



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internal control over financial reporting identified by management. Such report must also contain a statement that our auditors have issued an attestation report on management's assessment of such internal controls. We are still performing the system and process documentation and evaluation needed to comply with Section 404, which is both costly and challenging.

During this process, if our management identifies one or more material weaknesses in our internal control over financial reporting, we will be unable to assert such internal control is effective. If we are unable to assert that our internal control over financial reporting is effective (or if our auditors are 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 would have an adverse effect on our stock price.

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

The Financial Accounting Standards Board has published revisions to Statement of Financial Accounting Standards No. 123 which requires all public entities to treat the value of stock options granted to employees as an expense. As a public entity as contemplated by SFAS 123R, we are required to record, as of the first annual reporting period beginning after June 15, 2005, a compensation expense equal to the value of each stock option granted. This expense would likely be recognized over the vesting period of the stock option. The requirement to expense stock option grants reduces the attractiveness of granting stock options because the additional expense associated with these grants may adversely affect our profitability. However, stock options remain an important employee recruitment and retention tool, and 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 program. Our employees are critical to our ability to develop and design systems that advance our productivity and technology goals, increase our sales goals and provide support to customers. Accordingly, as a result of the requirement to adopt SFAS 123R to expense

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stock option grants beginning with the first fiscal year after June 15, 2005, our future profitability would be reduced, as would our ability to use stock options to recruit, retain and motivate key employees.

Because 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 interests.

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 violations of United States federal securities laws relating to offers and sales of ordinary shares, 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 United States courts predicated upon the civil liability provisions of the United States federal securities laws.

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Our corporate affairs are governed by our charter documents, consisting of our memorandum and articles of association, and by the Companies Law of the Cayman Islands. The rights of our 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 and United States law. However, we believe that English case law, although not binding in the courts of the Cayman Islands, would be regarded as persuasive. Due to this relative vagueness of Cayman Islands law, our public shareholders may have more difficulty in protecting their interests in the face of actions by our management, directors or controlling shareholders than would shareholders of a corporation incorporated in a jurisdiction in the United States.

### 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, O//2//Micro, Inc., which was incorporated as a California corporation in March 1995. In March 1997, O2 Micro 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 O//2// Micro, Inc. After the exchange, we held all of the outstanding capital stock of O//2// Micro, Inc., our wholly owned subsidiary in the United States.

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 O//2//Micro, Inc., 3118 Patrick Henry Drive, Santa Clara, CA 95054.

Since January 1, 2002, our principal capital expenditures were investments in and loans to various private companies of approximately \$17.2 million in the aggregate, \$21.6 million in the purchase of land, property and equipment, and \$12.1 million deposited for Taiwan court bonds in connection with preliminary injunction actions in Taiwan.

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#### BUSINESS OVERVIEW

We design, develop and market high performance integrated circuits for power management and security applications. We focus on integrated circuits that use mixed signal designs, which combine analog and digital circuits on a single chip, reducing the number of semiconductors needed and decreasing the size, weight, power requirements and cost of the end product. We focus our product design efforts on integrated circuits for the markets of computer, consumer electronics, industrial and communications products. Products in these markets include notebook computers, internet security devices, mobile phones, global positioning systems, portable DVD players, LCD monitors and LCD television sets. Our system-level expertise, proprietary design methodologies and extensive experience with power management systems allow us to develop products quickly so that our customers can achieve rapid time to market with new devices. Our products are used in electronic devices currently sold by large computer and consumer electronics companies.

Industry Background

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 fundamental computer technologies. 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 to help address the need for longer battery life in mobile applications. However, since power systems are analog by nature, mixed signal 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 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 expertise; and basic differences in the technologies used in digital and analog circuit design make combining the technologies problematic.

In addition, mixed signal circuits are comprised of 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, simpler to produce 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 designs among manufacturers make it more difficult to design intelligent systems that are optimized for particular power systems.

Most analog integrated circuit companies offer broad product lines of analog and, in some cases, mixed signal integrated circuit products. Their products are typically designed to function in a wide range of applications, and thus are not optimized for specific power system applications. Their products also usually must be combined with other discrete circuit components, creating larger and heavier products that are more difficult to manufacture and can be less reliable. In addition, many of these companies lack the digital circuit design and system-level expertise and focus necessary to design new products quickly to meet the rapidly changing needs of mobile computing and communications device manufacturers. Finally, many of these companies' existing integrated circuit products are not currently designed to take full advantage of recently developed standards-based battery design parameters, which can enable the use of simpler and more efficient power management systems.

Most mobile computing, communications and other consumer electronics product manufacturers need mixed signal and analog integrated circuit products specifically designed to optimize the power system usage in their devices so that they can offer new devices with richer functionality and longer battery lives. These integrated circuit products should also be highly integrated and standards-based to help manufacturers, create

products that are smaller, lighter, easier to use, more reliable and more

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cost-efficient to design and produce. In addition, in mobile device markets where product life cycles can be less than one year, these solutions need to be developed using advanced design methodologies to allow manufacturers to achieve rapid time to market with their new products.

### Products

O2Micro designs, develops, and markets innovative power management and security components for manufacturers of products for the computer, consumer electronics, industrial and communications markets. The company's integrated circuit products are produced with digital, analog, and mixed signal integrated circuit manufacturing processes.

Our products control and monitor battery charging and discharging, select and switch between power sources, manage and provide power for lighting of liquid crystal displays, and link external notebook plug-in cards and provide internet security.

O2Micro's products include:

- . Battery chargers and controllers for notebook computers and other applications. Our products control and monitor battery charging and discharging for various battery chemistry compositions and capacities. They incorporate a variety of built-in features such as temperature monitors, voltage monitors, current monitors, voltage limiting devices, current limiting devices, and the selection and switching between power sources.
- . Intelligent Inverter for the control of backlight cold cathode fluorescent lamps (CCFL) in LCD displays in notebook computers, LCD monitors, LCD televisions, Global Positioning Systems (GPS), and other mobile applications.
- . DC/DC Controllers for use in providing power to portable computing sub-systems and microprocessors.
- . CardBus products, including SmartCardBus, 4-in-1 Memory CardBus, and Standard CardBus for PCMCIA interface reader for the direct detection and reading of smart card, four standard flash memory media cards, and standard modem cards.

### Marketing, Sales, and Customer Support

Our marketing strategy is focused on the sale of proprietary mixed signal products to customers in the computer, consumer electronics, industrial and communications markets. These markets tend to be dominated by a limited number of major brand name companies. As a result, we focus our resources on the major suppliers in each market.

We sell primarily standard products to our customers and work with them on new product development. We market these products through a combination of direct sales people, independent sales representatives and distributors in Asia, Europe and North America.

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 and Japan for post order servicing and applications support.

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### Customers

We focus on the major suppliers of products to the mobile computing, display, communications and other consumer electronics markets. Many of these major suppliers use third party providers, such as electronic manufacturing services (EMS) providers or other intermediaries, to produce their products or portions of their products containing our components. Hence, the majority of our sales occur with these third party service providers.

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

Location of customers	Years Ended December 31		
	2002	2003	2004
Asia	\$ 70,149	\$ 88,548	\$ 92,105
United States	31	51	53
Other regions	7	-	38
	<u>\$ 70,187</u>	<u>\$ 88,599</u>	<u>\$ 92,196</u>

### Manufacturing

We subcontract the manufacture of our products to wafer foundries, assembly and test companies. This "fabless" approach allows us to focus on our product development strengths, minimize fixed costs and capital expenditures, and access diverse manufacturing technologies.

We use established mainstream processes for the manufacture of our products. The value added by our products is provided by differentiated functionality rather than leading edge processes. This approach reduces our technical risks and minimizes the risks related to production capacity constraints.

Currently, the majority of our products are manufactured using 0.25 to 0.80 micron CMOS semiconductor processes. Our major wafer foundry providers include UMC, TSMC and X-FAB. We maintain second source capacity on selected products. We utilize several assembly and test service providers in Taiwan and other parts of Asia on a monthly or quarterly purchase order basis.

### Competition

We compete in the market for mixed signal integrated circuit products based on such factors as product performance, power efficiency, new technologies, functional innovation, reliability, price and availability.

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

### Intellectual Property

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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

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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, 2004, we had approximately 51 patents issued in the United States and approximately 43 patents issued in other countries. In addition, we had approximately 117 patent applications pending in the United States Patent and Trademark Office. We also had approximately 230 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. We also enter into confidentiality agreements with our employees, consultants and customers and seek to control access to, and distribution of, our other 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.

The laws of some foreign countries do not protect our proprietary rights to as great an extent as do the laws of the United States, and many companies have encountered substantial infringement problems in these countries, some of which are 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 adequately protect our intellectual property, it would be easier for our competitors to sell competing products.

We have initiated and are pursuing certain patent infringement actions in Taiwan. In January 2003, the Shihlin District Court in Taiwan issued a preliminary injunction prohibiting Monolithic Power Systems, Inc. or MPS from designing, manufacturing, selling, importing or displaying its MP1011A and MP1015 products. In March 2003, the Taipei District Court in Taiwan issued a preliminary injunction prohibiting Beyond Innovation Technology Co., Ltd. ("Bitek") from making, selling, using, or importing for the purposes of making, selling and using, their BIT3105, BIT3105-P & BIT3106 "high efficiency ZVS CCFI controller" related products, irrespective of their various types of package. In August 2003, the Taipei District Court issued a preliminary injunction prohibiting Bitek from designing, making, selling, displaying and importing and all other disposing acts related to its parts, which infringe on our Taiwan Patent Number 152318, including without limitation BIT3107. As of December 31, 2004, we have deposited \$13.9 million with the Taiwan courts for court bonds in connection with those preliminary injunction actions and related provisional attachment actions as well as other preliminary injunction actions and

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provisional attachment actions. The court bonds provide security for the enjoined party to claim damages against in the event we do not ultimately prevail in the underlying infringement action associated with the particular preliminary injunction action or provisional attachment action.

We have also been in litigation against MPS in the U.S. MPS has alleged that our OZ960, OZ961, OZ969A and OZ970 products infringe on one of their patents and a continuation of that patent. Litigation on such claim is pending in the United States District Court in the Northern District of California. We have answered MPS' claims, denying all of their substantive allegations. In addition, given the results of the claims constructions adopted by the Court on November 26, 2001 and December 27, 2002, we believe that we have meritorious defenses against MPS' allegations. On May 28, 2004, the Court granted our motion for summary judgment that MPS lacked evidence of damages. As the case currently stands, MPS will not be able to recover damages at trial but may only attempt to seek injunctive relief and attorneys' fees. Trial on these claims is currently scheduled for June 2005.

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Given the inherent uncertainties in litigation, there cannot be any assurance that we will prevail in any of the pending litigations, and we cannot predict the outcome of any such litigation. If any party was to prevail in its claims against us, our operating results 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, 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 a holding 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 Incorporation
O//2//Micro, Inc.	U.S.A.	March 1995
O//2//Micro Electronics, Inc.	Taiwan	March 1999
O//2//Micro International Japan Limited	Japan	August 1999
O//2//Micro PTE Limited-Singapore	Singapore	September 1999
O//2//Micro (Wuhan) Co., Ltd.	People's Republic of China	January 2001

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O//2//Micro (Beijing) Co., Ltd.      People's Republic of China      February 2001

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O//2//Micro (Shanghai) Co., Ltd.      People's Republic of China      April 2001

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O//2//Micro (Chengdu) Co., Ltd.      People's Republic of China      July 2004  
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### PROPERTY, PLANT AND EQUIPMENT

The table below describes our headquarters and the facilities where the above subsidiaries are located as of December 31, 2004:

Location	Approx. Available Square Feet	Lease Expiration
California, USA.....	37,180	not applicable
Taipei, Taiwan.....	20,779	2006
Hsin-Chu, Taiwan.....	25,450	2006
Singapore.....	7,078	2005
Shanghai, China.....	12,276	2005
Beijing, China.....	17,608	2007
Wuhan, China.....	10,884	2006
Chengdu, China.....	10,291	2005
Grand Cayman, Cayman Islands.....	1,000	2006
Tokyo, Japan.....	1,301	2006

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We use our Cayman Islands facility for performing invoicing and receiving amounts payable. Research and development, marketing, applications and administrative staff are located in California. We also have sales offices in Pflugerville, Texas and Houston, Texas. Marketing, sales, applications, worldwide production support, final inspection and shipping, and general and administrative staff are located in Hsin-Chu and Taipei, Taiwan. We have an office in Tokyo, Japan housing marketing, sales and applications staff, and offices in Singapore, Beijing, Shanghai, Wuhan and Chengdu primarily for research and development activities. We believe our current leased 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 March 2005, we purchased a 10,350 square foot facility in Shanghai, China for approximately \$2.3 million. In May 2005, we purchased an additional 20,559 square feet of space for the Shanghai, China facility for approximately \$4.9 million.

### ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS

#### Overview

We design, develop and market high performance integrated circuits for power management and computer security applications. Our net sales have been derived primarily from the sale of mixed signal integrated circuit products to customers in the computer, consumer electronics, industrial and communications products markets.



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Our net sales have grown from \$70.2 million in 2002 to \$88.6 in 2003 and \$92.2 million in 2004. This increase in net sales was due primarily to introduction of our new products, higher unit shipments of our existing products and expansion of our customer base and the number of intermediaries we supply to. We continued to diversify our customer base and market focus entering additional market segments in the consumer electronics, 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 specific products we sell will typically decline over the life of these products due to competitive pressures and volume pricing agreements.

Operating expenses grew from \$31.3 million in 2002 to \$36.7 million in 2003 and \$41.9 million in 2004. Our operating expenses increased as we continued our new product development efforts, expanded our operations and hired additional personnel. Our net income was \$10.7 million in 2002, \$13.2 million in 2003 and \$14.1 million in 2004. We have been profitable in each quarter since the quarter ended September 30, 1999. We believe this profitability was 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 \$31.3 million at December 31, 2004.

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. Because we are 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 also use third parties to test and assemble our products, which reduces the capital we need to invest in these activities.

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

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

### Critical Accounting Policies--

#### Revenue Recognition and Accounts Receivable Allowances

We recognize revenue 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,

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and (4) collectibility is reasonably assured. Determination of criteria (4) is based on the management's judgments regarding the collectibility of those fees.

In certain limited instances, we sell products through distributors. We have limited control over these distributors' selling of products to third parties. Accordingly we recognize revenues on sales to distributors when the distributors sell the products to third parties. We defer recognition of such sales until the product is sold by the distributors to their end customers. Products held by distributors are included in our inventory balance. Accounts receivable from distributors are recognized and inventory is relieved upon shipment as title to inventories generally transfers upon shipment at which point we have a legally enforceable right to collection under normal terms.

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

As of December 31, 2002, 2003 and 2004, the allowance we set aside for product returns and sales allowances was \$314,000, \$315,000 and \$317,000, respectively, representing 0.4%, 0.4% and 0.3% of our revenue as of those dates. For the years ended December 31, 2002 and 2003, we did not have to record any additional provisions subsequent to the year ended because actual returns and sales allowances were lower than the estimated amounts. For the year ended December 31, 2004, we also did not have to record any additional provisions as of May 7, 2005.

### Inventories

Our inventories are stated at the lower of standard cost or market value. Cost is determined on a currently adjusted standard basis, which approximates actual cost on a first-in first-out basis. Because of the cyclicity of the market, inventory levels, obsolescence of technology and 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

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conditions may be lower than those projected by us. This difference could have a material adverse effect on our gross margin should inventory write downs beyond those initially recorded become necessary.

As of December 31, 2002, 2003 and 2004, we recorded inventory allowances in an aggregate amount of \$1.1 million, \$1.3 million and \$791,000, respectively. Our inventory valuation allowances were primarily for estimated scraps and defects. For the years ended December 31, 2002 and 2003, we did not have to record any additional allowances subsequent to the year ended because actual write-offs were lower than the estimated amounts. For the year ended December 31, 2004, we also did not record any additional allowances as of May 7, 2005.

### Long-Lived Assets

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

### Income Taxes

Our income taxes are accounted 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 years. Deferred income tax assets are primarily the tax effects of the operating loss carryforwards and temporary differences. On a periodic basis we evaluate the deferred tax assets balance for realizability. To the extent we believe it is more likely than not that some portion of deferred tax assets will not be recognized, we will increase the valuation allowance against the deferred tax assets. Realization of the deferred tax assets is dependent primarily upon future taxable income, changes in tax laws and other factors. These changes, if any, may require possible material adjustment to the deferred tax assets, resulting in a reduction in net income in the period when such determinations are made.

### Legal Contingencies

We are currently involved in various claims and legal proceedings. We periodically assess each matter in order to determine if a contingent liability in accordance with Statement of Financial Accounting Standards No. 5 (SFAS 5), "Accounting for Contingencies," should be recorded. In making the determination, we, 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 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.

### Operating Results

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

	Year Ended December 31,		
	2002	2003	2004
Consolidated Statement of Operations Data:			
Net sales.....	100.0%	100.0%	100.0%
Cost of sales.....	40.1	43.2	40.6
Gross margin.....	59.9	56.8	59.4
Operating expenses:			
Research and development.....	27.0	21.7	22.0
Selling, general and administrative...	16.8	15.3	17.7
Patent litigation .....	0.8	4.5	5.8
Stock-based compensation.....	0.1	-	-
Total operating expenses.....	44.6	41.4	45.5
Income from operations.....	15.3	15.4	13.9
Non-operating income-net .....	2.4	1.6	2.9
Income tax expenses.....	2.4	2.1	1.6
Net income.....	15.3%	14.9%	15.2%

Years Ended December 31, 2004 and 2003

**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, 2004 were \$92.2 million, an increase of \$3.6 million or 4.1% from \$88.6 million for the year ended December 31, 2003. This increase in net sales resulted from increased unit shipments of our existing products as well as shipments of new products and expansion of our customer base and the number of intermediaries we supply to. In 2004, we introduced new Cardbus and CCFL inverter controller products. We also enhanced the features of certain products in every existing product group in 2004 (except for Audio DJ 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, 2004 was \$54.8 million, an increase of \$4.5 million or 9.0% from \$50.3 million for the year ended December 31, 2003. This increase in absolute dollars was due to increased sales. Gross profit as a percentage of net sales for the year ended December 31, 2004 increased to 59.4% from 56.8% for the year ended December 31, 2003 due to increased sales of higher 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, 2004 were \$20.3 million, an increase of \$1.0 million or 5.4% from \$19.2 million for the year ended December 31, 2003. This increase primarily reflected the addition of research and development personnel. As a

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percentage of net sales, research and development expenses were 22.0% for the year ended December 31, 2004, an increase from 21.7% for the year ended December 31, 2003. Research and development expenses as a percentage of net sales will fluctuate from quarter to quarter depending on the

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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 many 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 product leadership with 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, legal fees, travel and other promotional expenses. Selling, general and administrative expenses for the year ended December 31, 2004 were \$16.3 million, an increase of \$2.8 million or 20.9% from \$13.5 million for the year ended December 31, 2003. This increase in absolute dollars was primarily due to additional personnel, additional traveling and increased sales and marketing expenses. As a percentage of net sales, selling, general and administrative expenses were 17.7% for the year ended December 31, 2004, an increase from 15.3% for the year ended December 31, 2003. We expect that selling, general and administrative expenses will continue to increase in absolute dollars for the foreseeable future.

**Patent Litigation Expenses.** Patent litigation expenses consist primarily of fees paid to outside counsel and consultants engaged by outside counsel. Patent litigation expenses for the year ended December 31, 2004 were \$5.3 million, an increase of \$1.4 million or 34.9% from \$4.0 million for the year ended December 31, 2003. This increase in absolute dollars was primarily due to increased litigation activity in existing cases and filing of additional litigation by us. As a percentage of net sales, patent litigation expenses were 5.8% for the year ended December 31, 2004, an increase from 4.5% for the year ended December 31, 2003. We expect that patent litigation expenses will continue to fluctuate for the foreseeable future. (Please see also, "Business Overview - Intellectual Property.")

**Non-operating Income-net.** Non-operating income-net reflects interest earned on average cash balances, less interest on borrowings, foreign exchange transaction gains and losses, gain on sales of long-term investments and impairment loss on investment in shares of stock. Non-operating income-net was \$2.7 million for the year ended December 31, 2004 increasing from \$1.4 million for the year ended December 31, 2003, reflecting additional foreign exchange transaction gains and gains on sales of long-term investments.

**Income Taxes.** Income tax expenses were \$1.5 million for the year ended December 31, 2004, compared to income tax expenses of \$1.8 million for the year ended December 31, 2003. This decrease in the amount of our income tax expenses was primarily due to a change in the global sales mix and the reversal of additional income tax payable for the 2000 tax year as a result of an examination and approval of our 2000 income tax return by the local Taiwan tax office authority. The effective tax rate was 9.5% for the year ended December 31, 2004, compared to 12.2% for the year ended December 31, 2003.

Years Ended December 31, 2003 and 2002

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**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, 2003 were \$88.6 million, an increase of \$18.4 million or 26.2% from \$70.2 million for the year ended December 31, 2002. This increase in net sales resulted from increased unit shipments of our existing products as well as shipments of new products and expansion of our customer base and the number of intermediaries we supply to. In 2003, we introduced Cardbus Power Switch (OZ2216) and Cardbus Security (OZH31B) products. We also enhanced the features of certain products in every existing product group in 2003.

**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

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these products. Gross profit for the year ended December 31, 2003 was \$50.3 million, an increase of \$8.2 million or 19.6% from \$42.0 million for the year ended December 31, 2002. This increase in absolute dollars was due to increased sales. Gross profit as a percentage of net sales for the year ended December 31, 2003 decreased to 56.8% from 59.9% for the year ended December 31, 2002 due to increased sales of 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 of, expenses for outside engineering consultants. Research and development expenses for the year ended December 31, 2003 were \$19.2 million, an increase of \$284,000 or 1.5% from \$18.9 million for the year ended December 31, 2002. This increase primarily reflected the addition of research and development personnel. As a percentage of net sales, research and development expenses were 21.7% for the year ended December 31, 2003, a decrease from 27.0% for the year ended December 31, 2002. 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 many 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 product leadership with our existing products and to provide innovative new product offerings. Therefore, we expect to continue to make significant research and development investments 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, legal fees, travel and other promotional expenses. Selling, general and administrative expenses for the year ended December 31, 2003 were \$13.5 million, an increase of \$1.7 million or 14.7% from \$11.8 million for the year ended December 31, 2002. This increase in absolute dollars was primarily due to additional personnel, additional traveling and increased sales commissions relating to higher sales. As a percentage of net sales, selling, general and administrative expenses were 15.3% for the year

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ended December 31, 2003, a decrease from 16.8% for the year ended December 31, 2002. We expect that selling, general and administrative expenses will continue to increase in absolute dollars for the foreseeable future.

**Patent Litigation Expenses.** Patent litigation expenses consist primarily of fees paid to outside counsel and consultants engaged by outside counsel. Patent litigation expenses for the year ended December 31, 2003 were \$4.0 million, an increase of \$3.4 million or 639.1% from \$535,000 for the year ended December 31, 2002. This increase in absolute dollars was primarily due to increased litigation activity in existing cases and filing of additional litigation by us. As a percentage of patent litigation expenses were 4.5% for the year ended December 31, 2003, an increase from 0.8% for the year ended December 31, 2002. We expect that patent litigation expenses will continue to fluctuate for the foreseeable future. (Please see also, "Business Overview - Intellectual Property.")

**Stock-based Compensation.** For accounting purposes, we recognize deferred stock-based compensation whenever we grant options or warrants to purchase our ordinary shares to employees with exercise prices that are less than the deemed fair market value of the underlying shares at the grant date and whenever we grant options or warrants to consultants. Amortization of deferred stock-based compensation recorded in the year ended December 31, 2003 was \$0, a decrease of \$44,000 or 100.0% from \$44,000 for the year ended December 31, 2002.

**Non-operating Income-net.** Non-operating income-net reflects interest earned on average cash balances, less interest on borrowings, impairment loss on investment in shares of stock and foreign exchange transaction gains and losses. Non-operating income-net was \$1.4 million for the year ended December 31, 2003

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decreasing from \$1.7 million for the year ended December 31, 2002, reflecting less interest earned in our cash and short-term investment.

**Income Taxes.** Income tax expenses were \$1.8 million for the year ended December 31, 2003, compared to income tax expenses of \$1.7 million for the year ended December 31, 2002. This increase in the amount of our income tax expenses was primarily due to increase in our net income. The effective tax rate was 12.2% for the year ended December 31, 2003, compared to 13.5% for the year ended December 31, 2002.

### 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 and short-term investments were \$120.1 million at December 31, 2004 as compared to \$120.4 million at December 31, 2003. Our operating activities provided cash in the amount of \$14.1 million in the year ended December 31, 2004, \$14.8 million in the year ended December 31, 2003 and \$9.5 million in the year ended December 31, 2002.

Non-cash charges consist of depreciation of fixed assets, impairment of investment in shares of stock, changes of deferred income tax assets and amortization of stock-based compensation from stock options and warrants. 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.

These net cash inflows for operations resulted from net income offset by

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increases in inventory and accounts receivable due to increased sales and also resulted from increases in notes and accounts payable, income tax payable and accrued liabilities.

Our investing activities used cash of \$25.2 million in the year ended December 31, 2004, \$23.5 million in the year ended December 31, 2003 and \$34.7 million in the year ended December 31, 2002. Investing activities in the year ended December 31, 2004 primarily represented increase in short-term investments, acquisition of land, property and equipment and additional long-term investments. Investing activities in the year ended December 31, 2003 primarily represented the increases of short-term investments and the increase of restricted assets. Investing activities in the year ended December 31, 2002 primarily represented short-term investments, investment in shares of stock and purchases of capital equipment. In the year ended December 31, 2004, there were net purchases of \$11.0 million in short-term investments and \$1.9 million increase of restricted assets. In the year ended December 31, 2003, there were net purchases of \$11.0 million in short-term investments and \$10.0 million increase of restricted assets. In the year ended December 31, 2002, there were net purchases of \$22.3 million on short-term investments, \$7.0 million investment in shares of stocks and \$4.3 million purchase of capital equipment. In the year ended December 31, 2004, we sold 1,000,000 shares of stock in 360 Degree Web for \$1.0 million, purchased \$313,000 of stock in Etrend Hightech and purchased \$4.5 million of common stock in CSMC Technologies Corporation.

Net cash provided by financing activities was \$946,000 in the year ended December 31, 2004, primarily due to exercise of stock options and issuance of shares under our Employee Stock Purchase Plan and offset by repurchases of our stock under a share repurchase program. Net cash provided by financing activities was \$5.9 million in the year ended December 31, 2003, primarily due to exercises of stock options and issuance of shares under our Employee Stock Purchase Plan, offset by repurchases of our stock from shareholders under share repurchases program. Net cash used in financing activities was \$4.4 million in the year ended December 31, 2002, primarily due to repurchases of our stock under the Company's existing share repurchase program offset by proceeds from the exercise of stock options, exercise of warrants and issuance of shares under Employee Stock Purchase Plan.

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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 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, 2004, we had approximately 257 full-time employees world-wide engaged in research and development efforts. Our total expenditures for research and development were \$20.3 million for the year ended December 31, 2004, \$19.2 million for the year ended December 31, 2003, and \$18.9 million for the year ended December 31, 2002. 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 and the



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opening of additional design centers in China.

We employ designers who have the necessary engineering and systems qualifications and 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.

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 - Japan, Taiwan, China, Korea and the United States. These direct applications engineering personnel assist with capturing business and supporting existing products at key customers. Additionally, we work closely with our customers to develop highly efficient power management products for specific mobile 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, 2004:

Contractual Obligations	Payments due by period				M
	Total	Less than 1 year	1-3 years	3-5 years	
(in thousands)					
Operating Lease Obligations.....	\$ 1,340	\$ 998	\$ 342	\$	\$
Licenses, Maintenance and Support.....	547	304	243	-	-
Total.....	1,887	1,302	585	-	-

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## ITEM 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES

### Directors and Senior Management

Our executive officers and directors and their ages as of December 31,

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2004, were as follows:

Name ----	Age ---	Position -----
Sterling Du.....	45	Chief Executive Officer, Class I Director and Chairman of Board
Chuan Chiung "Perry" Kuo.....	45	Chief Financial Officer, Class I Director and Secretary
Ivan Chang .....	42	Vice-President, Finance
Johnny Chiang .....	47	Vice-President, Logistics and Backend
James Keim.....	60	Class II Director and Head of Marketing and Sales
Michael Austin.....	69	Class III Director
Geok Ling Goh.....	63	Class I Director and member of Audit Committee
Lawrence Lin.....	54	Class II Director and member of Audit Committee
Keisuke Yawata.....	70	Class III Director and member of Audit Committee

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 O//2//Micro, 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.

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.

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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

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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.

Michael Austin has served as a director since October 1997 and as a Class III director since June 2001. 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 1969. 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 the Chairman of Tuas Power and as a director on the boards of Sembcorp Industries Ltd., Plato Capital Ltd. (formerly PKTech International Ltd), Venture Corporation Ltd., DBS Group Holdings Ltd. and DBS Bank Ltd. He also serves as a council member of Nanyang Technology University. He received a bachelor of engineering degree from Sydney University.

Lawrence Lin has served as a Class II director and member of the Audit Committee since June 2003. He is a Certified Public Accountant in Taiwan. Mr. Lin co-founded L&C Company, Certified Public Accountants, a member firm of Urbach Hacker Young International, in 1990. Mr. Lin has been a partner of L&C Company since 1990 and a Director of Urbach Hacker Young International from October 1994 to October 1998. Prior to L&C Company, he had been a partner at T N Soong & Co. Mr. Lin serves as Corporate Supervisor for a number of Taiwan companies including Cellink Company Limited and Tex Year Industries Inc. He received a bachelor of science degree from Taipei Vocational Commercial School.

Keisuke Yawata has served as a director since October 1999, as a member of the Audit Committee since August 2000 and as a Class III director since June 2001. Mr. Yawata is 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

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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.

There are no family relationships among any of our directors or executive officers.

### Compensation

We paid an aggregate amount of compensation during 2004 to our directors and officers as a group equal to approximately \$2,713,962. All of our officers and directors are eligible to participate in our employee benefit plans.

### Share Ownership of Directors and Senior Management

As of December 31, 2004, the aggregate number of ordinary shares beneficially owned by our directors and officers was 2,473,717. This number includes options to purchase an aggregate of 751,184 ordinary shares under our 1997 Stock Plan and 1999 Stock Plan exercisable within 60 days of December 31, 2004.

### 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 have authorized a total of 3,700,000 ordinary shares for issuance pursuant to the 1997 stock plan, as amended. As of December 31, 2004, options outstanding and exercisable under the 1997 stock plan were 478,866. No more grants have been made under this plan after the consummation of our initial public offering.

**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. 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 a smaller number as determined by the administrator. In the year ended December 31, 2004, the number of shares reserved under the 1999 stock plan was increased by 1,000,000 shares. 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

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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, 2004, options outstanding under the 1999 stock plan were 3,994,235, of which 1,612,934 were exercisable.

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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 through payroll deductions. Initially, an aggregate of 1,000,000 ordinary shares were reserved for issuance under the 1999 purchase plan and available for purchase thereunder, subject to adjustment in the event of a stock split, stock dividend or other similar change in our ordinary shares or our capital structure. Commencing on January 1, 2001, the number of shares reserved under this plan will be increased by a number equal to the lesser of 2% of the fully-diluted number of ordinary shares outstanding on that date, 800,000 shares or a smaller number determined by the administrator. All of our employees and the employees of our subsidiaries (including officers) who have been employed by us for at least ten days and whose customary employment is for more than five months in any calendar year and more than 20 hours per week are eligible to participate in the 1999 purchase plan. Employees subject to the rules or laws of a foreign jurisdiction that prohibit or make impractical their participation in the 1999 purchase plan are not eligible to participate in the 1999 purchase plan. As of December 31, 2004, 415,576 shares had been issued under the 1999 purchase plan.

The 1999 purchase plan designates offer periods, purchase periods and exercise dates. Offer periods are generally overlapping periods of 24 months, with new offering periods (other than the first offering period) commencing on May 1 and November 1 of each year. The initial offer period commenced on September 1, 2000 and ended on October 31, 2002. Purchase periods are generally six-month periods, with the initial purchase period commencing on September 1, 2000 and ending on April 30, 2001. The exercise date is the last day of each purchase period.

On the first day of each offer period, a participating employee is granted purchase rights, which are a form of option to be automatically exercised on the forthcoming exercise dates within the offer period during which deductions are to be made from the pay of participants in accordance with their authorizations and credited to their accounts under the 1999 purchase plan. When a purchase right is exercised, the participant's withheld salary is used to purchase ordinary shares. The price per share at which ordinary shares are to be purchased under the 1999 purchase plan during any offer period is the lesser of 85% of the fair market value of our ordinary shares on the date of the grant of the option or 85% of the fair market value of our ordinary shares on the applicable exercise date. The participant's purchase right is exercised in this manner on all four exercise dates arising in the offer period unless, on the first day of any purchase period, the fair market value of our ordinary shares is lower than the fair market value of the ordinary shares on the first day of the offer period. If so, the participant's participation in the original offer period is terminated, and the participant is automatically enrolled in the new offer period commencing on that day.

Payroll deductions may range in whole percentage increments from 1% to 10% of a participant's regular base pay, including commissions, overtime, bonuses, annual awards and other incentive payments. Participants may not make direct cash payments to their accounts. An employee may purchase a maximum of

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2,000 ordinary shares under the 1999 purchase plan during a purchase period. Additional limitations on the amount of ordinary shares that may be purchased during any calendar year are imposed by the Internal Revenue Code.

### 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.

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#### Terms of Directors and Officers

Our memorandum and articles of association allow our shareholders by ordinary resolution to appoint any person to be a director and in a like manner to remove any director and appoint another person in his place. Further, our directors have the power at any time to appoint any person to become one of our directors, either to fill a vacancy or as an addition to the existing directors, except that the total number of directors may not exceed the number fixed in accordance with our memorandum and articles of association. We have currently set the number of directors at not less than five or more than nine persons, but a majority of our shareholders may, by ordinary resolution, increase or reduce the limits on the number of directors. Prior to completion of our initial public offering, our memorandum and articles of association were amended to provide for our board of directors to be elected on a staggered basis which means shareholders can only elect, or remove, a limited number of our directors in any given year and can make it more difficult for a third party to acquire us without the consent of our board of directors. At our first annual general meeting after becoming eligible to have a classified board, our board of directors were divided into three classes, designated Class I, Class II, and Class III, as nearly equal in number as the then total number of directors permits. At that annual general meeting, three Class I directors were elected for a one-year term, two Class II directors for a two-year term and two Class III directors for a three-year term. At each subsequent annual general meeting, successors to the class of directors whose terms expires at that annual general meeting will be elected for a three-year term. If the number of directors is changed, any increase or decrease will be apportioned among the classes so as to maintain the number of directors in each class as nearly as possible, and any additional directors of any class elected to fill a vacancy resulting from an increase in that class will 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 director. 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.

#### Committees of the Board of Directors

We have an audit committee and a compensation committee. Each of our audit committee members qualifies as an "independent" director for purposes of the rules and regulations of the Nasdaq National Market System. 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

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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 four meetings in 2004. 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 the 1999 stock plan. Currently, Messrs. Lin, Austin and Kuo serve on the compensation 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.

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### Employees

As of December 31, 2004, we had 426 full-time employees, 104 of which were based in the United States, 289 in Asia, 30 in Europe and three 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 December 31, 2004, by each shareholder known by us to own beneficially more than 5% of our ordinary shares.

Name of Beneficial Owner	Shares Beneficially Owned	
	Number	Percent
Wasatch Advisors, Inc.	6,859,366	17.49
Fidelity Management & Research Company	5,881,890	15.00
Capital Research	3,640,000	9.28
RS Investment Management Co. LLC	2,253,088	5.75

None of the major shareholders listed above have differing voting rights with respect to the ordinary shares of the Company.

#### RELATED PARTY TRANSACTIONS

##### Loans

In 2001, James Keim, one of our directors, accepted the assignment of

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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. As of December 31, 2004, approximately \$18,000 had been repaid.

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 C 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. Upon completion of the transaction, our ownership was reduced to

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19.8%. As of December 31, 2004, one of our directors serves as a director of 360 Degree Web. From time to time, we may make additional loans to 360 Degree Web on similar terms.

### 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

#### ORDINARY SHARE PRICES AND RELATED MATTERS

Our ordinary shares are listed and traded on the Nasdaq National Market and the Cayman Islands Stock Exchange. The following table sets forth for the periods indicated the high and low last reported sales prices per ordinary share since trading on August 23, 2000 as furnished by the Nasdaq National Market. The initial public offering of our ordinary shares on August 23, 2000 was at the price of \$9.00 per share.



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(a) Annual high and low market prices

	High	Low
August 23, 2000 through December 31, 2000	\$ 26.00	\$ 6.75
January 1, 2001 through December 31, 2001	\$ 24.05	\$ 5.50
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

(b) Quarterly high and low market prices

Fourth Quarter 2001	\$ 24.05	\$ 11.81
First Quarter 2002	\$ 25.28	\$ 15.90
Second Quarter 2002	\$ 18.74	\$ 8.99
Third Quarter 2002	\$ 13.00	\$ 7.88
Fourth Quarter 2002	\$ 13.60	\$ 5.30
First Quarter 2003	\$ 12.00	\$ 8.01
Second Quarter 2003	\$ 17.05	\$ 10.45
Third Quarter 2003	\$ 18.25	\$ 13.45
Fourth Quarter 2003	\$ 25.29	\$ 14.56
First Quarter 2004	\$ 24.98	\$ 14.10
Second Quarter 2004	\$ 18.30	\$ 13.44
Third Quarter 2004	\$ 16.20	\$ 9.04
Fourth Quarter 2004	\$ 13.16	\$ 10.27
First Quarter 2005	\$ 10.95	\$ 8.74

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(c) Monthly high and low market prices

October 2004	\$ 12.42	\$ 10.49
November 2004	\$ 13.15	\$ 12.10
December 2004	\$ 13.16	\$ 10.27
January 2005	\$ 10.87	\$ 8.74
February 2005	\$ 10.95	\$ 8.78
March 2005	\$ 10.63	\$ 9.43
April 2005	\$ 10.41	\$ 9.35
May 2005	\$ 12.78	\$ 10.05

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 107 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, if the director's interest in such contract or arrangement is material, the interested director declares such interest at the earliest meeting of the board. Article 117 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 126 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 95,000,000 ordinary shares with a par value of US \$0.001. 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,

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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 ten days 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

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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, 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 and sanctioning the re-registration of an ordinary non-resident company as an exempted company.

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 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 5,000,000 preference shares with a par value of \$0.001 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

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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.

### 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

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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 5,000,000 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

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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 contacts listed under Item 19--Exhibits, 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 95,000,000 ordinary shares with a par value of \$0.001 per share. Of those 95,000,000 authorized ordinary shares, 39,188,062 shares were issued and outstanding as of December 31, 2004, 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.

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## 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 (2003 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 of ordinary shares held as a capital asset by a "U.S. Investor." 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 or local tax consequences of the ownership of ordinary shares.

A "U.S. Investor" means a person who is any of the following:

- . a citizen or resident of the United States;
- . a corporation or other entity treated as a corporation created or organized in or under the laws of the United States or any political subdivision thereof;
- . 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 control of all of its substantial decisions by one or more U.S. persons;

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- . a trust 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. tax purposes) is a beneficial owner of ordinary shares, the U.S. tax treatment of 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 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.

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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;
- . 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;
- . investors who hold our ordinary shares 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. 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.

Dividends. 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, other than a pro rata distribution of ordinary shares or rights with respect to the ordinary shares, that U.S. Investor will be required to include the distribution in gross income as a taxable dividend to the extent that a distribution is paid from our current or accumulated earnings and profits as determined for United States federal income tax purposes. Distributions in excess of our current and accumulated earnings and profits will first be treated, for United States federal income tax purposes, as a nontaxable return on capital to the extent of the U.S. Investor's basis in the ordinary shares and thereafter as gain from the sale or exchange of a capital asset. Dividends paid by us will not be eligible for the corporate dividends received deduction. The



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amount of any distribution of property other than cash will be the fair market value of that property on the date of distribution. The Jobs and Growth Tax Reconciliation Act of 2003 provides, for taxable years beginning after December 31, 2002 and before January 1, 2009, that "qualified dividend income" paid to an individual shareholder 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 various statutory requirements, including a specified holding period, are satisfied. In order for dividends to constitute "qualified dividend income," the shareholder generally must have held the ordinary shares for more than 60 days during the 120-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. We believe that any dividends paid by us would generally constitute "qualified dividend income" if the shareholder satisfies the holding period requirements and is not subject to such an obligation to make related payments, so long as we are not classified as a passive

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foreign investment company for our taxable year in which the dividend is paid or the preceding taxable year (see " -Passive Foreign Investment Company Status" below).

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. For this purpose, dividends distributed by us with respect to the ordinary shares will be "passive income" or in certain circumstances "financial services income" to a U.S. Investor. 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 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 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.

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

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Dispositions of Shares. 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 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. The capital gain or loss will be long-term capital gain or loss if the U.S. Investor has held the ordinary shares for more than one year at the time of the sale or exchange. If you are an individual, you 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, 2009) on long-term capital gain. You may deduct any loss resulting from the sale or exchange of the ordinary shares only against other capital gains, except that if you are an individual, up to \$3,000 of capital loss in excess of your capital gains may be deducted against ordinary income. Excess losses may be carried forward. Gain or loss realized by a U.S. Investor will be treated as U.S. source gain or loss for U.S. foreign tax credit purposes, except that loss will be treated as foreign source loss to the extent you received dividends that were includible in the financial services income basket during the 24-month period prior to the sale.

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, 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 our projected expenditure plans for the current year and future years and 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 shares 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 shares, it is subject to change. We believe our valuation approach is

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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 the extent to which we spend the cash we have raised, which is a passive asset for purposes of the passive foreign investment company asset test discussed above, on acquisitions and capital expenditures. 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 the 2005 taxable year or for any future taxable year. If we determine that we have become a passive foreign investment company, we will notify all U.S. investors who have been record shareholders 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.

Special U.S. tax rules apply to U.S. Investors of interests in a passive

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

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;
- . 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 and any gain realized on the disposition of the ordinary shares.

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 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 Nasdaq. If the election is made, a U.S. Investor would be required to mark the stock to market each taxable year and recognize ordinary gain for any increase in market value for that taxable year and would be allowed to recognize an

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ordinary loss for any decrease in that market value to the extent that prior gains exceed prior losses. The adjusted basis in the stock of the passive foreign investment company 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, you 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, you should consult with your tax adviser regarding whether to make a mark-to-market or qualified electing fund election.

Information Report and Backup Withholding. In general, information reporting requirements will apply to dividends in respect of our ordinary shares or the proceeds received on the sale, exchange or redemption of our ordinary shares paid within the United States (and, in certain cases, outside the United States) to U.S. Investor other than certain exempt recipients, such as corporations, and a 28% backup withholding tax 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. The amount of any backup withholding from a payment to a U.S. Investor will be allowed as credit against the U.S. Investor's U.S. federal income tax liability provided that the appropriate returns are filed.

### 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, 450 Fifth Street N.W., 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

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prices, including interest rates and foreign exchange rates, of financial instruments. In the normal course of business, our financial

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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. 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, 2004, the fair value of the 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 operating results or cash flows to be affected to any significant degree by the effect of a sudden short-term change in market interest rate exposures. We did not purchase or hold any derivative financial instruments for trading purposes.

The table below provides information about our financial instruments whose maturity dates are greater than three months as of December 31, 2004.

	2005 ----	2006 ----	2007 ----	2008 ----	2009 ----	Thereafter -----	Total ----
US Treasury Bills:							
Fixed rate (US\$) .....	3,963	-	-	-	-	-	3,963
Government Bonds:							
Fixed rate (US\$) .....	-	4,224	6,973	-	1,667	-	12,864
Time Deposit							
Fixed rate (US\$) .....	11,742	-	-	-	-	-	11,742
Corporate Bonds							
Fixed rate (US\$) .....	11,908	-	-	-	-	-	11,908

### Foreign currency risk

Fluctuations in exchange rates may adversely affect our financial results. The functional currencies for our foreign subsidiaries are the local currency. As a result, certain of our assets and liabilities, including certain bank accounts, accounts receivable, restricted assets, short-term investments and accounts payable, exist in non-US dollar-denominated currencies, which are sensitive to foreign currency exchange rate fluctuations. As of December 31, 2004, we held approximately \$18.8 million in government bonds, certificates of deposits and bank demand accounts denominated in foreign currencies.

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We have not engaged in hedging techniques designed to mitigate foreign currency exposures and we may experience economic losses as a result of foreign currency exchange fluctuations. We will monitor the currency exchange fluctuations periodically. For the year ended December 31, 2004, we

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experienced gains of \$648,000 due to foreign currency exchange fluctuations, which are reflected in the results of operations.

### Recent Accounting Pronouncements

In December 2004, the Financial Standards Board issued SFAS No. 123 (R) "Share-Based Payment". It required that companies recognize compensation expense equal to the fair value of stock options or other share based payment. As a public entity as contemplated by SFAS No. 123 (R), we are required to record, as of the first annual reporting period beginning after June 15, 2005. SFAS No. 123 (R) applies to all awards granted, and prior period's awards that are modified, repurchased, or cancelled. The impact on our net income will include the remaining amortization of the fair value of existing options currently disclosed as pro forma expense and is contingent upon the number of future options granted, the selected transition method and the selection of either the Black-Scholes or the binominal lattice model for valuing options. The adoption of this standard will have no impact on our cash flows.

### 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

There are no material modifications to the rights of security holders that are required to be disclosed.

#### USE OF PROCEEDS

As of December 31, 2004, 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 15. CONTROLS AND PROCEDURES

We maintain disclosure controls and procedures that are

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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

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desired control objectives. In addition, the design of any control system is based in part upon certain assumptions about the likelihood of future events. Due to these and other inherent limitations of any controls and procedures, there can be no assurance that any such design will succeed in achieving its stated goals under all potential future conditions.

Within 90 days prior to the date of this annual report on Form 20-F, 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.

There have been no significant changes in our internal controls or in other factors that could significantly affect the internal controls subsequent to the date we completed our evaluation.

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.

ITEM 16B. CODE OF ETHICS

We have adopted the O2 Micro 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](http://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 auditors for each of the fiscal years in the two-year period ended December 31, 2004. The appointment of the independent auditor 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, 2003 and 2004.

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	Year ended December 31, 2003	Year ended December 31, 2004
	-----	-----
Audit Fees	272,835	\$ 312,000
Audit-related Fees	26,944	12,821
Tax Fees	4,215	111,785
All Other Fees	-	111,126
 Total	 \$ 303,994	 \$ 547,732

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.

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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 and technical tax consultation.

All Other Fees: This category consists primarily of fees for the review and study of financial and other information processes.

The Audit Committee pre-approves all audit and permissible non-audit services provided by the independent registered public accounting firms. These services may include audit services, audit-related services, tax services and other services. During the year ended December 31, 2004, 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	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (1)	M S B t
-----				
April 1, 2004	10,000	\$ 17.22	10,000	
June 18, 2004	1,000	16.11	1,000	
August 20, 2004 to August 30, 2004	95,000	10.88	95,000	
September 9, 2004	14,200	10.34	14,200	



(1) In May 2002, we announced a share repurchase program to repurchase up to 3,000,000 shares of our Ordinary Shares. There is no expiration date for the share repurchase program.

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PART IV

ITEM 17. FINANCIAL STATEMENTS

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

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.

Independent Auditors' Report

Consolidated Balance Sheets as of December 31, 2003 and 2004

Consolidated Statements of Operations and Comprehensive Income for the years ended December 31, 2002, 2003 and 2004

Consolidated Statements of Shareholders' Equity for the years ended December 31, 2002, 2003 and 2004

Consolidated Statements of Cash Flows for the years ended December 31, 2002, 2003 and 2004

Notes to Consolidated Financial Statements

ITEM 19. EXHIBITS

1. Memorandum and Articles of Association of the registrant (incorporated by reference from Exhibits 3.1 and 3.2 to the Registration Statement on Form F-1 (File No. 333-12386) filed by 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)

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- 8.1 List of registrant's subsidiaries
- 10.1 Consent of Deloitte & Touche, independent registered public accounting firm
- 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.

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

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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.

O2 MICRO INTERNATIONAL LIMITED

Date: June 20, 2005

By: /s/ STERLING DU

-----  
Name: Sterling Du  
Title: Chief Executive Officer

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O2 MICRO INTERNATIONAL LIMITED

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O//2//Micro International Limited and  
Subsidiaries

Consolidated Financial Statements as of  
December 31, 2003 and 2004 and  
Report of Independent Registered Public  
Accounting Firm

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[LETTERHEAD OF DELOITTE & TOUCHE TAIPEI, TAIWAN]

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and the Shareholders  
O//2//Micro International Limited

We have audited the accompanying consolidated balance sheets of O2Micro International Limited and subsidiaries (the "Company") as of December 31, 2003 and 2004 and the related consolidated statements of operations and comprehensive income, shareholders' equity, and cash flows for each of the years ended December 31, 2002, 2003 and 2004 (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, 2003 and 2004 and the results of their operations and their cash flows for each of the years ended December 31, 2002, 2003 and 2004, in conformity with accounting principles generally accepted in the United States of America.

/s/ Deloitte & Touche

January 28, 2005 (May 10, 2005 as to Note 2 "Stock-based Compensation" and Note 12)

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O//2//MICRO INTERNATIONAL LIMITED AND SUBSIDIARIES

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

-----

December 31

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ASSETS	----- 2003 -----	2004 -----
CURRENT ASSETS		
Cash and cash equivalents	\$ 66,489	\$ 56,320
Restricted cash	1,892	1,887
Short-term investments	53,923	63,768
Accounts receivable, net	9,794	9,431
Inventories	9,613	11,231
Prepaid expenses and other current assets	3,365	4,491
	-----	-----
Total current assets	145,076	147,128
	-----	-----
LONG-TERM INVESTMENTS	7,865	11,781
	-----	-----
LAND, PROPERTY AND EQUIPMENT, NET	4,880	10,758
	-----	-----
RESTRICTED ASSETS	10,044	13,873
	-----	-----
OTHER ASSETS	1,428	1,656
	-----	-----
TOTAL	\$ 169,293	\$ 185,196
	=====	=====
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES		
Notes and accounts payable	\$ 6,334	\$ 3,635
Income tax payable	2,852	3,751
Accrued expenses and other current liabilities	5,380	7,029
	-----	-----
Total current liabilities	14,566	14,415
	-----	-----
COMMITMENTS AND CONTINGENCIES		
SHAREHOLDERS' EQUITY		
Preference shares at \$0.001 par value per share		
Authorized - 5,000,000 shares	-	-
Ordinary shares at \$0.001 par value per share		
Authorized -- 95,000,000 shares		
Issued - 39,032,616 shares and 39,188,062 shares		
as of December 31, 2003 and 2004, respectively	39	39
Additional paid-in capital	137,076	139,581
Accumulated other comprehensive loss	(521)	(110)
Retained earnings	18,133	31,271
	-----	-----
Total shareholders' equity	154,727	170,781
	-----	-----
TOTAL	\$ 169,293	\$ 185,196
	=====	=====

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

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

	Years Ended	
	2002	2001
NET SALES	\$ 70,187	\$ 8,300
COST OF SALES	28,143	3,100
GROSS PROFIT	42,044	5,200
OPERATING EXPENSES		
Research and development (exclusive of amortization of deferred stock compensation of \$30, \$0 and \$0 in 2002, 2003 and 2004, respectively)	18,935	1,000
Selling, general and administrative (exclusive of amortization of deferred stock compensation of \$14, \$0 and \$0 in 2002, 2003 and 2004, respectively)	11,790	1,000
Patent litigation	535	
Stock-based compensation	44	
Total operating expenses	31,304	3,000
INCOME FROM OPERATIONS	10,740	2,200
NON-OPERATING INCOME (EXPENSES)		
Interest income	1,802	
Impairment loss on long-term investments	(483)	
Gain on sale of long-term investments	-	
Foreign exchange gain, net	4	
Other, net	339	
Total non-operating income	1,662	
INCOME BEFORE INCOME TAX	12,402	2,200
INCOME TAX EXPENSE	1,673	
NET INCOME	10,729	2,200
OTHER COMPREHENSIVE INCOME (LOSS)		
Translation adjustments on subsidiaries	132	
Unrealized gain (loss) on available-for-sale securities	(127)	
Total other comprehensive income	5	
COMPREHENSIVE INCOME	\$ 10,734	\$ 2,200

(Continued)

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	Years Ended	
	2002	2001
<b>EARNINGS PER SHARE:</b>		
Basic	\$ 0.28	\$ 0.27
Diluted	\$ 0.27	\$ 0.26
<b>SHARES USED IN EARNINGS PER SHARE CALCULATION:</b>		
Basic (in thousands)	38,300	38,300
Diluted (in thousands)	39,591	39,591

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

(Concluded)

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O//2//MICRO INTERNATIONAL LIMITED AND SUBSIDIARIES

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

	Ordinary Shares		Additional Paid-in Capital		
	Shares	Amount	Ordinary Shares	Stock Options	
BALANCE, JANUARY 1, 2002	38,134,511	\$ 38	\$ 129,068	\$ 1,129	\$ -
Issuance of:					
Shares issued for exercise of stock options	325,279	1	1,187	(275)	
Shares issued for 1999 ESPP Plan	97,304	-	737	-	
Shares issued for exercise of warrants	300,000	-	801	-	
Acquisition of treasury stocks - 720,700 shares	-	-	-	-	
Cancellation of stock options	-	-	-	(2)	
Options granted to nonemployees	-	-	-	371	
Amortization of deferred stock compensation	-	-	-	-	
Net income for 2002	-	-	-	-	
Translation adjustments on subsidiaries	-	-	-	-	
Unrealized loss on					

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available-for-sale securities	-	-	-	-	-
	-----	-----	-----	-----	-----
BALANCE, DECEMBER 31, 2002	38,857,094	39	131,793	1,223	
Issuance of:					
Shares issued for exercise of stock options	863,987	1	6,135	(503)	
Shares issued for 1999 ESPP Plan	109,735	-	942	-	
Cancellation of stock options	-	-	-	(23)	
Acquisition of treasury stock - 77,500 shares	-	-	-	-	
Retirement of treasury stock	(798,200)	(1)	(2,793)	-	
Options granted to nonemployees	-	-	-	302	
Net income for 2003	-	-	-	-	
Translation adjustments on subsidiaries	-	-	-	-	
Unrealized loss on available-for-sale securities	-	-	-	-	
	-----	-----	-----	-----	-----
BALANCE, DECEMBER 31, 2003	39,032,616	39	136,077	999	
Issuance of:					
Shares issued for exercise of stock options	157,167	-	1,359	(77)	
Shares issued for 1999 ESPP Plan	118,479	-	1,032	-	
Acquisition and retirement of treasury stock	(120,200)	-	(422)	-	
Options granted to nonemployees	-	-	-	613	
Net income for 2004	-	-	-	-	
Translation adjustments on subsidiaries	-	-	-	-	
Unrealized gain on available-for-sale securities	-	-	-	-	
	-----	-----	-----	-----	-----
BALANCE, DECEMBER 31, 2004	39,188,062	\$ 39	\$ 138,046	\$ 1,535	\$
	=====	=====	=====	=====	=====

	Accumulated Other Comprehensive Income (Loss)			
	Deferred Compensation	Unrealized Investment Gain (Loss)	Cumulative Translation Adjustment	Total
	-----	-----	-----	-----
BALANCE, JANUARY 1, 2002	\$ (44)	\$ 15	\$ (712)	\$ (697)
Issuance of:				
Shares issued for exercise of stock options	-	-	-	-
Shares issued for 1999 ESPP Plan	-	-	-	-
Shares issued for exercise of warrants	-	-	-	-
Acquisition of treasury stocks - 720,700 shares	-	-	-	-
Cancellation of stock options	-	-	-	-
Options granted to nonemployees	-	-	-	-
Amortization of deferred stock compensation	44	-	-	-
Net income for 2002	-	-	-	-
Translation adjustments on				

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subsidiaries	-	-	132	132
Unrealized loss on available-for-sale securities	-	(127)	-	(127)
BALANCE, DECEMBER 31, 2002	-	(112)	(580)	(692)
Issuance of:				
Shares issued for exercise of stock options	-	-	-	-
Shares issued for 1999 ESPP Plan	-	-	-	-
Cancellation of stock options	-	-	-	-
Acquisition of treasury stock - 77,500 shares	-	-	-	-
Retirement of treasury stock	-	-	-	-
Options granted to nonemployees	-	-	-	-
Net income for 2003	-	-	-	-
Translation adjustments on subsidiaries	-	-	(90)	(90)
Unrealized loss on available-for-sale securities	-	261	-	261
BALANCE, DECEMBER 31, 2003	-	149	(670)	(521)
Issuance of:				
Shares issued for exercise of stock options	-	-	-	-
Shares issued for 1999 ESPP Plan	-	-	-	-
Acquisition and retirement of treasury stock	-	-	-	-
Options granted to nonemployees	-	-	-	-
Net income for 2004	-	-	-	-
Translation adjustments on subsidiaries	-	-	714	714
Unrealized gain on available-for-sale securities	-	(303)	-	(303)
BALANCE, DECEMBER 31, 2004	\$ -	\$ (154)	\$ 44	\$ (110)

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

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O//2//MICRO INTERNATIONAL LIMITED AND SUBSIDIARIES

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

	Years Ended December 31	
	2002	2003
OPERATING ACTIVITIES		
Net income	\$ 10,729	\$ 13,201



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Adjustments to reconcile net income to net cash provided by operating activities:

Depreciation and amortization	1,937	2,623
Amortization of deferred stock compensation	44	-
Amortization of stock options granted for services	74	335
Gain on sale of long-term investments	-	-
Loss (gain) on sale of short-term investments	(385)	5
Deferred income tax assets	198	386
Impairment of long-term investments	483	17
Loss on sale of fixed assets	7	68
Changes in operating assets and liabilities:		
Accounts receivable, net	(3,895)	(2,199)
Inventories	(1,606)	(2,646)
Prepaid expenses and other current assets	(765)	(474)
Notes and accounts payable	1,632	1,132
Income taxes payable	737	895
Accrued expenses and other current liabilities	333	1,413
	-----	-----
Net cash provided by operating activities	9,523	14,756
	-----	-----

INVESTING ACTIVITIES

Receivables from employees	(262)	(104)
Acquisition of:		
Land, property and equipment	(4,275)	(1,749)
Long-term investments	(6,968)	(147)
Short-term investments	(188,231)	(116,138)
(Increase) decrease in:		
Restricted assets	-	(10,044)
Restricted cash	(860)	127
Other assets	(46)	(612)
Proceeds from:		
Sale of short-term investments	165,970	105,146
Sale of long-term investments	-	-
Sale of equipment	3	1
	-----	-----
Net cash used in investing activities	(34,669)	(23,520)
	-----	-----

(Continued)

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	Years Ended December 31		
	2002	2003	2004
	-----	-----	-----
FINANCING ACTIVITIES			
Acquisitions of treasury stock	\$ (6,823)	\$ (647)	\$ (1,368)
Proceeds from:			
Exercise of stock options	913	5,633	1,282
Issuance of shares for warrants exercised	750	-	-
Issuance of ordinary shares under ESPP Plan	737	942	1,032
Payments of principal of capital leases	(10)	(6)	-
	-----	-----	-----
Net cash provided by (used in) financing activities	(4,433)	5,922	946

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EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATE	99	(3)	(16)
NET DECREASE IN CASH AND CASH EQUIVALENTS	(29,480)	(2,845)	(10,169)
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	98,814	69,334	66,489
CASH AND CASH EQUIVALENTS AT END OF YEAR	\$ 69,334	\$ 66,489	\$ 56,320
SUPPLEMENTAL DISCLOSURES OF CASH FLOWS			
Cash paid for interest	\$ 4	\$ 1	\$ -
Cash paid for tax	\$ 744	\$ 600	\$ 641
NON-CASH INVESTING AND FINANCING ACTIVITIES			
Short-term investments reclassified to restricted assets	\$ -	\$ -	\$ 1,144
Convertible loans converted to long-term investments	\$ -	\$ 1,750	\$ -
Unrealized gain (loss) on investments accounted for available-for-sale	\$ (127)	\$ 261	\$ (303)

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

(Concluded)

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O//2//MICRO INTERNATIONAL LIMITED AND SUBSIDIARIES

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

1. GENERAL

Business

O//2//Micro, Inc. was incorporated in the state of California in the United States of America on March 29, 1995 to design, develop, and deliver semiconductor components primarily for mobile applications. In March 1997, O//2//Micro, Inc. reincorporated in the Cayman Islands under the name O//2//Micro International Limited (the "Company"). In connection with the reincorporation, all authorized and outstanding common stock, preferred stock and stock options of O//2//Micro, Inc. were exchanged for the Company's ordinary shares, preference shares and stock options with identical rights and preferences. O//2//Micro, Inc. became the Company's subsidiary after the shares exchange.

The Company had incorporated various wholly-owned subsidiaries, namely, O//2//Micro Electronics, Inc. (O//2//Micro - Taiwan), O//2//Micro International Japan Limited (O//2//Micro - Japan), O//2//Micro PTE Limited - Singapore (O//2//Micro - Singapore), and other subsidiaries. O//2//Micro-Taiwan and O//2//Micro - Japan are engaged in trading while O//2//Micro - Singapore and other subsidiaries are engaged in research and development. The Company also established a Taiwanese branch office, O//2//Micro International Limited - Taiwan Branch (O//2//Micro - Taiwan Branch) to engage in marketing and customer support related services.

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Due to the duplicate function of O//2//Micro - Taiwan Branch and O//2//Micro - Taiwan, the Board of Directors determined to dissolve O//2//Micro - Taiwan Branch on October 31, 2002. The dissolution process of O//2//Micro - Taiwan Branch was not completed as of December 31, 2004.

### 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 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 review of the expected collectibility of individual accounts.

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#### 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 short-term investments and long-term investments represent quoted market prices, if available. If no quoted market prices are available, fair values are estimated based on other factors. Fair value of restricted assets, which are composed of foreign government bonds, negotiated certificates of deposit and cash, is estimated based on 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.

#### Restricted Assets

The Company classifies deposits made for customs, collateral for obtaining foundry capacity, lines of credit and office leases as

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restricted cash. The deposits are classified as current asset if refundable within a twelve-month period. Restricted assets consist of deposits made for Taiwan court cases in the form of Taiwan Government bonds, negotiated certificates of deposit and cash.

### Short-term Investments

The Company maintains its excess cash in U.S. treasury bills and notes, government and corporate bonds issued by financial institutions with strong 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, 2004, all of the Company's investments were classified as available-for-sale securities and are recorded at market value. Unrealized gains and losses on these investments are included with 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 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.

### Land, Property and Equipment

Land, 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.

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Depreciation is provided on the straight-line method over estimated service lives that range as follows: building - 35 years, equipment - 3 to 10 years, furniture and fixtures - 3 to 15 years, equipment under capital lease - 3 to 5 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. Depreciation expense recognized during the years ended December 31, 2002, 2003 and 2004 was approximately \$1,884,000, \$2,325,000 and \$2,391,000, respectively.

Equipment covered by agreements qualifying as capital leases is stated at the lower of fair market value or the present value of the minimum lease payments at the inception of the lease, less depreciation.

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### 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, 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. Any future repurchases will be immediately retired.

### 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.

The Company provides its distributors with limited product rotation and price protection rights for products held in distributors' inventory. To date, the Company has given no price adjustments to or rotated any products for its distributors.

### Research and Development

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 construction of prototypes. All expenditures related to research and development activities of the Company are charged to operating expenses when incurred.

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### Advertising Expenses

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The Company expenses all advertising and promotional costs as incurred. These costs were \$1,577,000, \$795,000 and \$1,108,000 in the years ended December 31, 2002, 2003 and 2004, respectively. A portion of these costs were for advertising, which amounted to \$138,000 in 2002, \$153,000 in 2003 and \$367,000 in 2004.

### Income Taxes

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.

Under current Republic of China ("ROC") tax regulations, the current year's earnings, on a tax basis, that are not distributed in the following year are subject to a 10% additional income tax. This 10% additional income tax is recognized in the period during which the related income is generated.

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 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 more likely than not.

### Stock-based Compensation

The Company has elected to follow Accounting Principles Board Opinion ("APB") No. 25, "Accounting for Stock Issued to Employees" and complies 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 grant, between the fair value of the Company's stock and the exercise price.

Had the compensation expense for the Company's stock-based compensation plans been determined on the basis of the fair values under SFAS No. 123, the Company's fiscal 2002, 2003 and 2004 net income and net income per share would be the following.

	Years Ended December 31		
	2002	2003	2004
Net income as reported (in thousands)	\$ 10,729	\$ 13,201	\$ 15,100
Add: Stock-based compensation expense included in net income, including tax expense of \$0 for 2002, 2003 and 2004, respectively	44	-	-
Deduct: Stock-based compensation expense determined under SFAS No. 123 including tax expense of \$0 for 2002, 2003 and 2004, respectively	(8,643)	(8,061)	(8,061)
Pro forma net income	\$ 2,130	\$ 5,140	\$ 7,039

(Continued)

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	Years Ended December 31		
	2002	2003	2004
Pro forma shares used in calculation - basic (in thousands)	38,300	38,374	39,156
Pro forma earnings per share - basic	\$ 0.06	\$ 0.13	\$ 0.18
Earnings per share - basic as reported	\$ 0.28	\$ 0.34	\$ 0.36
Pro forma shares used in calculation - diluted (in thousands)	39,591	39,736	40,102
Pro forma earnings per share - diluted	\$ 0.05	\$ 0.13	\$ 0.18
Earnings per share - diluted as reported	\$ 0.27	\$ 0.33	\$ 0.35

#### 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 receivables and payables 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

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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. Because 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.

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### Recent Accounting Pronouncements

In December 2004, the FASB issued SFAS No. 123(R) "Share-Based Payment." SFAS No. 123(R) requires that companies recognize compensation expense equal to the fair value of stock options or other share based payments for the annual reporting period that begins after June 15, 2005. SFAS No. 123(R) applies to all awards granted after June 15, 2005, and prior period's awards that are modified, repurchased, or cancelled after June 15, 2005. The impact on the Company's net income will include the remaining amortization of the fair value of existing options currently disclosed as pro forma expense in Note 2 and is contingent upon the number of future options granted, the selected transition method and the selection of either the Black-Scholes or the binominal lattice model for valuing options. The adoption of this standard will have no impact on the Company's cashflows.

### Reclassifications

Certain amounts reported in previous years have been reclassified to conform to the 2004 presentation.

### 3. CASH AND CASH EQUIVALENTS

	December 31	
	2003	2004
	(In Thousands)	
US treasury bills and corporate bonds	\$ 17,122	\$ 21,534
Time deposits	34,951	19,383
Savings and checking accounts	14,409	15,389
Petty cash	7	14
	\$ 66,489	\$ 56,320

### 4. SHORT-TERM INVESTMENTS

The following is a summary of available-for-sale securities:

	December 31	
	2003	2004
	(In Thousands)	
Time deposits	\$ 10,611	\$ 23,038
US treasury bills	33,958	19,967
Corporate bonds	8,185	17,014



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Foreign government bonds	1,144	3,724
Others	25	25
	-----	-----
	\$ 53,923	\$ 63,768
	=====	=====

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Available-for-sale securities by contractual maturity are as follows:

	December 31	
	-----	-----
	2003	2004
	-----	-----
	(In Thousands)	
Due within one year	\$ 52,752	\$ 61,023
Due after one year through two years	-	1,698
Due after two years	1,171	1,047
	-----	-----
	\$ 53,923	\$ 63,768
	=====	=====

The Company's gross realized gains and losses on the sale of investments for the year ended December 31, 2003 were \$0 and \$5,000, respectively, and for the year ended December 31, 2004 were \$0. Gross unrealized gains and losses at December 31, 2003 were \$196,000 and \$47,000, respectively and at December 31, 2004 were \$293,000 and \$182,000, respectively. The Company did not provide the disclosure of fair value and unrealized losses by category of investment as required by EITF No 03-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments" as the amount of the unrealized losses for 2003 and 2004 are deemed insignificant.

5. ACCOUNTS RECEIVABLE, NET

	December 31	
	-----	-----
	2003	2004
	-----	-----
	(In Thousands)	
Accounts receivable	\$ 10,195	\$ 9,838
Allowances for		
Doubtful receivables	(86)	(90)
Sales returns and discounts	(315)	(317)
	-----	-----
	\$ 9,794	\$ 9,431
	=====	=====

The changes in the allowances are summarized as follows:

	2002	2003	2004
	-----	-----	-----
	(In Thousands)		
Allowances for doubtful receivables			
Balance, beginning of year	\$ 55	\$ 64	\$ 86
Additions	9	22	4
	-----	-----	-----
Balance, end of year	\$ 64	\$ 86	\$ 90
	=====	=====	=====
Allowances for sales returns and			

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discounts				
Balance, beginning of the year	\$	314	\$	314
Additions		-		1
				2
Balance, end of the year	\$	314	\$	315
				317

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6. INVENTORIES

		December 31	
		2003	2004
		(In Thousands)	
Finished goods	\$	2,042	\$ 2,844
Work-in-process		3,608	4,336
Raw materials		3,963	4,051
	\$	9,613	\$ 11,231

7. LONG-TERM INVESTMENTS

		December 31	
		2003	2004
		(In Thousands)	
Cost method			
X-FAB Semiconductor Foundries AG (X-FAB)	\$	4,968	\$ 4,968
360 Degree Web Ltd. (360 Degree Web)		1,750	1,070
GEM Services, Inc. (GEM)		500	500
Etrend Hightech Corporation (Etrend)		647	960
		7,865	7,498
Available for sale securities - noncurrent			
CSMC Technologies Corporation (CSMC)		-	4,283
	\$	7,865	\$ 11,781

The Company invested in X-FAB's ordinary shares in July 2002. X-FAB is a European-American foundry group that specializes in mixed signal applications. As of December 31, 2004, the Company held 530,000 shares at the value of \$4,968,000 (4,982,000 EURO), which represents a 2.03% ownership of X-FAB.

On January 3, 2003, the Company exercised its option to convert its convertible loans of \$1,750,000 in 360 Degree Web to 2,083,333 Series B preference shares of capital stock at \$0.36 per share and 1,000,000 Series B2 preference shares of capital stock at \$1.00 per share. 360 Degree Web designs, develops and markets intelligent security software solutions that provide secure computing environment for personal computer mobile devices and the internet. After the conversion, the Company had a 35.2% ownership in 360 Degree Web. The Company did not participate in 360 Degree Web's financing during 2003 and the ownership was diluted to 29.3% as of December 31, 2003. The Company accounts for its investment under the cost method of accounting as it does not

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actively participate in the decision-making process of 360 Degree Web, holds one director seat and management of 360 Degree Web holds the controlling interest.

In March 2004, the Company sold 1,000,000 shares of its stock in 360 Degree Web and recognized a gain of \$340,000. Upon completion of the transaction, the Company's ownership was reduced to 19.8% as of December 31, 2004.

The Company invested in GEM's preferred shares in August 2002. GEM is a multinational semiconductor assembly and test company. As of December 31, 2004, the Company held 333,334 shares at the value of \$500,000, which represents a 1.07 % ownership of GEM.

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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, 2003, the Company held 2,189,288 shares at the value of \$647,000, which represents approximately 12.5% ownership of Etrend. The Company invested an additional \$313,000 for Etrend's financing in March 2004. As of December 31, 2004, the Company's ownership was reduced to 11.2%.

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", strained-silicon products and other engineered multi-layer structures to microelectronics and photonics industries 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 recognized an impairment loss of \$483,000 and \$17,000, respectively. The Company held 23,946 shares of SiGen as of December 31, 2004 representing 0.07% ownership in SiGen with a carrying value of zero.

In August 2004, the Company invested in CSMC's ordinary shares which are listed in Hang Seng Stock Market in Hong Kong. CSMC is a semiconductor foundry company. The Company held 70,200,000 shares acquired for a purchase price of \$4,547,000, which represents approximately 2.67% ownership of CSMC. As of December 31, 2004, the Company recognized unrealized losses of \$265,000.

### 8. LAND, PROPERTY AND EQUIPMENT, NET

	December 31	
	2003	2004
	(In Thousands)	
Cost		
Land	\$ -	\$ 2,510
Buildings	-	2,150
Equipment	10,457	13,035
Furniture and fixtures	336	1,054
Equipment under capital lease	165	160
Leasehold improvements	727	1,309
Transportation equipment	56	56

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Prepayment for leasehold improvement	43	179
	-----	-----
	11,784	20,453
	-----	-----
Accumulated depreciation		
Buildings	-	39
Equipment	6,096	8,337
Furniture and fixtures	131	420
Equipment under capital lease	162	160
Leasehold improvements	486	698
Transportation equipment	29	41
	-----	-----
	6,904	9,695
	-----	-----
	\$ 4,880	\$ 10,758
	=====	=====

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9. OTHER ASSETS

	December 31	
	-----	-----
	2003	2004
	-----	-----
	(In Thousands)	
Deferred charges, net	\$ 473	\$ 789
Long-term note receivables from employees	551	435
Refundable deposits	404	432
	-----	-----
	\$ 1,428	\$ 1,656
	=====	=====

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 term 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. As of December 31, 2004, \$18,000 had been repaid.

10. ACCRUED EXPENSES AND OTHER CURRENT LIABILITIES

	December 31	
	-----	-----
	2003	2004
	-----	-----
	(In Thousands)	
Salaries, bonus and benefits	\$ 1,827	\$ 2,150
Legal and audit fees	1,180	1,917
Deferred income tax liabilities	444	388
Commissions	239	126
Other accrued expenses	1,690	2,448
	-----	-----
	\$ 5,380	\$ 7,029
	=====	=====

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11. INCOME TAXES

Income before income taxes consisted of:

	Years Ended December 31		
	2002	2003	2004
	(In Thousands)		
Cayman	\$ 10,735	\$ 12,159	\$ 15,496
Other subsidiaries	1,667	2,868	60
	\$ 12,402	\$ 15,027	\$ 15,556

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Income tax expense consisted of:

	Years Ended December 31		
	2002	2003	2004
	(In Thousands)		
Current	\$ 1,475	\$ 1,440	\$ 1,540
Deferred	198	386	(68)
Income tax expense	\$ 1,673	\$ 1,826	\$ 1,472

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 is as follows:

	Years Ended December 31		
	2002	2003	2004
Cayman statutory rate	0%	0%	0%
Foreign in excess of statutory rate	12.40%	10.72%	7.09%
Research and development credits	(5.90%)	(4.39%)	(6.08%)
Adjustments to prior years' taxes	0.40%	0.09%	3.49%
Valuation allowance	5.70%	2.55%	4.59%
Others	0.90%	3.18%	0.37%
Effective tax rate	13.50%	12.15%	9.46%

The deferred income tax assets and liabilities as of December 31, 2003 and 2004 consisted of the following:

	December 31	
	2003	2004
	(In Thousands)	
Deferred income tax assets		
Research and development credits	\$ 3,409	\$ 4,443

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Net operating loss carryforwards	390	254
Accrued vacation	118	117
Depreciation and amortization	104	7
Others	165	149
	-----	-----
	4,186	4,970
Valuation allowance	(3,909)	(4,681)
	-----	-----
Total net deferred income tax assets	277	289
	-----	-----
Deferred income tax liabilities		
Withholding tax liabilities	359	413
Unrealized foreign exchange	9	(64)
Unrealized capital allowance	76	39
	-----	-----
Total deferred income tax liabilities	444	388
	-----	-----
Net deferred income tax liabilities	\$ (167)	\$ (99)
	=====	=====
Balance sheet caption reported in:		
Prepaid expenses and other current assets	\$ 277	\$ 289
Accrued expenses and other current liabilities	444	388
	-----	-----
	\$ (167)	\$ (99)
	=====	=====

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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 \$772,000 and \$469,000 for the years ended December 31, 2004 and 2003, respectively.

As of December 31, 2004, O2Micro, Inc. had U.S. federal and California state net operating loss carryforwards of approximately \$ 0 and \$4,345,000, and U.S. federal and California state research and development credit carryforwards of approximately \$2,651,000 and \$2,716,000, respectively. The California state net operating loss carryforwards will expire in 2004 and 2005 if not utilized. The U.S. federal research and development credit will expire from 2012 through 2024 if not utilized, while the California state research and development credit will never expire. Utilization of the net operating loss carryforwards may be subject to significant annual limitation due to ownership change limitations provided by the U.S. Internal Revenue Code of 1986 and similar provisions in the State of California's tax regulations. The annual limitation may result in the expiration of net operating losses before utilization.

The Company reversed \$375,000 of income tax payable for the 2000 tax year in September 2004 due to completion of the examination and approval of its filed income tax return for the year ended December 31, 2000.

On May 24, 2004, O2 Micro-Taiwan applied to the Taiwan Custom's officials for the rectification of the value of the imported goods reported for the period from March 2003 to March 2004. The Company had mistakenly reported a lower amount to the Taiwan Custom's Authority than the correct amount that was reported on the Company's tax return for the year ended December 31, 2003 and the amount that will be reported on the

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Company's tax return for the year ended December 31, 2004. However, rectification of custom's records usually cannot extend prior to the latest six month period reported. The Company has further obtained the opinion of Taiwan's Ministry of Finance as to accept rectification of the value of the imported goods prior to the latest six month period. The Company will continue to apply for the rectification to the Taiwan Custom's Authority. If the Company's rectification application for the period prior to the latest six months is rejected, the understated cost of the imported goods reported to the customs officials may be deemed to be the actual cost and thus the taxable income for the year ended December 31, 2003 would be higher. The Company has determined the maximum impact on income tax would be \$1,680,000 (NT\$52,000,000) for O2 Micro-Taiwan. The Company believes that it would be able to minimize the maximum exposure by providing records of actual costs paid. Accordingly, the Company has estimated the probable outcome and accrued \$658,000 (NT\$22,000,000) at December 31, 2004.

### 12. EMPLOYEE BENEFIT PLANS

#### Savings Plan

The Company has a savings plan that qualifies under Section 401(k) of the U.S. Internal Revenue Code. Participating employees may defer up to 15% of pretax salary, but not more than statutory limits. The Company may make voluntary contributions to the savings plan but has made no contributions since the inception of the savings plan.

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#### 1999 Employee Stock Purchase Plan ("1999 Purchase Plan")

In 1999, the Company's Board of Directors adopted the 1999 Purchase Plan, which was approved by the shareholders prior to the consummation of its initial public offering in August 2000. A total of 1,000,000 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 800,000 shares as approved by the Board of Directors. 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 at a price equal to the lesser of 85% of the fair market value of the Company's ordinary shares on the date of grant of the option to purchase or 85% of the fair market value of the Company's ordinary shares on the applicable exercise date. Employees may elect to discontinue their participation in the purchase plan at any time during the enrollment period. 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 2003 and 2004, 109,735 and 118,479 ordinary shares, respectively, had been purchased under the 1999 Purchase Plan. As of December 31, 2004, 584,424 shares were available for issuance.

#### Stock Option Plans

In 1997, the Company's Board of Directors adopted the 1997 Stock Plan, and in 1999, adopted the 1999 Stock Incentive Plan (collectively, the "Plans"). The Plans provide for the granting of stock options to

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employees, directors and consultants of the Company. Options granted under the Plans may be either incentive stock options ("ISO") within the meaning of Section 422 of the United States Internal Revenue Code, or nonstatutory stock options ("NSO"). ISOs may be granted only to Company employees and directors. NSOs may be granted to Company employees and consultants.

Options under the Plans may be granted for periods of up to ten years and at prices no less than 85% of the estimated fair value of the shares (in the case of NSOs) on the date of grant as determined by the Board of Directors, provided, however, that (i) the exercise price of an ISO may not be less than 100% of the estimated fair value of the shares on the date of grant, and (ii) the exercise price of an ISO granted to a 10% shareholder may not be less than 110% of the estimated fair value of the shares on the date of grant. Options may be exercised following the termination of a grantee's continuous service only to the extent provided in the award agreement. Options generally expire no later than ten years after grant, or five years in the case of an ISO granted to a 10% shareholder. The options generally vest over a period of four years from the vesting commencement date. Options may be granted with different vesting terms from time to time.

Under the 1997 Stock Plan, the Board of Directors reserved 3,700,000 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 3,000,000 ordinary shares plus an annual increase on January 1 of each year, commencing in 2001, equal to the least of 1,500,000 shares (in the case of ISOs) or 4% of the outstanding ordinary shares on the last day of the preceding fiscal year or a smaller number determined by the administrator. As of December 31, 2004, the number of options outstanding and exercisable was 478,866 under the 1997 Stock Plan, and 3,994,235 and 1,612,934 under the 1999 Stock Incentive Plan, respectively.

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A summary of the Company's stock option activity and related information is as follows:

	Available for Grant	Number of Outstanding Options	Weighted Average Exercise Price
	-----	-----	-----
Balance, January 1, 2002	1,587,379	3,113,777	
Additional shares authorized	1,500,000	-	
Granted	(1,310,400)	1,310,400	\$ 12.30
Exercised	-	(325,113)	\$ 2.96
Canceled	54,894	(54,894)	\$ 10.83
	-----	-----	
Balance, December 31, 2002	1,831,873	4,044,170	
Additional shares authorized	1,500,000	-	
Granted	(913,300)	913,300	\$ 13.88
Exercised	-	(863,987)	\$ 6.52
Canceled	173,623	(173,623)	\$ 13.05
	-----	-----	
Balance, December 31, 2003	2,592,196	3,919,860	
Additional shares authorized	1,000,000	-	
Granted	(904,050)	904,050	\$ 13.54



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Exercised	-	(156,167)	\$	8.15
Canceled	194,642	(194,642)	\$	14.02
	-----	-----		
Balance, December 31, 2004	2,882,788	4,473,101		
	=====	=====		

The following table summarizes information about the stock options outstanding as of December 31, 2004:

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Number Outstanding	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number Exercisable and Vested	Weighted Average Exercise Price
\$0.03-\$0.09	64,292	2.43	\$ 0.04	64,292	\$
\$0.18-\$0.25	1,167	3.77	\$ 0.24	1,167	\$
\$0.50	46,333	4.19	\$ 0.50	46,333	\$
\$3.95-\$5.88	254,536	5.26	\$ 4.81	246,225	\$
\$6.50-\$9.74	1,128,624	7.15	\$ 8.59	737,568	\$
\$10.06-\$14.97	1,934,366	8.05	\$ 12.82	593,391	\$
\$15.38-\$24.18	1,043,783	8.04	\$ 18.02	402,824	\$
	-----	-----	-----	-----	-----
	4,473,101	7.54	\$ 12.20	2,091,800	\$
	=====	-----	-----	=====	-----

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 of Directors for grants prior to August 23, 2000. The fair value of subsequent option grants were based on the market price of ordinary shares on the day of grant.

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The Company calculated the fair value of each option grant on the date of grant using the Black-Scholes option pricing model as prescribed by SFAS No. 123. The Black-Scholes option valuation model was developed for estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option valuation model requires the input of highly subjective assumptions, including the expected stock price volatility. The Company used the following weighted-average assumptions in calculating the fair value of the options granted:

	Stock Options			Employee Stock Purchase Plan	
	Years Ended December 31				
	2002	2003	2004	2002	2003
Risk-free interest rate	2.76%	3.34%	3.54%	1.82%	1.58%-1.80%

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Expected life	5-9 years	5-9 years	5-7 years	0.50-2.03 years	0.51-1.53 years
Volatility	75%	70%	65%	85%	65%
Dividend	-	-	-	-	-

Expected life of stock options is estimated to be one year after vesting.

The weighted average fair values under SFAS No. 123 for options granted during the years ended December 31, 2002, 2003 and 2004 was \$9.83, \$7.64 and \$8.63, respectively. The weighted average fair values under SFAS No. 123 for purchase rights granted pursuant to the Employee Stock Purchase Plan during the years ended December 31, 2002, and 2003 was \$5.13 and \$5.40, respectively. There is no purchase rights granted pursuant to the Employee Stock Purchase Plan during the year ended December 31, 2004.

Deferred Compensation

In connection with stock option grants since the Company's inception, the Company recognized accumulated deferred compensation totaling \$3,056,000 which was fully amortized as of December 31, 2002. Amortization expense recognized during the years ended December 31, 2002, was approximately \$44,000.

Ordinary Shares Reserved

Ordinary shares reserved for future issuance was as follows at December 31, 2004:

Outstanding stock options	4,473,101
Shares reserved for future stock option grants	2,882,788
Shares reserved for employee stock purchase plan	584,424
	-----
	7,940,313
	=====

13. 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 either the "as if converted" method for convertible preference shares or the treasury stock method for options and warrants.

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

	Years Ended December 31		
	2002	2003	2004
Net income (in thousands)	\$ 10,729	\$ 13,201	\$ 14,084
Weighted average thousand shares	=====	=====	=====

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outstanding - basic	\$ 38,300	\$ 38,374	\$ 39,156
Effect of dilutive securities:			
Options	1,194	1,362	946
Warrants	97	-	-
	-----	-----	-----
Weighted average thousand shares outstanding - diluted	\$ 39,591	\$ 39,736	\$ 40,102
	=====	=====	=====
Earnings per share - basic	\$ 0.28	\$ 0.34	\$ 0.36
	=====	=====	=====
Earnings per share - diluted	\$ 0.27	\$ 0.33	\$ 0.35
	=====	=====	=====

Certain antidilutive outstanding options and warrants were excluded from the computation of diluted EPS since their exercise prices exceeded the average market price of the ordinary shares during the period. The antidilutive stock options excluded and their associated exercise prices per share were 1,141,900 shares at \$14.10 to \$24.18 as of December 31, 2002; 916,646 shares at \$15.38 to \$24.18 as of December 31, 2003 and 1,227,037 shares at \$ 14.97 to \$ 24.18 as of December 31, 2004.

14. LEASE COMMITMENTS

The Company leases office space and certain equipment under non-cancelable operating lease agreements that expire at various dates through February 2007. The Company's office lease provides for periodic rental increases based on the general rate of inflation.

As of December 31, 2004, minimum lease payments under all noncancelable leases were as follows:

Year	Operating Leases
	-----
	(In Thousands)
2005	\$ 1,113
2006	470
2007	13
	-----
Total minimum lease payments	\$ 1,596
	=====

15. CONTINGENCIES

Monolithic Power Systems, Inc. ("MPS"), a company based in Los Gatos, California, USA has alleged that our OZ960, OZ961, OZ969 and OZ970 products infringe on one of their patents and a continuation of that patent. Litigation on such claim is pending in the United States District Court in the Northern District of California. We have answered MPS' claims, denying all of their substantive allegations. In addition, given the results of the claims constructions adopted by the Court on November 26, 2001 and December 27, 2002, we believe that we have meritorious defenses against MPS' allegations. On May 28, 2004, the Court granted our motion for summary judgment that MPS lacked evidence of damages. As the judgment currently stands, MPS will not be able to recover damages at trial but may only attempt to seek injunctive relief and attorneys' fees. Trial on these claims is currently scheduled to commence June 2005.

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In January 2004, we filed a lawsuit in the U.S. District Court in the Eastern District of Texas against Beyond Innovation Technology Co., Ltd., SPI Electronic Co., Ltd., FSP Group and Lien Chang Electronic Enterprise Co., Ltd. The lawsuit asserts that those companies infringe one or more claims of U.S. Patent Nos. 6,259,615 and 6,396,722 and in an amended complaint, U.S. Patent No. 6,804,129. They have counterclaimed for antitrust violations and interference. Trial on these claims is currently scheduled to commence December 2005.

In October 2004, we filed a lawsuit in the U.S. District Court in the Eastern District of Texas against MPS alleging infringement of one or more claims of U.S. Patent No. 6,804,129. MPS has counterclaimed for antitrust violations and unfair competition.

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.

### 16. FINANCIAL INSTRUMENTS

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

	December 31			
	2003		2004	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
	(In Thousands)			
<b>Assets</b>				
Cash and cash equivalents	\$ 66,489	\$ 66,489	\$ 56,320	\$ 56,320
Restricted cash	1,892	1,892	1,887	1,887
Short-term investments	53,923	53,923	63,768	63,768
Long-term investment in CSMC	-	-	4,283	4,283
Restricted assets	10,044	10,796	13,873	13,577

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 values of restricted assets made in the form of Taiwan Government bonds are based on quoted market price; otherwise are carried at amounts

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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 charge is recorded in the period of decline in value.

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### 17. SEGMENT INFORMATION

The Company designs, develops and markets innovative power management and security components for mobile communication, computer, information appliance and LCD products. The Company's integrated circuit 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 so the Company has one reporting segment.

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

	Years Ended December 31		
	2002	2003	2004
	(In Thousands)		
Asia	\$ 70,149	\$ 88,548	\$ 92,105
United States	31	51	53
Europe	7	-	38
	-----	-----	-----
	\$ 70,187	\$ 88,599	\$ 92,196
	=====	=====	=====

Long-lived assets consist of land, property and equipment and are based on the physical location of the assets at the end of each year.

	Years Ended December 31	
	2003	2004
	(In Thousands)	
Taiwan	\$ 2,354	\$ 2,772
U.S.A.	1,251	6,551
Singapore	633	327
People's Republic of China	415	757
Others	227	351
	-----	-----
	\$ 4,880	\$ 10,758
	=====	=====

For the year ended December 31, 2002, two customers accounted for 18.6% and 15.9% of net revenues. For the year ended December 31, 2003, one customer accounted for 13.5% of net revenues and the same customer accounted for 17.54% of net revenues for the year ended December 31, 2004.

