VERIZON COMMUNICATIONS INC
Form 11-K
June 27, 2018

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 11-K
(Mark one):

ANNUAL REPORT PURSUANT TO SECTION 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2017

OR

TRANSITION REPORT PURSUANT TO SECTION 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____
COMMISSION FILE NUMBER 1-8606

A. Full title of the plan and the address of the plan, if different from that of the issuer named below:
VERIZON SAVINGS PLAN FOR
MANAGEMENT EMPLOYEES
B. Name of issuer of the securities held pursuant to the plan and the address of its principal executive office:
VERIZON COMMUNICATIONS INC.
1095 Avenue of the Americas
NEW YORK, NEW YORK 10036

VERIZON SAVINGS PLAN FOR MANAGEMENT EMPLOYEES

TABLE OF CONTENTS



* All other schedules required by Section 2520.103-10 of the Department of Labor Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974 are omitted as not applicable or not required.

## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Verizon Employee Benefits Committee and plan participants
Verizon Savings Plan for Management Employees

### Opinion on the Financial Statements

We have audited the accompanying statements of net assets available for benefits of the Verizon Savings Plan for Management Employees (the Plan) as of December 31, 2017 and 2016, and the related statement of changes in net assets available for benefits for the year ended December 31, 2017, and the related notes (collectively referred to as the "financial statements").

In our opinion, the financial statements present fairly, in all material respects, the net assets available for benefits of the Plan as of December 31, 2017 and 2016, and the changes in net assets available for benefits for the year ended December 31, 2017, in conformity with accounting principles generally accepted in the United States of America.

### Basis for Opinion

These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on the Plan's financial statements based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) (PCAOB) and are required to be independent with respect to the Plan in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement, whether due to error or fraud. The Plan is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. As part of our audits we are required to obtain an understanding of internal control over financial reporting but not for the purpose of expressing an opinion on the effectiveness of the Plan's internal control over financial reporting. Accordingly, we express no such opinion.

Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

### Supplemental Information

The supplemental information in the accompanying schedule of assets (held at end of year) as of December 31, 2017 has been subjected to audit procedures performed in conjunction with the audit of the Plan's financial statements. The supplemental information is the responsibility of the Plan's management. Our audit procedures included determining whether the supplemental information reconciles to the financial statements or the underlying accounting and other records, as applicable, and performing procedures to test the completeness and accuracy of the information presented in the supplemental information. In forming our opinion on the supplemental information, we evaluated whether the supplemental information, including its form and content, is presented in conformity with the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. In our opinion, the supplemental information is fairly stated, in all material respects, in relation to the financial statements as a whole.

/s/ Mitchell & Titus, LLP

We have served as the Plan's auditor since 2002.

New York, New York

June 27, 2018

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VERIZON SAVINGS PLAN FOR MANAGEMENT EMPLOYEES
Statements of Net Assets Available for Benefits
As of December 31, 2017 and 2016
(in thousands of dollars)

| | 2017 | 2016 |
|---|---|---|
| Assets | | |
| Investments at fair value | $23,802,806 | $21,229,998 |
| Notes receivable from participants | 545,802 | 537,613 |
| Employer contribution receivable | 145,827 | 103,049 |
| Net assets available for benefits | $24,494,435 | $21,870,660 |

The accompanying notes are an integral part of these financial statements.

VERIZON SAVINGS PLAN FOR MANAGEMENT EMPLOYEES
Statement of Changes in Net Assets Available for Benefits
For the Year Ended December 31, 2017
(in thousands of dollars)

| | |
|---|---|
| Additions: | |
| Participant contributions | $848,541 |
| Employer contributions | 643,738 |
| Total contributions | 1,492,279 |
| | |
| Net investment gain from investments in Master Trusts | 3,047,031 |
| Interest income on notes receivables from participants | 24,722 |
| Total additions | 4,564,032 |
| | |
| Deductions: | |
| Benefits paid to participants | 2,198,701 |
| Transfers to other plans and other, net | 7,649 |
| Administrative expenses | 68,830 |
| Total deductions | 2,275,180 |
| | |
| Net change | 2,288,852 |
| | |
| Transfers from other qualified savings plans (Note 1) | 334,923 |
| | |
| Net assets available for benefits | |
| Beginning of year | 21,870,660 |
| End of year | $24,494,435 |

The accompanying notes are an integral part of these financial statements.

VERIZON SAVINGS PLAN FOR MANAGEMENT EMPLOYEES
Notes to Financial Statements
December 31, 2017

## 1. Description of the Plan

The following description of the Verizon Savings Plan for Management Employees (the "Plan") provides only general information. Participants should refer to the Summary Plan Description and Plan Document for a complete description of the Plan's provisions. The Plan is a defined contribution plan subject to the provisions of the Employee Retirement Income Security Act of 1974 ("ERISA").

### Eligibility

The Plan provides eligible employees, as defined by the Plan Document, of Verizon Communications Inc. ("Verizon" or "Plan sponsor") and certain of its subsidiaries ("Participating Affiliates") with a convenient way to save for both short-term and long-term needs.

Covered employees are eligible to make before-tax, Roth and/or after-tax contributions to the Plan and to receive matching employer contributions upon completion of enrollment in the Plan as soon as practicable following the date of hire. Beginning January 1, 2012, covered employees who are employed by Verizon or its Participating Affiliates on the last day of the year or who satisfy certain other requirements may receive employer annual discretionary awards ("profit sharing contributions") under the Plan.

An individual's active participation in the Plan shall terminate when the individual ceases to be an eligible employee; however, the individual shall remain a participant until the entire account balance under the Plan has been distributed or forfeited.

### Plan Transfers and Mergers

Verizon acquired Telogis, Inc. ("Telogis") on July 29, 2016; Fleetmatics Group PLC ("Fleetmatics") on November 7, 2016; Sensity Systems, Inc. ("Sensity") on October 4, 2016; XO Communications, Inc. ("XO Communications") on February 1, 2017; and Skyward IO, Inc. ("Skyward") on February 15, 2017. The employees of Telogis, Fleetmatics and Sensity were eligible to enroll in the Plan as of January 1, 2017. The employees of XO Communications and Skyward were eligible to enroll in the Plan as of April 1, 2017. As a result of these mergers, the following net assets were transferred to the Plan: $18.2 million from Telogis on April 21, 2017; $14.0 million from Fleetmatics on May 1, 2017; $1.9 million from Sensity on May 1, 2017; $293.4 million from XO Communications on May 23, 2017; and $0.3 million from Skyward on September 19, 2017. The total asset transfer of $334.9 million is reflected in the Statement of Changes in Net Assets Available for Benefits which includes $327.8 million net assets and $7.1 million notes receivables from participants.

### Subsequent Events

Verizon acquired Yahoo Holdings Inc.'s ("Yahoo") operating business on June 13, 2017. Yahoo employees were eligible to enroll and participate in the Plan as of January 1, 2018. As a result of the acquisition, net assets of $1.2 billion were transferred from Yahoo to the Plan on May 1, 2018. This asset transfer did not impact the current year's Plan financial statements. Effective January 1, 2018, the Plan was amended to add Oath Holdings, Inc. (formerly known as Yahoo Holdings Inc.) and to reflect the change in the name of AOL Inc. to "Oath Inc."

Investment Options

Participants direct their contributions to be invested in any of the current investment options.

Participant Accounts

Each participant's account is credited with the participant's contributions, rollovers, employer-matching contributions, profit sharing contributions, and allocations of Plan income. Allocations of Plan income are based on participant account balances. The benefit to which a participant is entitled is the benefit that can be provided from the participant's vested account.

Vesting

A participant shall be fully vested in the employer-matching and profit sharing contributions allocated to his or her account or Employee Stock Ownership Plan ("ESOP") account and any income thereon upon completing three years of vesting service or upon death, disability, retirement from Verizon or its Participating Affiliates, attainment of normal retirement age, or involuntary termination (other than for cause).

Forfeitures

A terminated employee's non-vested employer-matching and profit sharing contributions are forfeited and offset against subsequent employer-matching and profit sharing contributions to the Plan. Forfeitures used to reduce employer-matching contributions were $26.6 million for the year ended December 31, 2017. The balance in the forfeiture account was $31.9 million and $33.5 million at December 31, 2017 and 2016, respectively.

Contributions

The Plan is funded by employee contributions up to a maximum of 50% of compensation (16% for highly compensated employees as defined in the Plan Document) and by employer-matching and profit sharing contributions. The employer-matching contributions are equivalent in value to 100% of the initial 6% of the participants' contributions of eligible compensation for each payroll period. Employees attaining the age of 50 or older can elect to make additional catch-up contributions to the Plan. Effective with the 2012 Plan year, Verizon or its Participating Affiliates may make a discretionary, performance-based profit sharing contribution to the Plan in an amount up to 3% of each employee's eligible compensation for the Plan year.

Participant contributions may be made on a before-tax or Roth after-tax basis ("elective contributions") or from currently taxed compensation ("after-tax contributions"). Each participant's elective contributions for the 2017 Plan year were limited to $18,000. For 2017, the total amount of elective contributions, after-tax contributions, employer-matching contributions, profit sharing contributions, and certain forfeitures that may be allocated to a Plan participant was limited to the lesser of (1) $54,000 or (2) 100% of the participant's total compensation, and the compensation on which such contributions were based was limited to $270,000. The catch-up contribution limit is $6,000 for eligible participants.

Effective January 1, 2017, employer-matching contributions and profit sharing contributions are made in cash, which is invested in the same investment options as the participant's current contributions. In prior years, employer-matching contributions and profit sharing contributions were made half in cash and half in Verizon common stock. For the year ended December 31, 2017, total employer-matching and profit sharing contributions were made in cash in the amount of $643.7 million, of which $145.8 million represents the 2017 discretionary profit sharing contribution.

Effective January 1, 2016, the Plan was amended to make employer contributions (and earnings thereon) invested in the Verizon Company Stock Fund immediately eligible for diversification into other investment options in the Plan, regardless of an employee's age or years of service.

Notes Receivable from Participants

The Plan includes a loan provision authorizing participants to borrow an aggregate amount generally not exceeding the lesser of (1) $50,000 or (2) 50% of their vested account balances in the Plan, subject to certain limitations. Loans are generally repaid by payroll deductions. The general term of repayment for loans is a minimum of six months and a maximum of five years (fifteen years for a loan to purchase a principal residence). Beginning January 1, 2012, each new loan bears interest at a rate based on the prime rate plus one percent as determined on the last business day of the calendar quarter immediately preceding the calendar quarter in which the loan is made. Loans made prior to January 1, 2012 bear interest at a rate based upon the prime rate. A loan processing fee of $50 is charged to a participant's savings plan account upon initiation of a new loan. Participant loans have been classified as "Notes receivable from participants" in the Statements of Net Assets Available for Benefits. Interest rates range from 2.75% to 10.50% for the year ended December 31, 2017.

Payment of Benefits

Benefits are recorded when paid. Benefits are payable in a lump sum cash payment unless a participant elects, in writing, one of the following three optional forms of benefit payment: (1) a lump sum in Verizon shares for investments in the Verizon Company Stock Fund, or the ESOP Shares Fund with the balance in cash, (2) annual, semi-annual, quarterly, or monthly installments in cash of approximately equal amounts to be paid out for a period of 2 to 20 years, as selected by the participant, or (3) for those participants eligible to receive their distribution in installments as described in (2) above, a pro rata portion of each installment payment in Verizon shares for investments in the Verizon Company Stock Fund or the ESOP Shares Fund, with the balance of each installment in cash.

Administrative Expenses

Plan administrative fees may include legal, accounting, trustee, recordkeeping, and other administrative fees and expenses associated with maintaining the Plan. The cost of administering the Plan is paid by participants through a combination of fees allocated to each participant's account and fees that are paid as part of the investment fees that are allocated to the Plan's investment options. Participants are provided with a detailed schedule of fees in the annual disclosure notice.

Master Trusts and Trustees

The Plan holds interests in the net assets of the Verizon Master Savings Trust (the "Master Trust") and the net assets of the defined contribution account in the Bell Atlantic Master Trust (referred to collectively as the "Master Trusts"). Fidelity Management Trust Company (the "Trustee" or "Fidelity") has been designated as the trustee and record keeper of the Verizon Master Savings Trust and is responsible for the control and disbursement of the funds and portfolios of the Plan. The Trustee is also responsible for the investment and reinvestment of the funds and portfolios of the Plan, except to the extent that it is directed by Verizon Investment Management Corp. ("VIMCO") or by third-party investment managers appointed by VIMCO.

The Bell Atlantic Master Trust holds both defined benefit and defined contribution assets, which are either pooled between defined benefit plans and defined contribution plans, or specific defined benefit plans, or specific defined contribution plans. The Bank of New York Mellon ("BNY Mellon") is the trustee of the Bell Atlantic Master Trust.

Plan Modification and Plan Termination

The Board of Directors of Verizon may terminate or partially terminate the Plan at any time and also may modify, alter or amend the Plan at any time. The most senior Human Resources officer of Verizon also has the right to modify, alter or amend the Plan at any time. The chief legal counsel to the Verizon Employee Benefits Committee may also amend the Plan for changes required by the Internal Revenue Service ("IRS") in connection with a determination letter or voluntary compliance application, changes required for compliance with applicable law, and administrative changes required in connection with a merger, consolidation, or transfer of assets to or from the Plan. No amendment may permit any of the assets held pursuant to the Plan to be used for any purpose other than for the exclusive benefit of the participants and their beneficiaries or for paying reasonable expenses of administering the Plan. In the event the Plan terminates, participants will become fully vested in their accounts.

2. Accounting Policies

Basis of Accounting

The accompanying financial statements have been prepared on the accrual basis of accounting and in conformity with accounting principles generally accepted in the United States ("U.S. GAAP").

Use of Estimates

U.S. GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements, accompanying notes and supplemental schedule. Actual results could differ from those estimates.

Notes Receivable from Participants

Notes receivable from participants represent participant loans that are recorded at their unpaid principal balance plus any accrued but unpaid interest. Interest income on notes receivable from participants is recorded when it is earned. Related fees are recorded as administrative expenses and are expensed when they are incurred. No allowance for credit losses has been recorded as of December 31, 2017 or 2016. A participant loan is in default if loan repayments are delinquent beyond the end of the Plan's grace period. Defaulted loans are treated as an offset distribution or deemed distribution for tax purposes and become taxable income to the participant in the year in which the default occurs. In the case of an offset distribution, the participant loan balance is reduced and a distribution is recorded on the participant's account.

Recently Issued Accounting Standards

In February 2017, the Financial Accounting Standards Board issued the Accounting Standards Update ("ASU") No. 2017-06, "Employee Benefit Plan Master Trust Reporting." This ASU requires an employee benefit plan to disclose the plan's percentage interest in a master trust and a list of the investments held by the master trust, presented by general type, within the plan's financial statements. This ASU also removes the requirement to disclose the plan's overall percentage interest in a master trust for plans with divided interests and requires that all plans disclose the dollar amount of their interest in each general type of investment. In addition, the ASU requires the disclosure of the master trust's other asset and liability balances and the dollar amount of the plan's interest in each of those balances. The amendments in this ASU are effective for fiscal years beginning after December 15, 2018 and will be applied retrospectively. Early adoption is permitted. The Plan sponsor is currently evaluating the impact that this ASU will have on the presentation of the financial statements and disclosures.

Investment Valuation and Income Recognition

The Plan's interests in the Master Trusts are stated at fair value. The Statement of Changes in Net Assets Available for Benefits reflects the net investment gain from the Plan's interests in the Master Trusts which consists of the realized gains or losses and the unrealized appreciation/(depreciation) in fair value, as well as interest and dividends earned. Purchases and sales of investments are reflected as of the trade date. Realized gains and losses on sales of investments are determined on the basis of average cost. Dividend income is recorded on the ex-dividend date. Interest earned on investments is recorded on the accrual basis. Net appreciation/(depreciation) includes gains and losses on investments bought and sold, as well as held during the year.

Risks and Uncertainties

The Plan provides investment options for participants who can invest in combinations of stocks, fixed income securities, and other investment securities. Investment securities are exposed to various risks, such as interest rate, market, equity price, and credit risks. Due to the level of risk associated with certain investment securities, it is reasonably possible that changes in the values of investment securities will occur in the near term and that such changes could materially affect participants' account balances and the amounts reported in these financial statements.

Fair Value Measurements

Fair value of financial and non-financial assets and liabilities is defined as an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. The three-tier hierarchy for inputs used in measuring fair value, which prioritizes the inputs used in the methodologies of measuring fair value for assets and liabilities, is as follows:

Level 1 – Quoted prices in active markets for identical assets or liabilities

Level 2 – Observable inputs other than quoted prices in active markets for identical assets and liabilities

Level 3 – Unobservable pricing inputs in the market for assets and liabilities

Financial assets and financial liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurements. The Plan sponsor's assessment of the significance of a particular input to the fair value measurements requires judgment, and may affect the valuation of the assets and liabilities being measured and their categorization within the fair value hierarchy. Valuation techniques maximize the use of observable inputs and minimize the use of unobservable inputs.

3. Investments in Master Trusts

The Plan's interests in the net assets of the Master Trusts at December 31, 2017 and 2016 were approximately 73.6% and 72.6%, respectively. This percentage is based on a pro rata share of the assets in the Master Trusts, which may include receivables and payables from unsettled trades and accrued income and expenses.

The defined contribution net investments in the Bell Atlantic Master Trust are held in a unitized commingled account measured at net asset value ("NAV") per share, as a practical expedient. The net investments are reflected as "Investments measured at NAV" presented as a component of the "Total investments at fair value" below. The net investments were valued at $162.8 million and $139.8 million at December 31, 2017 and 2016, respectively, of which the Plan held an interest of approximately 96.1% in both years.

The Plan's participating interest in the investment funds of the Master Trusts is based on account balances of the participants and their elected investment funds. The net assets of the Master Trusts are allocated by assigning to each plan participating in the Master Trusts those transactions that can be specifically identified as related to the plan, such as contributions, benefit payments, and plan-specific expenses. The income and expenses resulting from the collective investments of the Master Trusts' assets are allocated in proportion to the fair value of the assets assigned to such plan. On a monthly basis, investments, investment income and expenses are allocated to the Plans in accordance with their proportionate interest in the Master Trusts. Investment fees are charged against the earnings of the funds and portfolios.

The Plan's interest in the fair value of the investments in the Master Trusts and the related investment gains are reported in "Investments at fair value" and "Net investment gain from investments in Master Trusts" in the Statements of Net Assets Available for Benefits and in the Statement of Changes in Net Assets Available for Benefits, respectively.

The accounting records of the Master Trusts are maintained in U.S. dollars. Foreign currency denominated assets and liabilities are translated into U.S. dollars at the prevailing rates of exchange at the end of each accounting period, with the impact of fluctuations in foreign exchange rates reflected as an unrealized gain or loss in the fair value of the investments.

Cash receipts and payments derived from investment trades involving foreign currency denominated investments are translated into U.S. dollars at the prevailing exchange rate on the respective transaction date. Net realized gains and losses on foreign currency transactions result from the disposition of foreign currency denominated investments as a result of fluctuations in foreign exchange rates between the trade and settlement dates and the difference between the amount of net investment income accrued and the U.S. dollar amount actually received.

The foreign exchange effect on foreign currency denominated investments is not segregated from the impact of changes in market prices in the Statement of Changes in Net Assets Available for Benefits.

Valuation of Investments

Cash and cash equivalents include short-term investment funds (less than 90 days to maturity), primarily in diversified portfolios of investment grade money market instruments, and are valued using quoted market prices or other valuation methods. The carrying value of cash equivalents approximates fair value due to the short-term nature of these investments.

Investments in securities traded on national and foreign securities exchanges are valued by the custodian at the last reported sale prices on the last business day of the year or, if no sales were reported on that date, at the last reported bid prices. Government obligations, corporate bonds, international bonds and asset-backed securities are valued using matrix prices with input from independent third-party valuation sources. Over-the-counter securities are valued at the bid and ask prices or the average of the bid and ask prices on the last business day of the year from published sources or, if not available, from other sources considered reliable such as multiple broker quotes.

Commingled funds not traded on national exchanges are valued by the custodian or fund administrator at their NAV. Commingled funds held by third-party custodians appointed by the fund managers provide the fund managers with a NAV. The fund managers have the responsibility for providing this information to the custodian of the respective plan. Hedge fund investments include those investments seeking to maximize absolute returns using a broad range of strategies to enhance returns and provide additional diversification. Hedge funds are valued by the custodian at NAV based on statements received from the investment manager. These funds are valued in accordance with the terms of their corresponding offering or private placement memoranda. Commingled funds and hedge funds for which fair value is measured using the NAV per share as a practical expedient are not leveled within the fair value hierarchy and are included as a component of the total investments in the Master Trusts.

The following table sets forth by level, within the fair value hierarchy, the Master Trusts’ net investments by investment type measured at fair value as of December 31, 2017 (in thousands):

| | Assets at Fair Value as of December 31, 2017 | | | |
|---|---|---|---|---|
| | Level 1 | Level 2 | Level 3 | Total |
| Investments | | | | |
| Cash and cash equivalents | $482 | $84,877 | $— | $85,359 |
| Verizon common stock | 6,817,351 | — | — | 6,817,351 |
| Mutual funds | | | | |
| U.S. fixed income | 561,301 | — | — | 561,301 |
| U.S. equity | 496,695 | — | — | 496,695 |
| U.S. small cap | 450,061 | — | — | 450,061 |
| International equity | 386,719 | — | — | 386,719 |
| Global fixed income | 294,706 | — | — | 294,706 |
| Equity | | | | |
| International equity | 2,935,454 | 2,057 | — | 2,937,511 |
| U.S. equity | 6,992,015 | 1,537 | — | 6,993,552 |
| Fixed income | | | | |
| U.S. bonds | 14,336 | 1,028,012 | 2,034 | 1,044,382 |
| U.S. treasuries and agencies | 1,231,304 | 357,181 | — | 1,588,485 |
| Asset-backed securities | — | 130,241 | — | 130,241 |
| International bonds | 5,943 | 497,327 | 190 | 503,460 |
| Convertible securities | — | 22,578 | — | 22,578 |
| Total investments in the fair value hierarchy | 20,186,367 | 2,123,810 | 2,224 | 22,312,401 |
| Investments measured at NAV | | | | 9,689,269 |
| Total investments at fair value | $20,186,367 | $2,123,810 | $2,224 | $32,001,670 |

The following table states the change in fair value of the Master Trusts’ Level 3 assets for the year ended December 31, 2017 (in thousands):

| | Fair Value January 1, 2017 | Transfer Out | Transfer In | Acquisitions | Dispositions | Realized Gain/(Loss) | Change in Unrealized Loss | Fair Value December 31, 2017 |
|---|---|---|---|---|---|---|---|---|
| Fixed income | | | | | | | | |
| U.S. bonds | $ 978 | $ — | $ — | $ 2,536 | $ (1,315 ) | $ (151 ) | $ (14 ) | $ 2,034 |
| International bonds | 270 | — | — | — | (270 ) | 194 | (4 ) | 190 |
| Total investments | $ 1,248 | $ — | $ — | $ 2,536 | $ (1,585 ) | $ 43 | $ (18 ) | $ 2,224 |

Assets are monitored to assess the appropriate levels assigned within the fair value hierarchy. Changes in economic conditions, such as bankruptcy, default or delisting, may require the transfer of an asset from one fair value level to another. When such a transfer occurs, it is recognized as of the end of the reporting period.

The total net appreciation of $3.1 billion for the year ended December 31, 2017 includes gains and losses on investments bought and sold, as well as held during the year, for all the Master Trusts' investments. Interest and dividends, along with the net appreciation/(depreciation) in fair value or contract value of investments, are allocated to the Plan on a daily basis based upon the Plan's participation in the various investment funds and portfolios that comprise the Master Trusts as a percentage of the total participation in such funds and portfolios. Interest and dividend income for the Master Trusts was $736.3 million for the year ended December 31, 2017. The net appreciation for the Bell Atlantic Master Trust's net investments was $40.8 million for the year ended December 31, 2017, which is included in the total net appreciation.

The following table summarizes redemption restrictions for investments of the Master Trusts for which fair value is estimated using NAV per share as of December 31, 2017 (in thousands):

| Asset Type | Fair Value | Unfunded Commitments | Redemption Frequency | Redemption Notice |
|---|---|---|---|---|
| Commingled funds: | | | | |
| U.S. equity securities | $5,977,658 | N/A | Daily | Daily |
| International equity securities | 1,300,740 | N/A | Daily | Daily |
| U.S. fixed income securities | 558,058 | N/A | Daily | Daily |
| Hedge fund | 22,040 | N/A | Monthly | 30 Days |
| Cash equivalents | 1,186,304 | N/A | Daily | Daily |
| Real estate | 585,809 | N/A | Daily | Daily |
| Commodities | 58,660 | | | |
| Total | $9,689,269 | | | |

For a portion of the real estate fund, redemption requests will be scheduled for payment on the next valuation date which is at least three months after receipt of a written request for redemption (last business day of the quarter). Redemption requests are subject to fund management discretion based on cash available to meet redemption requests. In the event total redemption requests exceed the total cash available to honor such requests, available cash will be prorated among the contract-holders eligible for redemption.

The following table sets forth by level, within the fair value hierarchy, the Master Trusts' net investments by investment type measured at fair value as of December 31, 2016 (in thousands):

| | Assets at Fair Value as of December 31, 2016 | | | |
|---|---|---|---|---|
| | Level 1 | Level 2 | Level 3 | Total |
| Investments | | | | |
| Cash and cash equivalents | $99 | $58,060 | $— | $58,159 |
| Verizon common stock | 7,499,041 | — | — | 7,499,041 |
| Mutual funds | | | | |
| U.S. fixed income | 1,210,836 | — | — | 1,210,836 |
| U.S. equity | 370,219 | — | — | 370,219 |
| U.S. small cap | 401,443 | — | — | 401,443 |
| International equity | 284,670 | — | — | 284,670 |
| Global fixed income | 308,544 | — | — | 308,544 |
| Equity | | | | |
| International equity | 2,211,706 | — | — | 2,211,706 |
| U.S. equity | 6,067,660 | 117 | — | 6,067,777 |
| Fixed income | | | | |
| U.S. bonds | 5,520 | 1,003,669 | 978 | 1,010,167 |
| U.S. treasuries and agencies | 580,777 | 291,431 | — | 872,208 |
| Asset-backed securities | — | 145,488 | — | 145,488 |
| International bonds | 573 | 670,940 | 270 | 671,783 |
| Convertible securities | 2,262 | 6,530 | — | 8,792 |
| Total investments in the fair value hierarchy | 18,943,350 | 2,176,235 | 1,248 | 21,120,833 |
| Investments measured at NAV | | | | 7,524,910 |
| Total investments at fair value | $18,943,350 | $2,176,235 | $1,248 | $28,645,743 |

The following table states the change in fair value of the Master Trusts' Level 3 assets for the year ended December 31, 2016 (in thousands):

| | Fair Value January 1, 2016 | Transfer Out | Transfer In | Acquisitions | Dispositions | Realized Gain/(Loss) | Change in Unrealized Gain | Fair Value December 31, 2016 |
|---|---|---|---|---|---|---|---|---|
| Fixed income | | | | | | | | |
| U.S. bonds | $ 752 | $ — | $ — | $ 826 | $ (653 ) | $ (68 ) | $ 121 | $ 978 |
| International bonds | — | — | — | 265 | — | 5 | — | 270 |
| Total investments | $ 752 | $ — | $ — | $ 1,091 | $ (653 ) | $ (63 ) | $ 121 | $ 1,248 |

Assets are monitored to assess the appropriate levels assigned within the fair value hierarchy. Changes in economic conditions, such as bankruptcy, default or delisting, may require the transfer of an asset from one fair value level to another. When such a transfer occurs, it is recognized as of the end of the reporting period.

The following table summarizes redemption restrictions for investments of the Master Trusts for which fair value is estimated using NAV per share as of December 31, 2016 (in thousands):

| Asset Type | Fair Value | Unfunded Commitments | Redemption Frequency | Redemption Notice |
|---|---|---|---|---|
| Commingled funds: | | | | |
| U.S. equity securities | $4,827,367 | N/A | Daily | Daily |
| International equity securities | 781,488 | N/A | Daily | Daily |
| U.S. fixed income securities | 228,447 | N/A | Daily | Daily |
| International fixed income securities | 28,220 | N/A | Daily | Daily |
| Cash equivalents | 1,107,174 | N/A | Daily | Daily |
| Real estate | 530,136 | N/A | Daily | Daily |
| Commodities | 22,078 | | | |
| Total | $7,524,910 | | | |

4. Derivatives

In the normal course of operations, the Master Trust's assets may include derivative financial instruments. Derivatives are synthetic instruments used to get various market exposures with limited margin requirements and therefore with leverage risk involved. The contract or notional amounts disclosed in this footnote provide a measure of the Master Trust's involvement in such instruments but are not indicative of potential loss. The intent is to use derivative financial instruments to gain market exposure or as economic hedges to manage various risks such as market volatility risk, foreign currency exchange rate risk, interest rate risk or credit risk associated with the Master Trust's investment assets or to express investment managers' views of future market movements efficiently.

At December 31, 2017 and 2016, the Master Trust utilized futures, options, foreign currency forwards, interest rate and credit derivatives to manage risks such as price risk, foreign currency exchange rate risk, interest rate sensitivity and credit risk.

The following table presents the effect of gains with respect to these derivative instruments, by type of derivative. The gains are located on the Statement of Changes in Net Assets Available for Benefits under "Net investment gain from investments in Master Trusts" (in thousands):

| | For the year ended December 31, 2017 |
|---|---|
| Futures | $ 135 |
| Options | 29 |
| Swaps | 5,387 |
| Foreign currency forward contracts | 889 |
| Total | $ 6,440 |

Futures Contracts

Upon entering into a futures contract on behalf of the Master Trust, the investment manager is required to pledge to the broker an amount of cash or securities equal to the minimum “initial margin” requirements of the exchange on which the contract is traded. Pursuant to the contract, the investment manager agrees to receive from or pay to the broker an amount of cash equal to the daily fluctuation in the value of the contract. Such receipts or payments are known as variation margin and are recorded on a daily basis by the trustee as a realized gain or loss equal to the difference in the value of the contract between daily closing prices.

Option Contracts

Purchased and written option contracts are agreements between two parties giving the owner, under a purchased option, the right, but not the obligation, to buy or sell a specified item at a fixed price (“exercise” or “strike”) during a specified period and, under a written option, the obligation to buy or sell a specified item at a fixed price. When the investment manager buys or writes an option contract, a nonrefundable fee (the “premium”) is paid or received by the Master Trust, recorded as an asset or liability and subsequently adjusted to the current market value of the option purchased or written. The premiums paid or received from buying or writing options together with the option settlement amounts are recorded as realized gains or losses when the options expire. The difference between the premium and the amount paid or received on effecting a closing purchase or sale transaction is also treated as a realized gain or loss. If an option is exercised, the premium paid or received is recorded as a realized gain or loss if sold or an adjustment to cost of the underlying investment if acquired upon exercise.

Foreign Currency Forward Contracts

Foreign currency forward contracts are agreements to exchange foreign currencies at a specified future date and rate, the terms of which are not standardized on an exchange. Risk arises both from the possible inability of the counterparties to meet the terms of the contracts (credit risk) and from the movements in foreign currency exchange rates (market risk). The contracts are recorded at fair value on the date the contract is entered into, which is typically zero.

Interest Rate Swaps

An interest rate swap is a contract between a buyer and a seller under which the buyer and seller agree to exchange payments based on interest rate movements, typically fixed versus floating rates on an agreed upon notional amount. Counterparty risk, or the risk associated with the party one enters into a contract with, is an important consideration for all forms of contractual agreement that are settled over-the-counter.

Inflation Swaps

An inflation swap is a contract used to transfer inflation risk from one party to another through an exchange of cash flows. One party pays a fixed rate cash flow while the other party pays a floating rate linked to an inflation index, such as the Consumer Price Index.

Currency Swaps

A currency swap involves the exchange of interest and/or principal in one currency for the same in another currency. Interest payments are exchanged at fixed dates through the life of the contract.

Credit Default Swaps

A credit default swap ("CDS") is a particular type of swap designed to transfer the credit exposure of fixed income products between two parties. In a credit default swap, the buyer of the swap makes payments to the swap's seller up until the maturity date of a contract. In return, the seller agrees that, in the event that the debt ("reference name") issuer defaults or experiences another credit event, the seller will pay the buyer the security's principal as well as all interest payments that would have been paid between that time and the security's maturity date.

These triggering events may include the market standard of failure to pay on indebtedness, bankruptcy of the reference credit, debt restructuring, or the acceleration of indebtedness. The seller of such protection may not be required to make payments until a specified amount of losses has occurred with respect to the portfolio and/or may only be required to pay for losses up to a specified amount.

The notional amounts and fair values of the derivative instruments as of December 31, 2017 and 2016 are presented below. The fair values presented in the tables are included in the Statements of Net Assets Available for Benefits under "Investments at fair value" (in thousands):

| | | December 31, 2017 | | December 31, 2016 | |
|---|---|---|---|---|---|
| Type of Contract | Position | Notional Amount | Fair Value | Notional Amount | Fair Value |
| Equity | | | | | |
| Futures contracts | Long | $ 15,579 | $ 306 | $ 13,241 | $ 242 |
| Futures contracts | Short | (2,810) | (8) | (5,612) | 35 |
| Equity Total | | $ 12,769 | $ 298 | $ 7,629 | $ 277 |
| | | | | | |
| Fixed Income | | | | | |
| Futures contracts | Long | $ 322,539 | $ (822) | $ 453,199 | $ 263 |
| Futures contracts | Short | (284,728) | 658 | (304,554) | 425 |
| Fixed income options | Short | (13,000) | (59) | (15,800) | (69) |
| Inflation swaps | Long | 61,124 | (189) | 4,325 | (372) |
| Inflation swaps | Short | — | (63) | — | (4) |
| Interest rate swaps | Long | 180,801 | 2,231 | 72,418 | 7,617 |
| Interest rate swaps | Short | — | (93) | — | (40) |
| Currency swaps | Long | 27,731 | 27,712 | 23,354 | 23,365 |
| Currency swaps | Short | — | (25,071) | — | (31,082) |
| Credit default swaps | Long | 48,719 | 1,340 | 31,012 | 994 |
| Fixed Income Total | | $ 343,186 | $ 5,644 | $ 263,954 | $ 1,097 |
| | | | | | |
| Foreign Exchange | | | | | |
| Forward contracts | Cross | $ 1,779 | $ (10) | $ 2,617 | $ 11 |

| | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Forward contracts | Long | 442,295 | (4,221 ) | 718,762 | $ | $ | $ | $ | $ | $ | $ | $ | $ |

| | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Stock Option Benefits (including Restricted Share Units, if any)* | $ 97,664 | $ 49,026 | $ 8,608 | $ 8,608 | $ 8,608 | $ 8,608 | $ | $ | $ | $ | $ 8,608 | $ 189,730 |
| Total | $ 288,388 | $ 49,026 | $ 8,608 | $ 8,608 | $ 8,608 | $ 8,608 | $ | $ | $ | $ | $ 8,608 | $ 380,454 |
| 2004 | | | | | | | | | | | | |
| Salaries and other benefits | $ 190,343 | $ | $ | $ | $ | $ | $ | $ | $ | $ | $ | $ 190,343 |
| Stock Option Benefits(including Restricted Share Units, if any)** | $ | $ 221,464 | $ | $ | $ | $ | $ | $ | $ | $ | $ | $ 221,464 |
| Total | $ 190,343 | $ 221,464 | $ | $ | $ | $ | $ | $ | $ | $ | $ | $ 411,807 |

* For a description of any options granted and exercised in 2006, please see the summary of grants of options as set forth under Outstanding Share Options in this annual report.

On September 29, 2006, the Board granted to each Director an option to purchase 500,000 ordinary shares at a price per ordinary share of US$0.132. These options will be vested as to 50% on May 30, 2007 and as to 50% on May 30, 2008 and will expire as to 50% on the earlier of September 29, 2016 or 120 days after termination of the director s service to the Board and as to 50% on the earlier of September 29, 2016 or 120 days after termination of the director s service to the Board. Mr. Fang Yao and Mr. Jiang Shang Zhou have declined such option.

On September 29, 2006, the Board granted to Dr. Albert Y. C. Yu 500,000 Restricted Share Units. Shares under the Restricted Share Units are to be automatically vested as to 50% per year starting from May 30, 2007.

In 2005, the Board did not grant options to any Non-executive Director and independent Non-executive Director as compensation for their service on the Board. On May 11, 2005, the Board granted Dr. Richard Ru Gin Chang 2,000,000 Restricted Share Units. Shares under the Restricted Share Units are to be automatically vested as to 25% per year starting from July 1, 2005. 25% of such Restricted Share Units were vested on each of July 1, 2005 and July 1, 2006 and 500,000 ordinary shares were issued pursuant to such vesting of Restricted Share Units on each of November 9, 2005 and August 3, 2006.

On November 10, 2004, the Board granted to each independent Non-executive Director and Non-executive Director, an option to purchase 500,000 ordinary shares at a price per ordinary share of US$0.22. These options were fully vested on March 19, 2005 and will expire on November 9, 2009. As of December, 31, 2006, these options have not been exercised. Lai Xing Cai (who resigned as an Non-executive Director on February 6, 2006) has declined such option. The option granted to Mr. Yen-Pong Jou (who retired as an Independent Non-executive Director at the annual general meeting held on May 30, 2006) lapsed and cancelled on September 27, 2006.

Five Highest Paid Individuals

The five individuals whose emoluments were the highest in the Company for the year ended December 31, 2006 and 2005, included Richard Ru Gin Chang, the Company s President, Chief Executive Officer and an Executive Director, whose emoluments are reflected in the analysis presented above. The emoluments payable to the remaining four individuals during the year are as follows:

| | **2006 (in US $)** | **2005 (in US $)** |
|---|---|---|
| Salaries, Housing Allowances, Other Allowances, and Benefits in Kind | **$ 673,274** | $ 513,570 |
| Discretionary Bonuses | **$ 271,313** | $ 92,455 |
| Stock option benefits* | **$ 424,769** | $ 325,889 |
| Amounts paid to induce member to join Board | | |

* for a description of any options exercised in 2006, please see the summary of grants of options as set forth under Outstanding Share Options in this section of the annual report

The five individuals whose emoluments were the highest in the Company for 2006 and 2005 may not be the same.

| Emoluments | Number of Individuals | |
|---|---|---|
| (in HK$) | 2006 | 2005 |
| $1,000,000 $ 1,500,000 | | |
| $1,500,001 $ 2,000,000 | **3** | 3 |
| $2,000,001 $ 2,500,000 | **1** | 1 |
| $2,500,001 $ 4,500,000 | **1** | |
| $4,500,001 $ 5,000,000 | | |

Remuneration Policy

The Company s employees are compensated using cash and a variety of additional incentives. In addition to a monthly salary, the Company s employees have the opportunity to earn additional merit-based bonuses on a quarterly basis according to the overall performance of the Company, each individual and his or her department. Furthermore, the Company s employees are eligible to participate on a quarterly basis in the Company s profit-sharing plan. Additional benefits include participation in the Company s 2004 global equity incentive compensation program, social welfare benefits for qualified Chinese employees, a global medical insurance plan for overseas employees and optional housing benefits and educational programs for employees with families.

The Directors are compensated for their services as Directors, primarily by grants of options, to purchase ordinary shares under the Stock Option Plan. The compensation committee of the Company (the Compensation Committee ) proposes, and the Board, other than interested Directors, approves, for the Directors, a remuneration package, which is consistent with the compensation received by Board members in other similar publicly-traded companies.

Pursuant to an incentive program involving the offering for sale of housing constructed by the Company to the Directors, employees and certain service providers, the Company sold one property to each of Richard Ru Gin Chang, the Company s President, Chief Executive Officer and an Executive Director, and one to each of the Company s other five highest paid employees, at the same price as that at which other properties of the same type have been sold by the Company under the program.

The Company s local Chinese employees are entitled to a retirement benefit based on their basic salary upon retirement and their length of service in accordance with a state-managed pension plan. The PRC government is responsible for the pension liability to these retired staff. We are required to make contributions to the state-managed retirement plan equivalent to 20.0% 22.5% of the monthly basic salary of current employees. Employees are required to make contributions equivalent to 6% 8% of their basic salary. The employer s contribution of such an arrangement is approximately US$5.3 million, US$4.1 million and US$2.5 million for the years ended December 31, 2006, 2005 and 2004 respectively. The retirement benefits do not apply to expatriate employees.

Auditors

The retiring auditors, Deloitte Touche Tohmatsu, have signified their willingness to continue in office. A resolution will be proposed at the AGM to reappoint them as the auditors of the Company and to authorize the audit committee of the Company (the Audit Committee ) to fix their remuneration.

Connected Transactions

Article 156 of the Company s Articles provides (amongst others) that the Company may indemnify any person who is made a party to any action, suit or proceeding by reason of the fact that the person is or was a director, officer, employee or agent of the Company, or is or was serving at the Company s request as a director, officer, employee or agent of the Company at another entity, subject to certain limitations and applicable conditions.

The Company recognizes the substantial increase in corporate litigation in general, subjecting directors, officers, employees, agents and fiduciaries to expensive litigation risks.

The Company desires to attract and retain the services of highly qualified individuals to serve the Company and, in part, in order to induce such individuals to continue to provide services to the Company, the Company wishes to provide for the indemnification and advancing of expenses of its directors as permitted by law and the Listing Rules.

**Original Indemnification Agreements**

On or around March 18, 2004, upon completion of the Global Offering, the Company entered into identical indemnification agreements with each director whose appointment as director took effect immediately up on the Global Offering (the Global Offering Directors ), whereby the Company agreed to (inter alia) indemnify its Global Offering Directors in respect of liability arising from their capacity as Directors of the Company (collectively, the Original Indemnification Agreements ).

Pursuant to the Original Indemnification Agreements, the Company was obliged to indemnify each Global Offering Director, to the fullest extent permitted by law, against all costs, charges, expenses, liabilities, losses and obligations incurred in connection with any threatened, pending or completed action, suit, proceeding or alternative dispute resolution mechanism, or any hearing, inquiry or investigation which might lead to any of the foregoing (an Applicable Claim ) by reason of or arising out of any event or occurrence relating to the fact that he is or was Director of the Company, or any of its subsidiaries, or is or was serving as the Company s request at another incorporation or enterprise, or by reason of any activity or inactivity while serving in such capacity (an Indemnifiable Event ). The Company s obligation to indemnify its Global Offering Directors pursuant to the Original Indemnification Agreements was subject to certain exceptions and limitations set out therein.

**New Indemnification Agreements**

At the annual general meeting of the Company s shareholders on May 6, 2005 (the 2005 AGM ), the Company s shareholders, other than the Directors, chief executive officers of the Company and their respective Associates (as defined in the Listing Rules) approved an amendment to the form of the Original Indemnification Agreements (the New Indemnification Agreement ).

The New Indemnification Agreement reflects the new requirements under Rules 14A.35 of the Listing Rules to set a term of no longer than three years and a maximum aggregate annual value for each connected transaction (as defined under the Listing Rules). The New Indemnification Agreements executed by each of the Directors superseded the Original Indemnification Agreements which the Company had previously entered into with any existing directors. The terms of the New Indemnification Agreements are the same as the Original Indemnification Agreements, except that the New Indemnification Agreements are subject to a term of three years and an Annual Cap (as defined and described below).

The annual cap in relation to the New Indemnification Agreements will not exceed a maximum aggregate annual value as disclosed in the Company s previous announcement (the Current Limit ). In the event that the Current Limit is increased, the Company will make a further announcement and seek independent shareholders approval of the new maximum aggregate annual value of the New Indemnification Agreements.

The New Indemnification Agreement became effective upon execution by each Director. The New Indemnification Agreements will continue in effect with respect to Applicable Claims relating to Indemnifiable Events regardless of whether the relevant Director continues to serve as a Director or to serve at any other enterprise at its request.

For the year ended December 31, 2006, no payment was made to any Director under the New Indemnification Agreements.

The Independent Non-executive Directors have reviewed the above continuing connected transactions and confirm that these transactions have been entered into:

(a) in the ordinary and usual course of business of the Company;

(b) either on normal commercial terms or, if there are not sufficient comparable transactions to judge whether they are on normal commercial terms, on terms no less favorable to the Company than terms available to or from independent third parties; and

(c) in accordance with the relevant agreement governing them on terms that are fair and reasonable and in the interests of the Company s shareholders as a whole.

The Company s external auditors performed agreed-upon procedures in accordance with the Hong Kong Standard on Related Services 4400 Engagements to Perform Agreed-Upon Procedures Regarding Financial Information issued by the Hong Kong Institute of Certified Public Accountants and rendered a report to the Board of Directors that in relation to the New Indemnification Agreements:

(i) the continuing connected transactions have received the approval of the Board:

(ii) the continuing connected transactions were approved by the shareholders of the Company on May 6, 2005; and

(iii) certain members of the senior management of the Company represented to them that no payment was made by the Company to its Directors under any New Indemnification Agreements for the period from January 1, 2006 to December 31, 2006.

Employees

The following table sets forth, as of the dates indicated, the number of the Company s employees serving in the capacities indicated:

| | As of December 31, | | | |
|---|---|---|---|---|
| **Function** | **2003** | **2004** | **2005** | **2006** |
| Managers | 338 | 570 | 679 | **871** |
| Professionals[1] | 961 | 3,109 | 3,648 | **3,790** |
| Technicians | 2,746 | 3,389 | 4,127 | **4,804** |
| Clerical staff | 398 | 572 | 642 | **583** |
| Total[2] | 4,443 | 7,640 | 9,096 | **10,048** |

Notes:

(1) Professionals include engineers, lawyers, accountants and other personnel with specialized qualifications, excluding managers.
(2) Includes 38, 14, 283, and 275 temporary and part-time employees in 2003, 2004, 2005, and 2006 respectively.

The following table sets forth, as of the dates indicated, a breakdown of the number of the Company s employees by geographic location:

| | As of December 31, | | | |
|---|---|---|---|---|
| **Location of Facility** | **2003** | **2004** | **2005** | **2006** |
| Shanghai | 4,033 | 5,481 | 6,232 | **6,400** |
| Beijing | 341 | 1,026 | 1,534 | **1,827** |
| Tianjin | 49 | 1,107 | 1,034 | **1,073** |
| Chengdu | | | 261 | **715** |
| United States | 13 | 16 | 18 | **16** |
| Europe | 4 | 5 | 7 | **7** |
| Japan | 3 | 3 | 6 | **7** |
| Hong Kong | | 2 | 4 | **3** |
| Total | 4,443 | 7,640 | 9,096 | **10,048** |

The Company s success depends to a significant extent upon, among other factors, the Company s ability to attract, retain and motivate qualified personnel.

As of December 31, 2006, 1,127 and 124 of the Company s employees held master s degrees and doctorate degrees, respectively. As of the same date, 2,990 of the Company s employees possessed a bachelor s degree. The Company s engineers received an average of 40 hours of continuing training per person in 2006.

The Company has also entered into agreements with Shanghai University to offer a bachelor s degree program and Shanghai s Fudan University and Jiaotong University to offer graduate degree programs for its technicians. These employees can earn these degrees in either Microelectronics or solid-state circuitry. In addition, the Company employs many qualified personnel that have relocated back to China after receiving valuable industry experience overseas.

As a supplement to their salaries, the Company s employees have the opportunity to earn additional merit- based bonuses on a quarterly basis according to the overall performance of the Company, each individual and his or her department. Furthermore, the Company s employees are eligible to participate on a quarterly basis in the Company s profit-sharing plan. Additional benefits include participation in the 2004 global equity incentive compensation program, social welfare benefits for qualified Chinese employees, a global medical insurance plan for overseas employees and optional housing benefits and educational programs for employees with families.

The Company provides occupational health and hygiene management for the welfare of the Company s employees. This includes the monitoring of air quality, illumination, radiation, noise and drinking water. The Company s employees are not covered by any collective bargaining agreements.

Share Option Schemes

The Company s shareholders adopted the Stock Option Plan, the EIP and the Employee Stock Purchase Plan (the ESPP , together with the Stock Option Plan and the EIP, the Option Plans ) to attract and retain its employees.

**Stock Option Plan**

The following is a summary of the principal terms of the Stock Option Plan conditionally adopted by the Company by way of shareholders resolution dated February 16, 2004 and Directors resolutions passed on January 16, 2004. Adoption of the Stock Option Plan took effect on March 18, 2004 being the first date of dealings in the ordinary shares.

**Summary of the terms of the Stock Option Plan**

*(a) Purpose of the Stock Option Plan*

The purposes of the Stock Option Plan are to attract, retain and motivate employees and Directors of, and other service providers to the Company, to provide a means, on and after the Global Offering, of compensating them through the grant of stock options for their contribution to the Company s growth and profits, and to allow such employees, Directors and service providers to participate in such growth and profitability.

*(b) Who may join*

The Compensation Committee may, at its discretion, invite any employee, officer or other service provider of (including, but not limited to, any professional or other adviser of, or consultant or contractor to) the Company whether located in China, the United States or elsewhere to take up options to subscribe for ordinary shares at a price calculated in accordance with sub-paragraph (e) below. The Compensation Committee may also grant stock options to a Director who is not an employee of the Company ( Non Employee Director ).

*(c) Stock Options*

Stock options granted under the Stock Option Plan ( Stock Options ) shall entitle a participant ( Participant ) of the Stock Option Plan to purchase a specified number of ordinary shares or ADSs (the Plan Shares ) during a specified period at a price calculated in accordance with sub-paragraph (e) below. Three types of Stock Options may be granted under the Plans, an Incentive Stock Option, a Non-Qualified Stock Option or a Director Option. An Incentive Stock Option is a stock option that falls within the meaning of Section 422 of the U.S. Internal Revenue Code of 1986 and may only be granted to employees of the Company and its subsidiaries from time to time. A Non-Qualified Stock Option is a stock option that is not an Incentive Stock Option. A Director Option is a Non-Qualified Stock Option granted to a Non-Employee Director.

The Company shall issue an Award Document to each Participant of the Stock Option Plan who is granted a Stock Option. The Award Document shall set out the terms and provisions of the grant of a Stock Option to a Participant including applicable vesting dates or the attainment of specified performance goals (as determined by the Compensation Committee or the Administrator (as defined below), as the case may be) by the Participant. The Company may allow a Participant to exercise his or her Stock Options prior to vesting, provided the Participant agrees to enter into a repurchase agreement in respect of the Stock Option with the Company. The Compensation Committee may also (i) accelerate the vesting of a Stock Option, (ii) set the date on which any Stock Option may first become exercisable, or (iii) extend the period during which a Stock Option remains exercisable, except that no Stock Options may be exercised after the tenth anniversary of the date of grant.

The Stock Option Plan does not provide for any payment upon application or acceptance of an option.

*(d) Administration of the SOP*

The Compensation Committee shall be responsible for the administration of the SOP. Its responsibilities include granting Stock Options to eligible individuals, determining the number of Plan Shares subject to each Stock Option, and determining the terms and conditions of each Stock Option. The Compensation Committee is not obliged to grant Stock Options to Participants in uniform terms.

Accordingly, the terms and conditions which may be imposed may vary between Participants. Any determination by the Compensation Committee in relation to the carrying out and administering of the Stock Option Plan shall be final and binding. No member of the Compensation Committee shall be liable for any action or determination made in good faith, and the members of the Compensation Committee shall be entitled to indemnification and reimbursement in the manner provided in the Articles.

The Compensation Committee may delegate some or all of its authority under the Stock Option Plan to an individual or individuals (each an Administrator ) who may either be one or more of the members of the Committee or one or more of the officers of the Company. An individual s status as an Administrator shall not affect his or her eligibility to participate in the SOP. The Compensation Committee shall not delegate its authority to grant Stock Options to executive officers of the Company.

*(e) Exercise Price*

The exercise price per Plan Share purchasable under a Stock Option shall be fixed by the Committee at the time of grant or by a method specified by the Compensation Committee at the time of grant, but in no event shall be less than the Fair Market Value of a Plan Share on the date such Stock Option is granted.

The Fair Market Value of a Share will be the higher of (i) the closing price of the ordinary shares on the HKSE s daily quotation sheet on the applicable date of grant (which must be a business day), and (ii) the average closing price of the ordinary shares on the HKSE (as stated in the relevant daily quotation sheets of the HKSE) for the five business days immediately preceding the date of grant.

The Fair Market Value of the ADSs shall be the highest of (i) the closing price of the ADSs on the NYSE on the applicable date of grant, and (ii) the average closing price of the ADSs on the NYSE for the five business days immediately preceding the date of grant.

*(f) Limit of the Stock Option Plan*

The number of ordinary shares that may be issued under the Stock Option Plan and the ESPP (the Global Limit ) shall not exceed ten percent of the issued and outstanding ordinary shares immediately following the closing of the Global Offering (i.e., 1,694,186,849 ordinary shares of the Company, which represents approximately 9% of the total issued shares of the Company as at April 23, 2007).

The number of ordinary shares which may be issued pursuant to any outstanding Stock Options granted and yet to be exercised under the Stock Option Plan and all outstanding purchase right granted under the Employee Stock Purchase Plan or other employee stock purchase plan of the Company must not exceed in aggregate 30 percent of the issued and outstanding ordinary shares in issuance from time to time.

*(g) Individual Limit*

The total number of ordinary shares underlying Stock Options or other options granted by the Company to, and the total number of ordinary shares that may be purchased under one or more purchase rights granted under the Employee Stock Purchase Plan or any other employee stock purchase plan granted by the Company by, a Participant (including both exercised and outstanding Stock Options) in any twelve-month period may not exceed at any time one percent (1%) (or 0.1 percent in the case of an independent Non-executive Director) of the then issued and outstanding ordinary shares unless otherwise allowed under the Listing Rules.

*(h) Exercise of Option*

A Stock Option shall vest, and be exercised, in accordance with the terms of the SOP, the relevant Award Document and any rules and procedures established by the Compensation Committee for this purpose. However, the term of each Stock Option shall not exceed ten years from the date of grant.

*(i) Director Options*

Each non-employee Director may be granted Stock Options to purchase ordinary shares (or an equivalent of ADSs) on the terms set out in the relevant Award Document.

The Directors shall exercise all authority and responsibility with respect to Stock Options granted to Directors subject to the requirements of the Listing Rules.

All non-employee Directors Stock Options shall only vest provided that the Director has remained in service as a Director through such vesting date. The unvested portion of a Stock Option granted to a Director shall be forfeited in full if the Director s service with the Board ends for any reason prior to the applicable vesting date.

Following termination of a non-employee Director s service on the Board, such non-employee Director (or his or her estate, personal representative or beneficiary, as the case may be) shall be entitled to exercise those of his or her Stock Options which have vested as of the date of such termination within 120 days following such termination.

*(j) Termination or lapse of Option*
A Stock Option shall terminate or lapse automatically on:

(i) the expiry of ten years from the date of grant;

(ii) the termination of a Participant s employment or service with the Company for a reason set out in sub-paragraph (l) below;

(iii) save as to any contrary directions of the Compensation Committee, in the event of a complete liquidation or dissolution of the Company, all Stock Options outstanding at the time of the liquidation or dissolution shall terminate without further action by any person;

(iv) the sale or other divestiture of a subsidiary, division or operating unit of the Company (where the Participant is employed by such subsidiary, division or operating unit); and

(v) termination of the service relationship with a service provider (where the Participant is a service provider of the Company).

*(k) Rights are personal to Participant*
A Stock Option is personal to the Participant and shall be exercisable by such Participant or his Permitted Transferee (as defined below) only. An option shall not be transferred other than by will, by the laws of descent and distribution or pursuant to a domestic relations order. The Compensation Committee may also, at its discretion and subject to such terms and conditions as it shall specify, permit the transfer of a Stock Option for no consideration to a Participant s family members or to a trust or partnership established for the benefit of such family members (collectively Permitted Transferees ). Any Stock Option transferred to a Permitted Transferee shall be further transferable only by will or the laws of descent and distribution or, for no consideration, to another Permitted Transferee of the Participant.

*(l) Termination of employment or service*
If a Participant s employment or service with the Company is terminated for the following reasons:

(i) the failure or refusal of the Participant to substantially perform the duties required of him or her as an employee or officer of, or service provider to, the Company;

(ii) any material violation by the Participant of any law or regulation applicable to any business of the Company, or the Participant s conviction of, or a plea of nolo contendae to, a felony, or any perpetration by the Participant of a common law fraud against the Company; or

(iii) any other misconduct by the Participant that is materially injurious to the financial condition, business or reputation of the Company, then all Stock Options granted to the Participant, whether or not then vested, shall immediately lapse.

The Compensation Committee may permit any Incentive Stock Option to convert into a Non-Qualified Stock Option as of a Participant s termination of employment for purposes of providing such Participant with the benefit of any extended exercise period applicable to Non-Qualified Stock Options when the contract of employment of the holder of Incentive Stock Option terminates.

*(m) Change in control of the Company*

The Compensation Committee may specify at or after the date of grant of a Stock Option the effect that a Change in Control (as defined in the SOP) will have on such Stock Option. The Compensation Committee may also, in contemplation of a Change in Control, accelerate the vesting, exercisability or payment of Stock Options to a date prior to the Change in Control, if the Compensation Committee determines that such action is necessary or advisable to allow the participants to realise fully the value of their share options in connection with such Change in Control.

*(n) Change in the capital structure of the Company*

In the event of an alteration in the capital structure of the Company (which includes a capitalisation issue, reduction of capital, consolidation, sub-division of Plan Shares, or rights issue to purchase Plan Shares at a price substantially below market value), the Compensation Committee may equitably adjust the number and kind of Plan Shares authorised for issuance in order to preserve, the benefits or potential benefits intended to be made available under the SOP. In addition, upon the occurrence of any of the foregoing events, the number of outstanding Stock Options and the number and kind of shares subject to any outstanding Stock Option and the purchase price per share under any outstanding Stock Option shall be equitably adjusted so as to preserve the benefits or potential benefits intended to be made available to Participants.

*(o) Period of the Stock Option Plan*

The Stock Option Plan shall remain in force for a period of ten years commencing on the date of Shareholders approval of the Plan.

*(p) Amendments and Termination*

The Stock Option Plan may be altered, amended in whole or in part, suspended and terminated by the Board at any time provided alterations or amendments of a material nature or any change to the terms of the Stock Options granted must be approved by the shareholders of the Company, unless such alteration or amendment takes effect automatically under the terms of the Stock Option Plan. For the avoidance of doubt, any alteration or amendment pursuant to the exercise of any authority granted under the Stock Option Plan is deemed to take effect automatically under the terms of the Share Option Plan. Any alteration or amendment must be in accordance with the requirements of the Listing Rules or permitted by the HKSE.

If the Stock Option Plan is terminated early by the Board, no further Stock Options may be offered but unless otherwise stated in the Plan, Stock Options granted before such termination shall continue to be valid and exercisable in accordance with the Stock Option Plan.

*(q) Voting and dividend rights*

No voting rights shall be exercisable and no dividends shall be payable in relation to Stock Options that have not been exercised.

*(r) Cancellation of Stock Options*
Stock Options granted but not exercised may not be cancelled unless an offer to cancel share options has been made pursuant to Rule 13 of the Hong Kong Code on Takeovers and Mergers and the Hong Kong Securities and Futures commission has consented to such cancellation.

*(s) Ranking of Ordinary Shares*
The ordinary shares to be allotted upon the exercise of a Stock Option will be subject to the Articles for the time being in force and will rank pari passu with the Plan Shares in issue on the date of such allotment.

Employee Stock Purchase Plan

The following is a summary of the principal terms of the ESPP conditionally adopted by the Company by way of shareholders resolutions dated February 16, 2004 and Directors resolutions passed on January 16, 2004.

**Summary of the terms of the ESPP**

*(a) Purposes of the ESPP*
The purposes of the ESPP are to attract, retain and motivate employees of the Company, to provide a means of compensating the employees for their contributions to the growth and profitability by permitting such employees to purchase the ADSs of the Company at a discount and receive favourable U.S. income tax treatment on a subsequent qualifying disposition of such ADSs.

*(b) Who may join*
Subject to any contrary directions given by the Compensation Committee, all full-time and regular part-time employees (the Employees ) of the Company as at the first business day (the Offering Date ) of a given period specified by the Committee (the Offering Period ) shall be eligible to enroll in the ESPP. To be eligible to purchase ADSs, all Employees must maintain his or her employment status, without interruption, with the Company through the last day of each Offering Period (the Purchase Date ).

*(c) Administration of the ESPP*
The Compensation Committee shall be responsible for the administration of the ESPP. Its responsibility includes determining the maximum amount that any Employee may contribute to his or her account under the ESPP during any calendar year; determining the starting and ending dates of each Offering Period; changing the Offering Periods, limiting the frequency and/or number of changes in the amount withheld during an Offering Period, permitting payroll withholding in excess of the amounts designated by a participant ( Participant ) of the ESPP in order to adjust for delays or mistakes in the Company s processing of properly completed withholding elections, and ensuring that amounts applied towards the purchase of the Plan Shares for each Participant properly correspond with amounts withheld from the Participant s compensation.

Any determination by the Compensation Committee in relation to the carrying out and administering of the ESPP shall be final and binding. The Compensation Committee may delegate some or all of its authority under the ESPP to an Administrator. Any actions undertaken by the Administrator in accordance with the Compensation Committee s delegation of authority shall have the same force and effect as if undertaken directly by the Compensation Committee. No member of the Compensation Committee shall be liable for any action or determination made in good faith, and the members of the Compensation Committee shall be entitled to indemnification and reimbursement in the manner provided by the Company s by-laws as they may be amended from time to time.

*(d) Offering Period*

The ESPP shall be implemented by a series of Offering Periods. An eligible Employee of the Company may elect to participate in the ESPP for any Offering Period by completing the requisite documents. No Offering Period shall commence until the closing of an initial Public Offering (as defined in the ESPP). The Compensation Committee shall determine the starting and ending dates of each Offering Period but no Offering Period shall be shorter than 6 months or longer than 27 months.

*(e) Employees Contributions under the ESPP*

All amounts that a Participant contributes ( Contributions ) shall be credited to his or her account under the ESPP. Participants must elect to have payroll deductions made on each payday during the Offering Period in a dollar amount specified in the documents submitted by him or by her. The Compensation Committee may permit Participants to make supplemental Contributions into his or her account, on such terms and subject to such limitations as the Compensation Committee may decide.

Participants may, on one occasion only during an Offering Period, decrease the rate of his or her Contributions to his or her account for the Offering Period, including a decrease to zero. The Participant may restore his or her Contributions to the original level, prior to the earlier of,

(i) six months after the effective date of any such decrease; and

(ii) the end of the relevant Offering Period.

In addition, a Participant who has elected such a decrease in rate of Contribution may, prior to the end of the relevant Offering Period, make one or more supplemental Contributions into his or her account. The aggregate of the supplemental Contributions shall not exceed, in the aggregate, the total Contributions the Participant would have made for that Offering Period had the original rate of Contribution remained in effect throughout the entire Offering Period and the Participant s actual Contributions.

A Participant may change his or her rate of Contribution by filing the requisite documents with the Company. The change in amount shall be effective as at the beginning of the next payroll period following the date of filing of the requisite documents, provided the Participant filed the documents at least five business days prior to the beginning of the next payroll period. Should the Participant fail to file within five business days prior to the beginning of the next payroll period, the change in amount shall be effective as of the beginning of the next succeeding payroll period.

*(f) Grant of Purchase Right*

Each eligible Employee who elects to participate in the ESPP in any given Offering Period shall be granted on the Purchase Date, a right to purchase the Plan Shares (the Purchase Right ). The Purchase Right of a Participant shall be calculated in accordance with the following formula:

(i) dividing (A) the product of US$25,000 and the number of calendar years during all or part of which the Purchase Right shall be outstanding by (B) the closing price of the Plan Shares on the applicable exchange on which Plan Shares are trading (the Fair Market Value ) on the applicable exchange of the Plan Shares on the Offering Date; and

(ii) subtracting from the quotient thereof (A) the number of Plan Shares that the Employee has purchased during the calendar year in which the Offering Date occurs under the ESPP or under any other employee stock purchase plan of the Company or any subsidiary of the Company which is intended to qualify under Section 423 of the U.S. International Revenue Code of 1986 plus (B) the number of Plan Shares subject on the Offering Date to any outstanding Purchase Rights granted to the Employee under any related Plan.

If application of the above formula would result in the grant of Purchase Rights covering, in the aggregate, more than the number of Plan Shares that the Compensation Committee has made available for the relevant Offering Period, then the Compensation Committee shall adjust the number of Plan Shares subject to the Purchase Right in order that, following such adjustment, the aggregate number of Plan Shares subject to the purchase Right shall remain within the applicable limit.

All Purchase Rights outstanding at the tenth anniversary of the Plan shall remain outstanding through, and may be exercised upon the relevant Purchase Date, but no additional Purchase Right shall be granted under the ESPP.

*(g) Exercise of Purchase Right*

Unless a Participant withdraws from the ESPP, his or her Purchase Right shall become exercisable automatically, on the Purchase Date of the relevant Offering Period for the number of Plan Shares obtained by dividing the accumulated Contributions credited to the Participant s account as of the Purchase Date by the applicable Purchase Price, being an amount not less than 85 percent of the Fair Market Value of the Plan Shares on the Offering Date or on the Purchase Date, whichever is lower (the Purchase Price ).

The Compensation Committee may credit any Contributions that have been credited to a Participant s account under the ESPP with interest. Any interest credited to a Participant s account shall not be used to purchase ADSs and shall instead be paid to the Participant at the end of the relevant Offering Period.

If any portion of a Participant s accumulated Contributions is not used to purchase ordinary shares on a given Purchase Date, the remaining amount shall be held in the Participant s account and used for the purchase of Plan Shares under the next Offering Period, unless the Participant withdraws from the next Offering Period.

The exercise of the Purchase Right granted under the ESPP is not subject to any performance target.

*(h) Limit of the ESPP*

The number of ordinary shares that may be issued under the Stock Option Plan and the ESPP (the Global Limit ) shall not exceed ten percent of the issued and outstanding ordinary shares immediately following the closing of the Global Offering (i.e., 1,694,186,849 ordinary shares of the Company, which represents approximately 9% of the total issued shares of the Company as at April 23, 2007).

The number of ordinary shares that may be issued upon exercise of all outstanding Purchase Rights granted under the ESPP or other employee stock purchase plan of the Company or and any outstanding stock options granted under the Stock Option Plan or other stock option plan of the Company must not exceed, in the aggregate, thirty percent of the issued and outstanding ordinary shares in issuance from time to time.

No Employee shall be granted a Purchase Right pursuant to the terms of the ESPP if:

(i) immediately after the grant, such Employee would own capital stock of the Company and/or hold outstanding Purchase Right to purchase stock possessing five percent or more of the total combined voting power or value of all classes of stock of the Company or of any of its subsidiaries;

(ii) such Purchase Right would permit the Employees rights to purchase ADSs under all employee stock purchase plans of the Company and its subsidiaries to accrue at a rate that exceeds US$25,000 of the Fair Market Value of such ADSs or such lower amount as the Compensation Committee may determine for each calendar year in which such Purchase Right is outstanding at any time; and

(iii) such Purchase Right would permit the Employee s rights to purchase ADSs under all employee purchase plans or option plans of the Company granted to him or her in any twelve-month period to exceed one percent of the then issued and outstanding ordinary shares unless otherwise allowed under the Listing Rules.

*(i) Purchase Rights are personal to the Participants*

During his or her lifetime, a Participant s Purchase Right shall be exercised by him or her only. Neither contributions credited to a Participant s account under the ESPP nor any rights with regard to the exercise of a Purchase Right to receive Plan Shares under the ESPP may be assigned, transferred, pledged or otherwise disposed in any way by any Participant.

*(j) Designation of Beneficiary*

A Participant may designate a beneficiary to receive any ADSs and cash, if any, from his or her account under the ESPP in the event of the Participant s death. If a Participant is married and the designated beneficiary is not the spouse, the Company may determine that spousal consent shall be required for such designation to be effective.

A Participant may change a designation of beneficiary at any time by filing the requisite notice. In the event of the death of the Participant and in the absence of a beneficiary validly designated under the Plan who is living at the time of such Participant s death, the Company shall deliver ADSs and/or cash from the Participant s account under the ESPP to the executor or administrator of the Participant s estate, or if no such person has been appointed, the Company, in its discretion, may deliver such ADSs and/or cash to the Participant s spouse or to any one or more dependents, relatives, or such other person as the Company may designate.

*(k) Voluntary Withdrawal*

A Participant may withdraw all but not less than all the Contributions credited to his or her account under the ESPP at any time prior to a Purchase Date by submitting the requisite documents. A Participant s Purchase Right for the current period shall automatically be terminated and cancelled, and no further Contributions for the purchase of ADSs shall be accepted from the Participant during the Offering Period. A Participant s withdrawal from an offering shall not have any effect upon his or her eligibility to participate in the ESPP for the succeeding Offering Period.

*(l) Termination of Employment*

If a Participant to the ESPP terminates his or her employment under circumstances that qualify the Participant as a Qualified Terminated Participant, (as defined in the ESPP) and the effective date of the Participant s termination of employment is less than three months prior to the next Purchase Date, then the Participant shall continue to participate in the ESPP for the Offering Period then in progress, and the Participant s Purchase Right for such Offering Period shall be exercised in accordance with sub-paragraph (g) above. However, the Participant s Contribution to his or her account shall cease with the Contribution made from his or her final paycheck, and the Participant shall not be permitted to make any supplemental Contributions to the ESPP save as directed otherwise by the Compensation Committee. The Participant shall not be eligible to participate in any Offering Period that starts after the effective date of his or her termination of employment.

If a Participant terminates his or her employment under circumstances which do not qualify him or her as a Qualified Terminated Participant, the Company shall pay to the Participant all contributions credited to his or her account under the ESPP and the Participant s Purchase Right shall automatically terminate and lapse.

*(m) Voting and dividend rights*

No voting rights shall be exercisable and no Participants under the ESPP shall have any claim to the dividends in the ADSs covered by his or her rights to purchase the ADSs until such rights have been exercised.

*(n) Ranking of the ADSs*

ADSs allotted upon the exercise of Purchase Right shall rank pari passu (including, but not limited to, with respect to voting, dividend transfer rights and rights arising upon liquidation of the Company) in all respects with the ADSs in issue on the date of such allotment and will be subject to all the provisions of the Articles for the time being in force.

*(o) Change in the capital structure of the Company*

In the event of an alteration in the capital structure of the Company (which includes a capitalisation issue, reduction of capital, consolidation, sub-division of Plan Shares, or rights issue to purchase Plan Shares at a price substantially below market value) the Compensation Committee shall have discretion to make the appropriate adjustments in the number and/or the kind of shares which are subject to purchase under outstanding Purchase Rights, including, if the Compensation Committee deems appropriate, the substitution of similar Purchase Rights in shares of another company so that a Participant shall be entitled to the same proportion of the equity capital of the Company as that to which he or she was previously entitled to.

*(p) Period of the ESPP*

The ESPP shall continue for a term of ten years from the date of its approval by the Shareholders unless terminated in accordance with sub-paragraph (r).

*(q) Use of Funds*

The Company may, but shall not be obligated to, segregate Contributions under the ESPP and/or arrange for Contributions to be held by a third party financial institution or trustee for the benefit of the Participants. Whether or not segregated, Contributions shall remain the property of the relevant Participants and shall be subjected to the rights of the Participants and not to the claims of the Company s creditors.

*(r) Amendments and Termination of the ESPP*

The Compensation Committee may at any time amend the ESPP in any respect or terminate the ESPP, except that, without the approval of the Company s shareholders at a meeting duly called, no amendment shall be made in relation to:

(i) increasing the number of ADSs approved for the ESPP; or

(ii) decreasing the Purchase Price per ADSs.

Any alterations or amendments of a material nature or any change to the terms of the Purchase Rights granted must be approved by the shareholders of the Company, unless such alteration or amendment takes effect automatically under the terms of the ESPP. For the avoidance of doubt, any alteration or amendment pursuant to the exercise of any authority granted under the ESPP is deemed to take effect automatically under the terms of the ESPP. Any amendment made to the ESPP must be in accordance with the requirements of the Listing Rules or permitted by the SEHK.

If the ESPP is terminated by the Board prior to the tenth anniversary of the date of Board approval, unless the Compensation Committee has also terminated any Offering Period then in progress, Purchase Rights granted before such termination shall continue to be valid and exercisable in accordance with, and subject to, the terms and conditions of the Plan.

Rule 17.03(9) of the Listing Rules provide that the exercise price of any share option scheme operated by listed issuers may not be lower than effectively the market price of the ordinary shares. As a result of the capital intensive nature of the Company s business, we have traditionally relied on share options, rather than cash, as an important means of remunerating its employees. This is common in the industry and we wish to continue this practice following the Global Offering. Accordingly, we have applied to and obtained from the SEHK a waiver from strict compliance with Rule 17.03(9) of the Listing Rules such that the Company is allowed to continue to grant options over its ADSs to its employees under the ESPP at an exercise price which is at a discount (up to 15 percent discount) to market price.

STANDARD FORM OF SHARE OPTION PLAN FOR SUBSIDIARIES

The following is a summary of the principal terms of a standard form of share option plan involving the grant of options over shares in subsidiaries of the Company which adopt such plan to eligible participants such as employees, directors and service providers of the Group (the Subsidiary Plan ).which was approved by the shareholders at the annual general meeting held on May 30, 2006.

**(a) Purpose of the Subsidiary Plan**

The purposes of the Subsidiary Plan are to attract, retain and motivate employees and directors of and other service providers to the Group, to provide a means of compensating them through the grant of stock options for their contributions to the growth and profits of the Group, and to allow such employees, directors and service providers to participate in such growth and profitability.

**(b) Who may join**

The Compensation Committee of the board of directors of the relevant subsidiary (the Subsidiary Committee ) may, at its discretion, invite any employee, officer or other service provider of (including, but not limited to, any professional or other adviser of, or consultant or contractor to) the Group whether located in China, the United States or elsewhere to take up options to subscribe for shares ( Subsidiary Shares ) in the relevant subsidiary(ies) which has or have adopted the Subsidiary Plan at a price calculated in accordance with sub-paragraph (e) below. The Subsidiary Committee may also grant stock options to a director who is not an employee of the Company or the relevant subsidiary ( Non-Employee Director ).

**(c) Stock Options**

Stock Options granted under the Subsidiary Plan ( Stock Options ) shall entitle a participant ( Participant ) of the Subsidiary Plan to purchase a specified number of Subsidiary Shares during a specified period at a price calculated in accordance with sub-paragraph (e) below. Three types of Stock Options may be granted under a Subsidiary Plan, an Incentive Stock Option, a Non-Qualified Stock Option or a Director Option. An Incentive Stock Option is a stock option that falls within the meaning of Section 422 of the U.S. Internal Revenue Code of 1986 (the Code ) and may only be granted to employees of the Company and its subsidiaries from time to time. A Non Qualified Stock Option is a stock option that is not an Incentive Stock Option. A Director Option is a Non-Qualified Stock Option granted to a Non-Employee Director.

The relevant subsidiary shall issue an Award Document to each Participant of the Subsidiary Plan who is granted a Stock Option. The Award Document shall set out the terms and provisions of the grant of a Stock Option to a Participant including applicable vesting dates or the attainment of specified performance goals (as determined by the Subsidiary Committee or the Administrator (as defined below), as the case may be) by the Participant. The relevant subsidiary may allow a Participant to exercise his or her Stock Options prior to vesting, provided the Participant agrees to enter into a repurchase agreement in respect of the Stock Option with the relevant subsidiary. The Subsidiary Committee may also (i) accelerate the vesting of a Stock Option, (ii) set the date on which any Stock Option may first become exercisable, or (iii) extend the period during which a Stock Option remains exercisable, except that no Stock Options may be exercised after the tenth anniversary of the date of grant.

The Subsidiary Plan does not provide for any payment upon application or acceptance of an option.

**(d) Administration of the Subsidiary Plan**

The Subsidiary Committee shall be responsible for the administration of the Subsidiary Plan. Its responsibilities include granting Stock Options to eligible individuals, determining the number of Subsidiary Shares subject to each Stock Option, and determining the terms and conditions of each Stock Option. The Subsidiary Committee is not obliged to grant Stock Options to Participants in uniform terms.

Accordingly, the terms and conditions which may be imposed may vary between Participants. Any determination by the Subsidiary Committee in relation to the carrying out and administering of the Subsidiary Plan in accordance with its terms shall be final and binding. No member of the Subsidiary Committee shall be liable for any action or determination made in good faith, and the members of the Subsidiary Committee shall be entitled to indemnification and reimbursement in the manner provided in the articles of association, by-laws or other equivalent constitutional document of the relevant subsidiary.

The Subsidiary Committee may delegate some or all of its authority under the Subsidiary Plan to an individual or individuals (each an Administrator ) who may either be one or more of the members of the Subsidiary Committee or one or more of the officers of the Company or relevant subsidiaries. An individual s status as an Administrator shall not affect his or her eligibility to participate in the Subsidiary Plan. The Subsidiary Committee shall not delegate its authority to grant Stock Options to executive officers of the Company or its subsidiaries.

**(e) Exercise Price**

The exercise price per Subsidiary Share purchasable under a Stock Option shall be fixed by the Subsidiary Committee at the time of grant or by a method specified by the Subsidiary Committee at the time of grant, but, subject always to and in accordance with applicable requirements of the Listing Rules or permission of the Stock Exchange:

*(i) in the case of an Incentive Stock Option:*

(1) granted to a Ten Percent Holder, the exercise price shall be no less than 110% of the Fair Market Value per Subsidiary Share on the date of grant; and

(2) granted to any other Participant, the exercise price shall be no less than 100% of the Fair Market Value per Subsidiary Share on the date of grant; and

*(ii) in the case of any Stock Option:*

(1) granted to a Ten Percent Holder who is a resident of the State of California, the exercise price shall be no less than 110% of the Fair Market Value per Subsidiary Share on the date of grant; and

(2) granted to any other Participant who is a resident of the State of California, the exercise price shall be no less than 85% of the Fair Market Value per Subsidiary Share on the date of grant.

A Ten Percent Holder is any Participant who owns more than 10% of the total combined voting power of all classes of outstanding securities of the relevant subsidiary or any parent or subsidiary (as such terms are defined in and determined in accordance with the Code) of the relevant subsidiary.

Fair Market Value shall be determined as follows:

(i) If the Subsidiary Shares are listed on any established stock exchange or a national market system, including without limitation the NYSE, The Nasdaq National Market or The Nasdaq SmallCap Market of The Nasdaq Stock Market, its Fair Market Value shall be the closing sales price for such Subsidiary Shares (or the closing bid, if no sales were reported) as quoted on such exchange or system on the day of determination, as reported in The Wall Street Journal or such other source as the Administrator deems reliable;

(ii) If the Subsidiary Shares are regularly quoted by a recognized securities dealer but selling prices are not reported, its Fair Market Value shall be the mean between the high bid and low asked prices for the Subsidiary Shares on the day of determination, as reported in The Wall Street Journal or such other source as the Administrator deems reliable; or

(iii) In the absence of an established market for the Subsidiary Shares, the Fair Market Value thereof shall be determined in good faith by the Subsidiary Committee in accordance with any applicable law, rule or regulation.

**(f) Limit of the Subsidiary Plan**

The number of Subsidiary Shares that may be issued under the Subsidiary Plan and all other schemes of the relevant subsidiary involving the grant by such subsidiary of options over or other similar rights to acquire new shares or other new securities of such subsidiary ( Other Schemes ) shall not exceed ten per cent. of the issued and outstanding Subsidiary Shares of such subsidiary on the date of approval of the Subsidiary Plan by the board of directors of the relevant subsidiary (the Subsidiary Board ).

The number of Subsidiary Shares which may be issued pursuant to any outstanding Stock Options granted and yet to be exercised under the Subsidiary Plan and all Other Schemes of the relevant subsidiary must not exceed in aggregate 30 per cent. of the issued and outstanding Subsidiary Shares of the relevant subsidiary in issuance from time to time.

**(g) Individual Limit**

The total number of Subsidiary Shares underlying Stock Options or other options granted by the relevant subsidiary to a Participant (including both exercised and outstanding Stock Options) in any twelve-month period may not exceed at any time one per cent. (1%) (or 0.1 per cent. in the case of an independent non-executive Director of the Company) of the then issued and outstanding Subsidiary Shares unless otherwise allowed under the Listing Rules.

**(h) Exercise of Option**

A Stock Option shall vest, and be exercised, in accordance with the terms of the Subsidiary Plan, the relevant Award Document and any rules and procedures established by the Subsidiary Committee for this purpose. However, the term of each Stock Option shall not exceed ten years from the date of grant, provided that any Incentive Stock Option granted to a Ten Percent Holder shall not by its terms be exercisable after the expiration of five (5) years from the date of grant.

**(i) Director Options**

Each Non-Employee Director may be granted Stock Options to purchase Subsidiary Shares on the terms set out in the relevant Award Document.

The directors shall exercise all authority and responsibility with respect to Stock Options granted to directors subject to the requirements of the Listing Rules.

All Non-Employee Directors Stock Options shall only vest provided that the director has remained in service as a director through such vesting date. The unvested portion of a Stock Option granted to a director shall be forfeited in full if the director s service with the Company or the relevant subsidiary ends for any reason prior to the applicable vesting date.

Following termination of a Non-Employee Director s service on the Board, such Non-Employee Director (or his or her estate, personal representative or beneficiary, as the case may be) shall be entitled to exercise those of his or her Stock Options which have vested as of the date of such termination within 120 days following such termination.

**(j) Termination or lapse of Option**
A Stock Option shall terminate or lapse automatically on:

(i) the expiry of ten years from the date of grant;

(ii) the termination of a Participant s employment or service with the Company for a reason set out in sub-paragraph (l) below;

(iii) save as to any contrary directions of the Subsidiary Committee with the prior approval of the Board of Directors of the Company, in the event of a complete liquidation or dissolution of the relevant subsidiary, all Stock Options outstanding at the time of the liquidation or dissolution shall terminate without further action by any person;

(iv) the sale or other divestiture of a subsidiary, division or operating unit of the Company (where the Participant is employed by such subsidiary, division or operating unit); and

(v) termination of the service relationship with a service provider (where the Participant is a service provider of the Company or its subsidiaries).

**(k) Rights are personal to Participant**
A Stock Option is personal to the Participant and shall be exercisable by such Participant or his Permitted Transferee (as defined below) only. An option shall not be transferred other than by will, by the laws of descent and distribution or pursuant to a domestic relations order. The Subsidiary Committee may also, at its discretion and subject to such terms and conditions as it shall specify, permit the transfer of a Stock Option for no consideration to a Participant s family members or to a trust or partnership established for the benefit of such family members (collectively Permitted Transferees ). Any Stock Option transferred to a Permitted Transferee shall be further transferable only by will or the laws of descent and distribution or, for no consideration, to another Permitted Transferee of the Participant.

**(l) Termination of employment or service**
If a Participant s employment or service with the relevant member(s) of the Group is terminated for the following reasons:

(i) the failure or refusal of the Participant to substantially perform the duties required of him or her as an employee or officer of, or service provider to, the relevant member(s) of the Group;

(ii) any material violation by the Participant of any law or regulation applicable to any business of any relevant member(s) of the Group, or the Participant s conviction of, or a plea of nolo contendae to, a felony, or any perpetration by the Participant of a common law fraud against any relevant member(s) of the Group; or

(iii)

any other misconduct by the Participant that is materially injurious to the financial condition, business or reputation of the Group, then all Stock Options granted to the Participant, whether or not then vested, shall immediately lapse.

The Subsidiary Committee may permit any Incentive Stock Option to convert into a Non-Qualified Stock Option as of a Participant s termination of employment for purposes of providing such Participant with the benefit of any extended exercise period applicable to Non-Qualified Stock Options when the contract of employment of the holder of Incentive Stock Option terminates.

**(m) Change in control of the Company**

The Subsidiary Committee must seek the prior approval of the Board of Directors of the Company and may, subject to such prior approval by the Board of Directors of the Company, specify at or after the date of grant of a Stock Option the effect that a Change in Control (as defined in the Subsidiary Plan) will have on such Stock Option. The Subsidiary Committee may also, subject to such prior approval by the Board of Directors of the Company, in contemplation of a Change in Control, accelerate the vesting, exercisability or payment of Stock Options to a date prior to the Change in Control, if the Subsidiary Committee determines that such action is necessary or advisable to allow the participants to realise fully the value of their share options in connection with such Change in Control.

**(n) Change in the capital structure of the Company**

In the event of an alteration in the capital structure of the relevant subsidiary (which includes a capitalisation issue, reduction of capital, consolidation, sub-division of Subsidiary Shares, or rights issue to purchase Subsidiary Shares at a price substantially below market value), the Subsidiary Committee may equitably adjust the number and kind of Subsidiary Shares authorised for issuance in order to preserve, the benefits or potential benefits intended to be made available under the Subsidiary Plan. In addition, upon the occurrence of any of the foregoing events, the number of outstanding Stock Options and the number and kind of shares subject to any outstanding Stock Option and the purchase price per share under any outstanding Stock Option shall be equitably adjusted so as to preserve the benefits or potential benefits intended to be made available to Participants.

**(o) Period of the Subsidiary Plan**

The form of the Subsidiary Plan shall be approved by the shareholders of the Company and of the relevant subsidiary respectively, and shall become effective upon its approval by the Subsidiary Board in accordance with the terms thereof. Each Subsidiary Plan shall remain in force for a period of ten years commencing on the date of Subsidiary Board approval of the relevant Subsidiary Plan.

**(p) Amendments and Termination**

The Subsidiary Plan may be changed, altered, amended in whole or in part, suspended and terminated by the Subsidiary Board, subject to such prior approval by the Board of Directors of the Company, at any time provided alterations or amendments of a material nature or any change to the terms of the Stock Options granted, or any change to the authority of the Subsidiary Board or the Subsidiary Committee in relation to any alteration to the terms of the Subsidiary Plan, must be approved by the shareholders of the Company, unless such change, alteration or amendment takes effect automatically under the terms of the Subsidiary Plan. For the avoidance of doubt, any change, alteration or amendment pursuant to the exercise of any authority granted under a Subsidiary Plan shall be deemed to take effect automatically under the terms of the relevant Subsidiary Plan. Any change, alteration or amendment must be in accordance with the requirements of the Listing Rules or permitted by the Hong Kong Stock Exchange.

The Subsidiary Board may, subject to prior approval by the Board of Directors of the Company, at any time and from time to time make such changes, alterations or amendments to the Subsidiary Plan as may be necessary or desirable, including (without limitation) changes, alterations or amendments:

(i) relating to local legal, regulatory and/or taxation requirements and/or implications applicable to the relevant subsidiary and/or Eligible Participants; and/or

(ii) for the purposes of clarification, improvement or facilitation of the interpretation, and/or application of the terms of the Subsidiary Plan and/or for the purposes of improving or facilitating the administration of the Subsidiary Plan, and other changes, alterations or amendments of a similar nature.

If the Subsidiary Plan is terminated early by the Subsidiary Board, subject to prior approval by the Board of Directors of the Company, no further Stock Options may be offered but unless otherwise stated in the Subsidiary Plan, Stock Options granted before such termination shall continue to be valid and exercisable in accordance with the Subsidiary Plan.

**(q) Voting and dividend rights**

No voting rights shall be exercisable and no dividends shall be payable in relation to Stock Options that have not been exercised.

**(r) Cancellation of Stock Options**

If the relevant subsidiary is or becomes a public company (within the meaning of the Hong Kong Code on Takeovers and Mergers), then in the case of a Change in Control of the relevant subsidiary, Stock Options granted but not exercised may not be cancelled unless an offer or proposal in respect of the Stock Options has, where applicable, been made pursuant to Rule 13 of The Hong Kong Code on Takeovers and Mergers and the Hong Kong Securities and Futures Commission has consented to such cancellation.

**(s) Ranking of Subsidiary Shares**

The Subsidiary Shares to be allotted upon the exercise of a Stock Option will be subject to the articles of association (or equivalent constitutional document) of the relevant subsidiary for the time being in force and will rank pari passu with the Subsidiary Shares in issue on the date of such allotment.

The Subsidiary Plans will be administered by the relevant Subsidiary Committees and no other trustee is expected to be appointed in respect of any Subsidiary Plan.

As of December 31, 2006, none of the subsidiaries of the Company has adopted the Subsidiary Plan.

Outstanding Share Options

Details of the Stock Option Plans and the Stock Option Plan are as follows:

**2001 Stock Option Plan**

| Name/Eligible Employees | Date Granted | Period during which Rights Exercisable | | No. of Options Granted | Exercise Price Per Share (USD) | Options Outstanding as of 1/1/06 | Options Lapsed During Period | Options Lapsed Due to Repurchase of Ordinary Shares During Period* | Options Exercised During Period | Options Cancelled During Period | Options Outstanding as of 12/31/06 | Weighted Average Closing Price of Shares immediately before Dates on which Options were Exercised (USD) | Weighted Average Closing Price of Shares immediately before Dates on which Options were Granted (USD) |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Kawanishi, Tsuyoshi | 11/7/2002 | 7/11/2002 | 7/10/2012 | 500,000 | $ 0.05 | 500,000 | | | | | 500,000 | $ | $ 0.07 |
| Kawanishi, Tsuyoshi | 15/1/2004 | 1/15/2004 | 1/14/2006 | 1,000,000 | $ 0.10 | 1,000,000 | | | | | 1,000,000 | $ | $ 0.33 |
| Service Providers | 26/9/2002 | 9/26/2002 | 9/25/2012 | 50,000 | $ 0.05 | 50,000 | | | | | 50,000 | $ | $ 0.03 |
| Service Providers | 15/7/2003 | 7/15/2003 | 7/02/2005 | 20,000 | $ 0.05 | 20,000 | 20,000 | | | | | $ | $ 0.14 |
| Service Providers | 15/1/2004 | 1/15/2004 | 3/01/2005 | 4,100,000 | $ 0.10 | 100,000 | | | | | 100,000 | $ | $ 0.14 |
| Senior Management | 24/9/2001 | 9/24/2001 | 9/23/2011 | 1,450,000 | $ 0.01 | | | | | | | $ | $ 0.03 |
| Senior Management | 10/4/2002 | 4/10/2002 | 4/09/2012 | 1,350,000 | $ 0.02 | 1,350,000 | | | 1,350,000 | | | $ 0.13 | $ 0.05 |
| Senior Management | 24/4/2003 | 4/24/2003 | 4/23/2013 | 1,500,000 | $ 0.05 | 1,500,000 | | | 50,000 | | 1,450,000 | $ | $ 0.14 |
| Senior Management | 15/1/2004 | 1/15/2004 | 1/14/2014 | 10,700,000 | $ 0.10 | 2,450,000 | | | 395,000 | | 2,055,000 | $ 0.13 | $ 0.14 |
| Senior Management | 16/2/2004 | 2/16/2004 | 2/15/2014 | 900,000 | $ 0.25 | 900,000 | | | | | 900,000 | $ | $ 0.33 |
| Others | 15/1/2004 | 1/15/2004 | 1/14/2014 | 4,600,000 | $ 0.10 | 2,500,000 | | | | | 2,500,000 | $ | $ 0.35 |
| Others | 16/2/2004 | 2/16/2004 | 2/15/2014 | 12,300,000 | $ 0.25 | 7,380,000 | | | | | 7,380,000 | $ | $ 0.35 |
| Employees | 28/3/2001 | 3/28/2001 | 3/27/2011 | 89,385,000 | $ 0.01 | 7,084,000 | 140,000 | 712,500 | 1,605,500 | | 5,338,500 | $ 0.13 | $ 0.03 |
| Employees | 1/4/2001 | 4/1/2001 | 3/31/2011 | 2,900,000 | $ 0.01 | | | | | | | $ | $ 0.03 |
| Employees | 2/4/2001 | 4/02/2001 | 4/01/2011 | 2,216,000 | $ 0.01 | 330,000 | | | 14,000 | | 316,000 | $ 0.13 | $ 0.03 |
| Employees | 16/4/2001 | 4/16/2001 | 4/15/2011 | 575,000 | $ 0.01 | 35,000 | | | | | 35,000 | $ | $ 0.03 |
| Employees | 25/4/2001 | 4/25/2001 | 4/24/2011 | 600,000 | $ 0.01 | | | | | | | $ | $ 0.03 |
| Employees | 28/4/2001 | 4/28/2001 | 4/27/2011 | 60,000 | $ 0.01 | 42,000 | | | | | 42,000 | $ | $ 0.03 |
| Employees | 7/5/2001 | 5/7/2001 | 5/6/2011 | 1,650,000 | $ 0.01 | | | | | | | $ | $ 0.03 |
| Employees | 14/5/2001 | 5/14/2001 | 5/13/2011 | 1,597,000 | $ 0.01 | 25,000 | | | | | 25,000 | $ | $ 0.03 |
| Employees | 15/5/2001 | 5/15/2001 | 5/14/2011 | 95,000 | $ 0.01 | 35,000 | | | | | 35,000 | $ | $ 0.03 |
| Employees | 24/5/2001 | 5/24/2001 | 5/23/2011 | 35,000 | $ 0.01 | | | | | | | $ | $ 0.03 |
| Employees | 1/6/2001 | 6/01/2001 | 5/31/2011 | 80,000 | $ 0.01 | 40,000 | | | | | 40,000 | $ | $ 0.03 |
| Employees | 1/7/2001 | 7/1/2001 | 6/30/2011 | 745,000 | $ 0.01 | 69,000 | | | | | 69,000 | $ | $ 0.03 |
| Employees | 10/7/2001 | 7/10/2001 | 7/09/2011 | 20,000 | $ 0.01 | | | | | | | $ | $ 0.03 |
| Employees | 15/7/2001 | 7/15/2001 | 7/14/2011 | 1,045,000 | $ 0.01 | 570,000 | | | 148,000 | | 422,000 | $ 0.14 | $ 0.03 |
| Employees | 16/7/2001 | 7/16/2001 | 7/15/2011 | 2,220,000 | $ 0.01 | 128,000 | | | 40,000 | | 88,000 | $ 0.15 | $ 0.03 |
| Employees | 20/7/2001 | 7/20/2001 | 7/19/2011 | 20,000 | $ 0.01 | 14,000 | | | 14,000 | | | $ 0.16 | $ 0.03 |
| Employees | 27/7/2001 | 7/27/2001 | 7/26/2011 | 50,000 | $ 0.01 | 50,000 | | | | | 50,000 | $ | $ 0.03 |
| Employees | 30/7/2001 | 7/30/2001 | 7/29/2011 | 140,000 | $ 0.01 | 100,000 | | | | | 100,000 | $ | $ 0.03 |
| Employees | 1/8/2001 | 8/01/2001 | 7/31/2011 | 195,000 | $ 0.01 | 94,000 | | | 20,000 | | 74,000 | $ 0.14 | $ 0.03 |
| Employees | 7/8/2001 | 8/07/2001 | 8/06/2011 | 20,000 | $ 0.01 | 20,000 | | | | | 20,000 | $ | $ 0.03 |

| Name/Eligible Employees | Date Granted | Period during which Rights Exercisable | | No. of Options Granted | Exercise Price Per Share (USD) | Options Outstanding as of 1/1/06 | Options Lapsed During Period | Options Lapsed Due to Repurchase of Ordinary Shares During Period* | Options Exercised During Period | Options Cancelled During Period | Options Outstanding as of 12/31/06 | Weighted Average Closing Price of Shares immediately before Dates on which Options were Exercised (USD) | Weighted Average Closing Price of Shares immediately before Dates on which Options were Granted (USD) |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Employees | 15/8/2001 | 8/15/2001 | 8/14/2011 | 100,000 | $ 0.01 | 100,000 | | | | | 100,000 | $ | $ 0.03 |
| Employees | 20/8/2001 | 8/20/2001 | 8/19/2011 | 20,000 | $ 0.01 | 20,000 | | | | | 20,000 | $ | $ 0.03 |
| Employees | 24/9/2001 | 9/24/2001 | 9/23/2011 | 99,158,500 | $ 0.01 | 37,555,200 | 1,216,000 | | 12,376,000 | | 23,963,200 | $ 0.14 | $ 0.03 |
| Employees | 28/9/2001 | 9/28/2001 | 9/27/2011 | 50,000 | $ 0.01 | 50,000 | | | | | 50,000 | $ | $ 0.03 |
| Employees | 24/1/2002 | 1/24/2002 | 1/23/2012 | 47,653,000 | $ 0.01 | 32,438,500 | 290,000 | | 13,462,000 | | 18,686,500 | $ 0.14 | $ 0.03 |
| Employees | 24/1/2002 | 1/24/2002 | 1/23/2012 | 7,684,500 | $ 0.02 | 3,663,640 | 8,240 | | 1,685,750 | | 1,969,650 | $ 0.14 | $ 0.03 |
| Employees | 10/4/2002 | 4/10/2002 | 4/09/2012 | 1,315,000 | $ 0.01 | 65,000 | | | 20,000 | | 45,000 | $ 0.14 | $ 0.05 |
| Employees | 10/4/2002 | 4/10/2002 | 4/09/2012 | 47,349,000 | $ 0.02 | 29,560,800 | | | 11,242,500 | | 18,318,300 | $ 0.13 | $ 0.05 |
| Employees | 11/4/2002 | 4/11/2002 | 4/10/2012 | 4,100,000 | $ 0.01 | 2,100,000 | | | | | 2,100,000 | $ | $ 0.05 |
| Employees | 28/6/2002 | 6/28/2002 | 6/27/2012 | 930,000 | $ 0.01 | 900,000 | | | 900,000 | | | $ 0.14 | $ 0.06 |
| Employees | 28/6/2002 | 6/28/2002 | 6/27/2012 | 39,740,000 | $ 0.02 | 26,404,200 | 442,000 | 504,000 | 8,728,200 | | 17,234,000 | $ 0.13 | $ 0.06 |
| Employees | 28/6/2002 | 6/28/2002 | 6/27/2012 | 18,944,000 | $ 0.05 | 12,498,000 | 31,000 | | 2,811,000 | | 9,656,000 | $ 0.13 | $ 0.06 |
| Employees | 11/7/2002 | 7/11/2002 | 7/10/2012 | 250,000 | $ 0.01 | | | | | | | $ | $ 0.07 |
| Employees | 11/7/2002 | 7/11/2002 | 7/10/2012 | 1,700,000 | $ 0.02 | 750,000 | | | | | 750,000 | $ | $ 0.07 |
| Employees | 11/7/2002 | 7/11/2002 | 7/10/2012 | 2,780,000 | $ 0.05 | 80,000 | | | | | 80,000 | $ | $ 0.07 |
| Employees | 26/9/2002 | 9/26/2005 | 9/25/2012 | 5,770,000 | $ 0.02 | 3,586,000 | 441,000 | 52,500 | 950,000 | | 2,195,000 | $ 0.13 | $ 0.08 |
| Employees | 26/9/2002 | 9/26/2005 | 9/25/2012 | 65,948,300 | $ 0.05 | 41,408,350 | 2,012,970 | | 8,739,580 | | 30,655,800 | $ 0.13 | $ 0.08 |
| Employees | 9/1/2003 | 1/09/2003 | 1/08/2013 | 53,831,000 | $ 0.05 | 36,358,700 | 2,903,100 | | 4,330,600 | | 29,125,000 | $ 0.13 | $ 0.10 |
| Employees | 10/1/2003 | 1/10/2003 | 1/09/2013 | 720,000 | $ 0.05 | 720,000 | | | | | 720,000 | $ | $ 0.10 |
| Employees | 22/1/2003 | 1/22/2003 | 1/21/2013 | 1,060,000 | $ 0.05 | 1,060,000 | | | | | 1,060,000 | $ | $ 0.10 |
| Employees | 1/4/2003 | 4/01/2003 | 3/31/2013 | 18,804,900 | $ 0.05 | 14,899,138 | 2,368,192 | | 1,366,162 | | 11,164,784 | $ 0.14 | $ 0.14 |
| Employees | 15/4/2003 | 4/15/2003 | 4/14/2013 | 550,000 | $ 0.05 | 550,000 | | | | | 550,000 | $ | $ 0.14 |
| Employees | 24/4/2003 | 4/24/2003 | 4/23/2013 | 58,838,000 | $ 0.05 | 34,443,350 | 884,600 | | 2,463,050 | | 31,095,700 | $ 0.14 | $ 0.14 |
| Employees | 15/7/2003 | 7/15/2003 | 7/14/2013 | 59,699,900 | $ 0.05 | 36,063,000 | 4,093,430 | | 2,607,460 | | 29,362,110 | $ 0.13 | $ 0.17 |
| Employees | 10/10/2003 | 10/10/2003 | 10/09/2013 | 49,535,400 | $ 0.10 | 30,874,460 | 3,229,370 | | 1,374,950 | | 26,270,140 | $ 0.13 | $ 0.29 |
| Employees | 5/1/2004 | 1/05/2004 | 1/04/2014 | 130,901,110 | $ 0.10 | 95,612,366 | 8,458,445 | | 7,877,780 | | 79,276,141 | $ 0.14 | $ 0.33 |
| Employees | 15/1/2004 | 1/15/2004 | 1/14/2014 | 12,885,000 | $ 0.10 | 9,554,000 | 375,000 | | 450,000 | | 8,729,000 | $ 0.14 | $ 0.33 |
| Employees | 15/1/2004 | 1/15/2004 | 1/14/2014 | 300,000 | $ 0.25 | | | | | | | $ | $ 0.33 |
| Employees | 16/2/2004 | 2/16/2004 | 2/15/2014 | 14,948,600 | $ 0.10 | 5,724,100 | 215,650 | | 146,250 | | 5,362,200 | $ 0.14 | $ 0.33 |
| Employees | 16/2/2004 | 2/16/2004 | 2/15/2014 | 76,954,880 | $ 0.25 | 60,674,235 | 10,737,755 | | | | 49,936,480 | $ | $ 0.33 |

Options to purchase ordinary shares issued to new employees generally vest at a rate of 10% upon the second anniversary, an additional 20% on the third anniversary and an additional 70% upon the fourth anniversary of the vesting commencement date. Beginning in January 2004, options to purchase ordinary shares issued to then-existing employees generally vest at a rate of 25% upon the first, second, third, and fourth anniversaries of the vesting commencement date.

The Company has not issued stock options under the 2001 Stock Option Plans since the completion of the Global Offering.

**2001 Preference Share Plan**

| Name/Eligible Employees | Date Granted | Period during which Rights Exercisable | | No. of Options Granted | Exercise Price Per Share (USD) | Options Outstanding as of 1/1/06 | Options Lapsed During Period | Options Lapsed Due to Repurchase of Ordinary Shares During Period* | Options Exercised During Period | Options Cancelled During Period | Options Outstanding as of 12/31/06 | Weighted Average Closing Price of Shares immediately before Dates on which Options were Exercised (USD) | Weighted Average Closing Price of Shares immediately before Dates on which Options were Granted (USD) |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Service Providers | 11/7/2002 | 7/11/2002 | 7/10/2012 | 462,000 | $ 0.11 | 202,000 | | | | | 202,000 | $ | $ 0.14 |
| Service Providers | 26/9/2002 | 9/26/2002 | 9/25/2012 | 50,000 | $ 0.11 | 50,000 | | | | | 50,000 | $ | $ 0.15 |
| Employees | 24/9/2001 | 9/24/2001 | 9/23/2011 | 254,098,700 | $ 0.11 | 25,865,800 | 24,000 | | 1,751,600 | | 24,090,200 | $ 0.14 | $ 0.11 |
| Employees | 28/9/2001 | 9/28/2001 | 9/27/2011 | 50,000 | $ 0.11 | 50,000 | | | | | 50,000 | $ | $ 0.11 |
| Employees | 3/11/2001 | 11/03/2001 | 11/02/2011 | 780,000 | $ 0.35 | 617,500 | 70,000 | | | | 547,500 | $ | $ 0.11 |
| Employees | 24/1/2002 | 1/24/2002 | 1/23/2012 | 58,357,500 | $ 0.11 | 8,523,190 | 150,590 | 150,000 | 928,450 | | 7,444,150 | $ 0.14 | $ 0.12 |
| Employees | 10/4/2002 | 4/10/2002 | 4/09/2012 | 51,384,000 | $ 0.11 | 6,294,800 | 129,000 | 25,000 | 1,503,000 | | 4,662,800 | $ 0.14 | $ 0.13 |
| Employees | 28/6/2002 | 6/28/2002 | 6/27/2012 | 63,332,000 | $ 0.11 | 15,723,500 | 157,000 | 150,000 | 2,654,000 | | 12,912,500 | $ 0.14 | $ 0.14 |
| Employees | 11/7/2002 | 7/11/2002 | 7/10/2012 | 4,530,000 | $ 0.11 | 805,000 | | | | | 805,000 | $ | $ 0.14 |
| Employees | 26/9/2002 | 9/26/2002 | 9/25/2012 | 73,804,800 | $ 0.11 | 17,995,090 | 842,770 | 75,000 | 2,418,000 | | 14,734,320 | $ 0.13 | $ 0.15 |
| Employees | 9/1/2003 | 1/09/2003 | 1/08/2013 | 12,686,000 | $ 0.11 | 2,157,000 | 14,000 | | 906,000 | | 1,237,000 | $ 0.12 | $ 0.17 |

Options to purchase preference shares issued to new employees generally vest at a rate of 10% upon the second anniversary, an additional 20% on the third anniversary and an additional 70% upon the fourth anniversary of the vesting commencement date. Employees may early exercise their options to purchase preference shares. If an employee early exercises 100% of his or her options, the options vest at a rate of 25% upon each first, second, third, and fourth anniversary of the vesting commencement date. Furthermore, in this case, if the employee remains employed by the Company and the Company has completed its initial public offering as of the third anniversary of the vesting commencement date, all options shall vest.

The options to purchase preference shares converted into options to purchase ordinary shares immediately prior to the completion of the Global Offering.

**2004 Stock Option Plan**

| me/Eligible Employees | Date Granted | Period during which Rights Exercisable | | No. of Options Granted | Exercise Price Per Share (USD) | Options Outstanding as of 1/1/06 | Additional Grant 2006 | Options Lapsed During Period | Options Lapsed Due to Repurchase of Ordinary Shares During Period* | Options Exercised During Period | Options Cancelled During Period | Options Outstanding as of 12/31/06 | Weighted Average Closing of Shares immediately before Dates on which Options were Exercised (USD) | Wei Ave Pri o Sha bef Da o wh Opt we Exer (US |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| nior Management | 18/3/2004 | 3/18/2004 | 3/17/2014 | 150,000 | $ 0.35 | 150,000 | | | | | | 150,000 | $ | $ 0 |
| hers | 18/3/2004 | 3/18/2004 | 3/17/2014 | 20,000 | $ 0.35 | 20,000 | | | | | | 20,000 | $ | $ 0 |
| ployees | 18/3/2004 | 3/18/2004 | 3/17/2014 | 49,949,700 | $ 0.35 | 40,155,400 | | 6,635,500 | | | | 33,519,900 | $ | $ 0 |
| hard Chang | 7/4/2004 | 4/07/2004 | 4/06/2014 | 100,000 | $ 0.31 | 100,000 | | | | | | 100,000 | $ | $ 0 |
| ployees | 25/4/2004 | 4/25/2004 | 4/24/2014 | 22,591,800 | $ 0.28 | 19,140,350 | | 3,103,450 | | | | 16,036,900 | $ | $ 0 |
| hers | 27/7/2004 | 7/27/2004 | 7/26/2014 | 200,000 | $ 0.20 | 200,000 | | | | | | 200,000 | $ | $ 0 |
| ployees | 27/7/2004 | 7/27/2004 | 7/26/2014 | 35,983,000 | $ 0.20 | 29,131,000 | | 7,537,100 | | | | 21,593,900 | $ | $ 0 |
| wanishi, Tsuyoshi | 10/11/2004 | 11/10/2004 | 11/09/2009 | 500,000 | $ 0.22 | 500,000 | | | | | | 500,000 | $ | $ 0 |
| ployees | 10/11/2004 | 11/10/2004 | 11/09/2014 | 52,036,140 | $ 0.22 | 41,553,810 | | 8,151,510 | | | | 33,402,300 | $ | $ 0 |
| Lin Hsu | 10/11/2004 | 11/10/2004 | 11/09/2009 | 500,000 | $ 0.22 | 500,000 | | | | | | 500,000 | $ | $ 0 |
| n-Pon Jou | 10/11/2004 | 11/10/2004 | 11/09/2009 | 500,000 | $ 0.22 | 500,000 | | 500,000 | | | | | $ | $ 0 |
| nry Shaw | 10/11/2004 | 11/10/2004 | 11/09/2009 | 500,000 | $ 0.22 | 500,000 | | | | | | 500,000 | $ | $ 0 |
| -Bu Tan | 10/11/2004 | 11/10/2004 | 11/09/2009 | 500,000 | $ 0.22 | 500,000 | | | | | | 500,000 | $ | $ 0 |
| ng Yang Yuan | 10/11/2004 | 11/10/2004 | 11/09/2009 | 500,000 | $ 0.22 | 500,000 | | | | | | 500,000 | $ | $ 0 |
| nior Management | 11/5/2005 | 5/11/2005 | 5/10/2015 | 1,100,000 | $ 0.20 | 1,100,000 | | | | | | 1,100,000 | $ | $ 0 |
| hers | 11/5/2005 | 5/11/2005 | 5/10/2015 | 100,000 | $ 0.20 | 100,000 | | | | | | 100,000 | $ | $ 0 |
| ployees | 11/5/2005 | 5/11/2005 | 5/10/2015 | 94,381,300 | $ 0.20 | 80,257,423 | | 11,281,216 | | | | 68,976,207 | $ | $ 0 |
| hard Chang | 11/5/2005 | 5/11/2005 | 5/10/2015 | 15,000,000 | $ 0.20 | 15,000,000 | | | | | | 15,000,000 | $ | $ 0 |
| ployees | 11/8/2005 | 8/11/2005 | 8/10/2015 | 32,279,500 | $ 0.22 | 31,107,500 | | 8,041,000 | | | | 23,066,500 | $ | $ 0 |
| nior Management | 11/11/2005 | 11/11/2005 | 11/10/2015 | 11,640,000 | $ 0.15 | 11,640,000 | | | | | | 11,640,000 | $ | $ 0 |
| hers | 11/11/2005 | 11/11/2005 | 11/10/2015 | 3,580,000 | $ 0.15 | 3,580,000 | | | | | | 3,580,000 | $ | $ 0 |
| ployees | 11/11/2005 | 11/11/2005 | 11/10/2015 | 149,642,000 | $ 0.15 | 147,345,000 | | 20,075,000 | | | | 127,270,000 | $ | $ 0 |
| ployees | 20/2/2006 | 2/20/2006 | 2/19/2016 | 62,756,470 | $ 0.15 | | 62,756,470 | 7,228,149 | | | | 55,528,321 | $ | $ 0 |
| hers | 12/5/2006 | 5/12/2006 | 5/11/2016 | 100,000 | $ 0.15 | | 100,000 | | | | | 100,000 | $ | $ 0 |
| ployees | 12/5/2006 | 5/12/2006 | 5/11/2016 | 22,216,090 | $ 0.15 | | 22,216,090 | 2,754,000 | | | | 19,462,090 | $ | $ 0 |
| wanishi, Tsuyoshi | 29/9/2006 | 9/29/2006 | 9/28/2011 | 500,000 | $ 0.13 | | 500,000 | | | | | 500,000 | $ | $ 0 |
| ployees | 29/9/2006 | 9/29/2006 | 9/28/2016 | 41,294,000 | $ 0.13 | | 41,294,000 | 1,998,000 | | | | 39,296,000 | $ | $ 0 |
| hard Chang | 29/9/2006 | 9/29/2006 | 9/28/2016 | 500,000 | $ 0.13 | | 500,000 | | | | | 500,000 | $ | $ 0 |
| Lin Hsu | 29/9/2006 | 9/29/2006 | 9/28/2011 | 500,000 | $ 0.13 | | 500,000 | | | | | 500,000 | $ | $ 0 |
| nry Shaw | 29/9/2006 | 9/29/2006 | 9/28/2011 | 500,000 | $ 0.13 | | 500,000 | | | | | 500,000 | $ | $ 0 |
| -Bu Tan | 29/9/2006 | 9/29/2006 | 9/28/2011 | 500,000 | $ 0.13 | | 500,000 | | | | | 500,000 | $ | $ 0 |
| ng Yang Yuan | 29/9/2006 | 9/29/2006 | 9/28/2011 | 500,000 | $ 0.13 | | 500,000 | | | | | 500,000 | $ | $ 0 |
| hers | 10/11/2006 | 11/10/2006 | 11/09/2016 | 2,450,000 | $ 0.13 | | 2,450,000 | | | | | 2,450,000 | $ | $ 0 |
| ployees | 10/11/2006 | 11/10/2006 | 11/09/2016 | 34,047,000 | $ 0.11 | | 34,047,000 | 1,914,000 | | | | 32,133,000 | $ | $ 0 |

Options to purchase ordinary shares issued to new employees generally vest at a rate of 10% upon the second anniversary, an additional 20% on the third anniversary and an additional 70% upon the fourth anniversary of the vesting commencement date. Options to purchase ordinary shares issued to then-existing employees generally vest at a rate of 25% upon the first, second, third, and fourth anniversaries of the vesting commencement date.

**2004 Equity Incentive Plan**

| ne/Eligible Employees | Date Granted | Period during which Rights Exercisable | | No. of Options Granted | Exercise Price Per Share (USD) | Options Outstanding as of 1/1/06 | Additional Options Granted During Period | Options Lapsed During Period | Options Lapsed Due to Repurchase of Ordinary Shares During Period* | Options Exercised During Period | Options Cancelled During Period | Options Outstanding as of 12/31/06 | Weighted Average Closing Price of Shares immediately before Dates on which Restricted Share Units were Vested (USD) | Wei Av Closin Sh imme be D o wh Rest Sh U were C (U |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| ior Management | 27/7/2004 | 7/27/2005 | 7/26/2015 | 1,130,000 | $ 0.00 | 772,500 | | | | 257,500 | | 515,000 | $ 0.14 | $ |
| ior Management | 11/8/2005 | 8/11/2005 | 8/10/2015 | 916,830 | $ 0.00 | 916,830 | | | | 180,359 | | 736,471 | $ 0.14 | $ |
| ior Management | 11/11/2005 | 11/11/2005 | 11/10/2015 | 2,910,000 | $ 0.00 | 2,910,000 | | | | | | 2,910,000 | $ | $ |
| ers | 11/8/2005 | 8/11/2005 | 8/10/2015 | 156,888 | $ 0.00 | 156,888 | | 89,485 | | 39,221 | | 28,182 | $ 0.14 | $ |
| ers | 11/11/2005 | 11/11/2005 | 11/10/2015 | 2,100,000 | $ 0.00 | 2,100,000 | | | | 500,000 | | 1,600,000 | $ 0.13 | $ |
| ers | 10/11/2006 | 11/10/2006 | 11/09/2016 | 1,400,000 | $ 0.00 | | 1,400,000 | | | | | 1,400,000 | $ 0.11 | |
| ployees | 1/7/2004 | 7/01/2005 | 6/30/2015 | 96,856,590 | $ 0.00 | 63,346,126 | | 11,142,485 | | 18,503,551 | | 33,700,090 | $ 0.14 | $ |
| ployees | 27/7/2004 | 7/27/2005 | 7/26/2015 | 19,447,520 | $ 0.00 | 10,093,140 | | 745,000 | | 3,199,380 | | 6,148,760 | $ 0.14 | $ |
| ployees | 10/11/2004 | 11/10/2005 | 11/09/2015 | 756,714 | $ 0.00 | 556,000 | | 500,000 | | 56,000 | | | $ | $ |
| ployees | 11/5/2005 | 5/11/2006 | 5/10/2016 | 4,630,000 | $ 0.00 | 2,060,000 | | 270,000 | | 505,000 | | 1,285,000 | $ 0.14 | $ |
| ployees | 11/8/2005 | 8/11/2005 | 8/10/2015 | 69,430,022 | $ 0.00 | 65,787,707 | | 9,734,654 | | 14,300,274 | | 41,752,779 | $ 0.14 | $ |
| ployees | 11/11/2005 | 11/11/2005 | 11/10/2015 | 40,275,000 | $ 0.00 | 39,540,000 | | 4,460,000 | | | 35,080,000 | $ | $ 0.15 | |
| ployees | 20/2/2006 | 2/20/2006 | 2/19/2016 | 3,110,000 | $ 0.00 | | 3,110,000 | 100,000 | | | | 3,010,000 | | $ |
| ployees | 12/5/2006 | 5/12/2006 | 5/11/2016 | 2,700,000 | $ 0.00 | | 2,700,000 | 100,000 | | | | 2,600,000 | | $ |
| ployees | 29/9/2006 | 9/29/2006 | 9/28/2016 | 1,220,000 | $ 0.00 | | 1,220,000 | | | | | 1,220,000 | | $ |
| ployees | 10/11/2006 | 11/10/2006 | 11/09/2016 | 7,628,864 | $ 0.00 | | 7,628,864 | 320,000 | | | | 7,308,864 | | $ |
| hard Chang | 11/5/2005 | 5/11/2006 | 5/10/2016 | 2,000,000 | $ 0.00 | 1,500,000 | | | | 500,000 | | 1,000,000 | $ 0.14 | $ |

Awards of the RSUs issued to new employees generally vest at a rate of 10% upon the second anniversary, an additional 20% on the third anniversary and an additional 70% upon the fourth anniversary of the vesting commencement date. Awards of the RSUs issued to then-existing employees generally vest at a rate of 25% upon the first, second, third, and fourth anniversaries of the vesting commencement date.

## Corporate Governance Report

The Company is committed to remaining an exemplary corporate citizen and maintaining a high level of corporate governance in order to protect the interests of its shareholders.

*Corporate Governance Practices*

In November 2004, the HKSE issued its report entitled the Code on Corporate Governance Practices and Corporate Governance Report , which subject to a grace period, has taken effect for accounting periods commencing on or after January 1, 2005. The HKSE s Code on Corporate Governance Practices (the CG Code ) as set out in Appendix 14 of the Listing Rules, which contains code provisions to which an issuer such as the Company, are expected to comply or advise as to reasons for deviations (the Code Provisions ) and recommended best practices to which an issuer is encouraged to comply (the Recommended Practices ). At the meeting of the Board on January 25, 2005, the Board approved the Corporate Governance Policy (the CG Policy ) with effect from such date. The updated CG Policy, a copy of which can be obtained on the Company s website at www.smics.com under Corporate Governance , incorporates all of the Code Provisions of the CG Code and many of the Recommended Practices.

In addition, the Company has adopted or put in place various policies, procedures, and practices in compliance with the provision of the CG Policy. None of the Directors is aware of any information which would reasonably indicate that the Company is not, or was not, during the financial period from January 1, 2006 to December 31, 2006, in compliance with the CG Policy.

*Model Code for Securities Transactions by Directors of Listed Issuers*

The Company has adopted an Insider Trading Compliance Program (the Insider Trading Policy ) which encompasses the requirements of the Model Code as set out in Appendix 10 of the Listing Rules. The Company, having made specific enquiry of all Directors, confirms that all members of the Board have complied with the Insider Trading Policy and the Model Code throughout the year ended December 31, 2006. The senior management as well as all officers, Directors, and employees of the Company and its subsidiaries are also required to comply with the provisions of the Insider Trading Policy.

**The Board**

The Board has a duty to the Company s shareholders to direct and oversee the affairs of the Company in order to maximize shareholder value. The Board acting itself and through the various committees of the Board, actively participates in the determination of the overall strategy of the Company, the establishment and monitoring of the achievement, of corporate goals and objectives, the oversight of the Company s financial performance and the responsibility for preparing the accounts, the establishment of corporate governance practices and policies, and the review of the Company s system of internal controls. The management of the Company is responsible for the implementation of the overall strategy of the Company and its daily operations and administration. The Board has access to the senior management of the Company to discuss enquiries on management information.

The Board consists of nine Directors as at the date of the annual report. Directors may be elected or re- elect to hold office until the expiration of their respective terms upon a resolution passed at a duly convened shareholders meeting by holders of a majority of the Company s outstanding shares being entitled to vote in person or by proxy at such meeting. The Board is divided into three classes with no more than one class eligible for re-election at any annual general meeting of shareholders.

Each class of Director will serve terms of three years. The Class I Directors were elected for a term of three years at the 2005 AGM (except Dr. Albert Y. C. Yu who was elected at the 2006 AGM). The Class II Directors were re-elected for a term of three years at the 2006 AGM. The Class III Directors will be re-elected at the AGM for a term of three years.

The following table sets forth the names, classes and categories of the Directors:

| **Name of Director** | **Category of Director** | **Class of Director** |
|---|---|---|
| Yang Yuan Wang | Chairman, Independent Non-executive Director | Class III |
| Richard Ru Gin Chang | President, Chief Executive Officer, Executive Director | Class I |
| Henry Shaw | Independent Non-executive Director | Class I |
| Albert Y. C. Yu | Independent Non-executive Director | Class I |
| Ta-Lin Hsu | Independent Non-executive Director | Class II |
| Jiang Shang Zhou | Independent Non-executive Director | Class II |
| Lip-Bu Tan | Independent Non-executive Director | Class II |
| Tsuyoshi Kawanishi | Non-executive Director | Class III |
| Fang Yao | Non-executive Director | Class III |

Brief biographical details for Board members are set out on pages 35 through 37. During the year ended December 31, 2006, the Board at all times exceeded the minimum requirements of the Listing Rules relating to the appointment of at least three Independent Non-executive Directors on the board, and complied with the requirement that these should include one such director with appropriate professional qualifications or accounting or related financial management expertise.

At the AGM, Yang Yuan Wang, Tsuyoshi Kawanishi and Fang Yao will retire from office on the date of the AGM pursuant to Article 90 of the Articles. Prof. Wang, Mr. Kawanishi and Mr. Yao will each offer himself for re-election at the AGM. If re-elected, each of Prof. Wang, Mr. Kawanishi and Mr. Yao would hold office until the 2010 AGM.

On an annual basis, each Independent Non-executive Director confirms his independence to the Company, and the Company considers these Directors to be independent as such term is defined in the Listing Rules. There are no relationships among members of the Board, including between the Chairman of the Board and the Chief Executive Officer.

The Board meets in person at least on a quarterly basis and on such other occasions as may be required to discuss and vote upon significant issues affecting the Company. The Board meeting schedule for a year is planned in the preceding year. The Company Secretary assists the Chairman in preparing the agenda for meetings and the Board in complying with relevant rules and regulations. The relevant papers for the Board meetings were dispatched to Board members in accordance with the CG Code. Directors may include matters for discussion in the agenda if the need arises. Upon the conclusion of the Board meeting, minutes are circulated to all Directors for their comment and review prior to their approval of the minutes at the following or subsequent Board meeting. Transactions in which Directors are considered to have a conflict of interest or material interests are not passed by written resolutions and the interested Directors are not counted in the quorum and abstain from voting on the relevant matters.

All Directors have access to the Company Secretary who is responsible for assisting the Board in complying with applicable procedures regarding compliance matters. Every Board member is entitled to have access to documents provided at the Board meeting or filed into the Company s minute-book. Furthermore, the Board has established the procedures pursuant to which a Director, upon reasonable request, may seek independent professional advice at the Company s expense in order for such Director to exercise such Director s duties. The Company Secretary continuously updates all Directors on the latest development of the Listing Rules and other applicable regulatory requirements to assist the Company s compliance with and maintenance of good corporate governance practices. Each new Director is provided with training with respect to such Director s responsibilities under the Listing Rules and other regulatory requirements and the Company s corporate governance policies and practices.

During the year ended December 31, 2006, the Board held a total of twelve (12) meetings. Details of Directors attendance at the Board meetings are set forth below:

| | Number of Meetings Attended | Attendance Rate |
|---|---|---|
| **From January to May** | | |
| Wang Yang Yuan(1a) | 6/6 | 100% |
| Richard Ru Gin Chang | 6/6 | 100% |
| Fang Yao(2a) | 5/6 | 83% |
| Ta-Lin Hsu(3a) | 6/6 | 100% |
| Yen-Pong Jou(4) | 5/6 | 83% |
| Tsuyoshi Kawanishi(5a) | 6/6 | 100% |
| Henry Shaw | 6/6 | 100% |
| Lip-Bu Tan | 6/6 | 100% |
| Average Attendance Rate | | 96% |
| **From June to December** | | |
| Wang Yang Yuan (1b) | 8/8 | 100% |
| Richard Ru Gin Chang | 8/8 | 100% |
| Fang Yao (2b) | 8/8 | 100% |
| Ta-Lin Hsu (3b) | 8/8 | 100% |
| Jiang Shang Zhou (6) | 3/8 | 38% |
| Tsuyoshi Kawanishi (5b) | 6/8 | 75% |
| Henry Shaw | 8/8 | 100% |
| Lip-Bu Tan (7) | 5/8 | 63% |
| Albert Y. C. Yu (8) | 8/8 | 100% |
| Average Attendance Rate | | 86% |

(1a) 2 of these meetings were attended by proxy
(1b) 5 of these meetings were attended by proxy
(2a) 1 of these meetings was attended by proxy
(2b) 1 of these meetings was attended by proxy
(3a) 1 of these meetings was attended by proxy
(3b) 1 of these meetings was attended by proxy
(4) Such meetings were attended by proxy and Mr. Jou retired as Director at the 2006 AGM.
(5a) 4 of these meetings were attended by proxy
(5b) 2 of these meetings were attended by proxy

(6) 2 of these meetings were attended by proxy. Mr. Jiang was elected as Director at the 2006 AGM.
(7) 1 of these meetings was attended by proxy
(8) 2 of these meetings were attended by proxy. Dr. Yu was elected as Director at the 2006 AGM.

**Procedure regarding the Appointment of Directors**

The standard procedures regarding the appointment of Directors, which was adopted by the Board on September 22, 2005, sets forth the process by which individuals are appointed as members of the Board. Under the policy, the Board will consider, among other factors, (i) the skills, qualifications and experience of the nominee, including other directorships held in listed public companies in the last three years and other major appointments; (ii) the nominee s shareholdings in the Company; (iii) the independence of the nominee under United States and/or Hong Kong listing rules; and (iv) the impact with respect to the Company s status as a foreign private issuer under the United States securities laws. The Board will then decide whether to appoint such nominee to fill a casual vacancy on the Board or to add the nominee to the existing Directors and to appoint such nominee into one of the three classes of directors as stipulated in the Articles of Association.

*Board Committees*

The Board has established the following principal committees to assist it in exercising its obligations. These committees consist of only Independent Non-executive Directors who have been invited to serve as members. The committees are governed by their respective charters setting out clear terms of reference.

**Compensation Committee**

As of December 31, 2006, the members of the Company s compensation committee (the Compensation Committee ) were Ta-Lin Hsu (chairman of Compensation Committee), Tsuyoshi Kawanishi and Lip-Bu Tan. None of these members of the Compensation Committee has been an executive officer or employee of the Company or any of its subsidiaries. See Connected Transactions for a description of transactions between the Company and the members of the Compensation Committee.

The responsibilities of the Compensation Committee include, among other things:

- approving and overseeing the total compensation package for the Company s executive officers and any other officer, evaluating the performance of and determining and approving the compensation to be paid to the Company s Chief Executive Officer and reviewing the results of the Chief Executive Officer s evaluation of the performance of the Company s other executive officers;

- reviewing and making recommendations to the Board with respect to Director compensation, including equity-based compensation;

- administering and periodically reviewing and making recommendations to the Board regarding the long-term incentive compensation or equity plans made available to the Directors, employees and consultants;

- reviewing and making recommendations to the Board regarding executive compensation philosophy, strategy and principles and reviewing new and existing employment, consulting, retirement and severance agreements proposed for the Company s executive officers; and ensuring appropriate oversight of the Company s human resources policies and reviewing strategies established to fulfill the Company s ethical, legal and human resources responsibilities.

In 2006, the Compensation Committee reviewed and approved the total compensation package for Richard Ru Gin Chang, who is the President and Chief Executive Officer of the Company and an Executive Director, as well as that of the other members of the management team of the Company. Based on the Compensation Committee s review of the Company s corporate goals for 2006 and comparable total compensation packages for presidents and chief executive officers of other publicly-listed companies in the same or a similar industry, the Compensation Committee awarded Richard Ru Gin Chang an emolument of US$348,968. In 2005, the Compensation Committee granted Dr. Chang fifteen million (15,000,000) options to purchase ordinary shares under the 2004 Stock Option Plan and awarded him two million (2,000,000) RSUs under the 2004 Equity Incentive Plan. As of December 31, 2006, none of such options have been exercised and 50% of such RSUs have vested.

On September 29, 2006, the Board granted to each Director an option to purchase 500,000 ordinary shares at a price per ordinary share of US$0.132. These options will be vested as to 50% on May 30, 2007 and as to 50% on May 30, 2008, and both options will expire on the earlier of September 29, 2016 or 120 days after termination of the director s service to the Board. Mr. Fang Yao and Mr. Jiang Shang Zhou have declined such option.

On September 29, 2006, the Board granted to Dr. Albert Y. C. Yu 500,000 Restricted Share Units. Shares under the Restricted Share Units are to be automatically vested as to 50% per year starting from May 30, 2007.

On November 10, 2004, the Board granted to each independent Non-executive Director and Non-executive Director, an option to purchase 500,000 ordinary shares at a price per ordinary share of US$0.22. These options were fully vested on March 19, 2005 and will expire on November 9, 2009. As of December, 31, 2006, these options have not been exercised. Lai Xing Cai (who resigned as an Non-executive Director on February 6, 2006) has declined such option. The option granted to Mr. Yen-Pong Jou (who retired as an Independent Non-executive Director at the annual general meeting held on May 30, 2006) lapsed and cancelled on September 27, 2006.

In addition to reviewing the remuneration of the Non-executive Directors and the members of the Company s management, the Compensation Committee reviewed:

(i) the remuneration policy for employees for the fiscal year 2006;

(ii) the profit-sharing and bonus policies;

(iii) the long term compensation strategy, including a review of the issuance of the shares under the Option Plans;

(iv) the accounting treatment and financial implications of the employees share options under U.S. GAAP; and

(v) the attrition rate.

The Compensation Committee reports its work, findings and recommendations to the Board during each quarterly Board meeting.

The Compensation Committee meets in person at least on a quarterly basis and on such other occasions as may be required to discuss and vote upon significant issues affecting the compensation policy of the Company. The meeting schedule for a year is planned in the preceding year. The Company Secretary assists the chairman of the Compensation Committee in preparing the agenda for meetings and assists the Compensation Committee in complying with the relevant rules and regulations. The relevant papers for the Compensation Committee meeting were dispatched to Compensation Committee members in accordance with the CG Code. Members of the Compensation Committee may include matters for discussion in the agenda if the need arises. Upon the conclusion of the Compensation Committee meeting, minutes are circulated to the members of the Compensation Committee for their comment and review prior to their approval of the minutes at the following or a subsequent Compensation Committee meeting.

During the year ended December 31, 2006, the Compensation Committee held a total of five (5) meetings. Details of Directors attendance at the Compensation Committee are set forth below:

| | Number of Meetings Attended | Attendance Rate |
|---|---|---|
| Ta-Lin Hsu | 5/5 | 100% |
| Tsuyoshi Kawanishi | 4/5 | 80% |
| Lip-Bu Tan | 5/5 | 100% |
| Average Attendance Rate | | 93% |

**Audit Committee**

As of December 31, 2006, the members of the Audit Committee were Henry Shaw (co-chairman of Audit Committee), Lip-Bu Tan (co-chairman of Audit Committee) and Yang Yuan Wang. None of these members of the Audit Committee has been an executive officer or employee of the Company or any of its subsidiaries. See Connected Transactions for a description of transactions between the Company and the members of the Audit Committee. In addition to acting as Audit Committee member of the Company, Mr. Lip-Bu Tan, one of the members of the Audit Committee, currently also serves on the audit committee of three other publicly traded companies, namely SINA Corporation, Flextronics International Ltd. and Integrated Silicon Solution, Inc. In general and in accordance with section 303A.07(a) of the Listed Company Manual of the New York Stock Exchange, the Board considered and determined that such simultaneous service would not impair the ability of Mr. Tan to effectively serve on the Company s Audit Committee.

The responsibilities of the Audit Committee include, among other things:

- making recommendations to the Board concerning the appointment, reappointment, retention, evaluation, oversight and termination of compensating and overseeing the work of the Company s independent auditor, including reviewing the experience, qualifications and performance of the senior members of the independent auditor team and pre-approving all non-audit services to be provided by the Company s independent auditor;

approving the remuneration and terms of engagement of the Company s independent auditor;

reviewing reports from the Company s independent auditor regarding its internal quality-control procedures and any material issues raised in the most recent review or investigation of such procedures and regarding all relationships between the Company and the independent auditor;

pre-approving the hiring of any employee or former employee of the Company s independent auditor who was a member of the audit team during the preceding two years;

reviewing the Company s annual and interim financial statements, earnings releases, critical accounting policies and practices used to prepare financial statements, alternative treatments of financial information, the effectiveness of the Company s disclosure controls and procedures and important trends and developments in financial reporting practices and requirements;

reviewing the planning and staffing of internal audits, the organization, responsibilities, plans, results, budget and staffing of the Company s Internal Audit Department (as defined and discussed below) and the quality and effectiveness of the Company s internal controls;

reviewing the Company s risk assessment and management policies;

reviewing any legal matters that may have a material impact and the adequacy and effectiveness of the Company s legal and regulatory compliance procedures;

establishing procedures for the treatment of complaints received by the Company regarding accounting, internal accounting controls, auditing matters, potential violations of law and questionable accounting or auditing matters; and

obtaining and reviewing reports from management, the Company s internal auditor and the Company s independent auditor regarding compliance with applicable legal and regulatory requirements.

During 2006, the Audit Committee reviewed:

the financial reports for the year ended December 31, 2005 and the six month period ended June 30, 2006;

the quarterly earnings releases and any updates thereto;

the report and management letter submitted by the Company s outside auditors summarizing the findings of and recommendations from their audit of the Company s fi nancial reports;

the Company s budget for 2006;

the findings and recommendations of the Company s outside consultants regarding the Company s compliance with the requirements of the Sarbanes-Oxley Act of 2002 (the Sarbanes-Oxley Act );

the effectiveness of the Company s internal control structure in operations, financial reporting integrity and compliance with applicable laws and regulations in collaboration with the Internal Audit Department;

the findings of the Company s Risk Management Committee (as defined and discussed below) which assesses risks relating to the Company and the compliance office, which ensures compliance with the CG Code and Insider Trading Policy;

the audit fees and other non-audit fees such as fees relating to transfer pricing, Sarbanes-Oxley compliance testing, for the Company s outside auditors; and

the Company s outside auditors engagement letters.

The Audit Committee reports its work, findings and recommendations to the Board during each quarterly Board meeting.

The Audit Committee meets in person at least on a quarterly basis and on such other occasions as may be required to discuss and vote upon significant issues affecting the audit policy of the Company. The meeting schedule for a year is planned in the preceding year. The Company Secretary assists the co-chairmen of the Audit Committee in preparing the agenda for meetings and assists the Compensation Committee in complying with the relevant rules and regulations. The relevant papers for the Audit Committee meetings were dispatched to the Audit Committee in accordance with the CG Code. Members of the Audit Committee may include matters for discussion in the agenda if the need arises. Upon the conclusion of the Audit Committee meeting, minutes are circulated to the members of the Audit Committee for their comment and review prior to their approval of the minutes at the following or a subsequent Audit Committee meeting.

During the year ended December 31, 2006, the Audit Committee held a total of eight (8) meetings. Details of Directors attendance at the Audit Committee are set forth below:

| | **Number of Meetings Attended** | **Attendance Rate** |
|---|---|---|
| Henry Shaw | 8/8 | 100% |
| Lip-Bu Tan(1) | 8/8 | 100% |
| Yang Yuan Wang(2) | 8/8 | 100% |
| Average Attendance Rate | | 100% |

(1) 1 of these meetings was attended by proxy

(2) 4 of these meetings were attended by proxy

At each quarterly Audit Committee meeting, the Audit Committee reviews with the Acting Chief Financial Officer and the Company s outside auditors, the financial statements for the financial period and the financial and accounting principles, policies and controls of the Company and its subsidiaries. In particular, the Committee discusses (i) the changes in accounting policies and practices, if any; (ii) the going concern assumptions, (iii) compliance with accounting standards and applicable rules and other legal requirements in relation to financial reporting and (iv) the internal controls of the Company relating to financial reporting. Upon the recommendation of the Audit Committee, the Board will approve the financial statements.

*Auditors Remuneration*

The following table sets forth the aggregate audit fees, Sarbanes-Oxley compliance testing fee, audit-related fees, tax fees and all other fees we paid or incurred for audit services, audit-related services, tax services and other services rendered by our principal accountants during the fiscal year ended December 31, 2006.

| | **2006** |
|---|---|
| Audit Fees | $ 1,460,000 |
| Audit-Related Fees | |
| Tax Fees | $ 33,789 |
| All Other Fees | $ 85,597 |
| Total | $ 1,579,386 |

*Internal Controls*

In June 2004, the Public Company Accounting Oversight Board, or PCAOB, adopted rules for purposes of implementing Section 404 of the Sarbanes-Oxley Act. Pursuant to the Sarbanes-Oxley Act and the various rules and regulations adopted pursuant thereto or in conjunction therewith, the Company is required to perform, on an annual basis, an evaluation of the Company s internal controls over financial reporting and, beginning in fiscal year 2006, to include management s assessment of the effectiveness of the Company s internal controls over financial reporting in the Company s annual report on Form 20F to be filed with the United States Securities and Exchange Commission. Beginning in fiscal year 2006, the Company s external auditors are required to attest to such assessment.

The Board, through the Audit Committee which receives reports on at least a quarterly basis from the Internal Audit Department, is responsible to ensure that the Company maintains sound and effective internal controls. The Company s system of internal control is designed to ensure the achievement of business objectives in operations, financial reporting integrity and compliance with applicable laws and regulations. The system of internal control is designed to manage, rather than completely eliminate, risks impacting the Company s ability to achieve its business objectives. Accordingly, the system can only provide reasonable but not absolute assurance that the financial statements do not contain a material misstatement or loss.

The Company assists the Board with respect to its duty to identify, evaluate, and manage the significant risks faced by the Company. The Company implements the Board s policies and procedures to mitigate such risks by (i) identifying and assessing the risks the Company faces and (ii) designing, operating and monitoring a system of internal controls to mitigate and control such risks. The Company has established an Internal Audit Department and the Risk Management Committee and other policies and procedures, for such purposes.

**Internal Audit Department**

Internal Audit Department works with and supports the Company s management team and the Audit Committee to evaluate and contribute to the improvement of risk management, control, and governance systems. On an annual basis, the Audit Committee will review and approve an annual internal audit plan, which is based on a risk assessment methodology, which assists in determining business risks and establishing appropriate audit frequencies.

Based on this annual audit plan, the Internal Audit Department will audit the practices, procedures, expenditure and internal controls of the various departments in the Company. The scope of the audit includes:

- reviewing management s control to ensure the reliability and integrity of financial and operating information and the means used to identify, measure, classify, and report such information;
- reviewing the systems established or to be established to ensure compliance with policies, plans, procedures, laws, and regulations that could have a significant impact on operations and reports, and determining whether the Company is in compliance;
- reviewing the means of safeguarding assets and, when appropriate, verifying the existence of assets;
- appraising the economy and efficiency with which resources are employed;
- identifying significant risks to the ability of the Company to meet its business objectives, communicating them to management and ensuring that management has taken appropriate action to guard against those risks; and
- evaluating the effectiveness of controls supporting the operations of the Company and providing recommendations as to how those controls could be improved.

In addition, the Internal Audit Department will audit areas of concern identified by the Risk Management Committee or conduct reviews and investigations on an ad hoc basis. In conducting these audits, the Internal Audit Department has free and full access to all necessary functions, records, properties and personnel.

After completing an audit, the Internal Audit Department furnishes the Company s management team with analysis, appraisals, recommendations, counsel, and information concerning the activities reviewed. Appropriate managers of the Company will be notified of any deficiencies cited by the Internal Audit Department, which will follow up with the implementation of audit recommendations. In addition, the Internal Audit Department will report their findings directly to the Audit Committee on at least a quarterly basis.

The Internal Audit Department has direct access to the Board through the co-chairmen of the Audit Committee. The Internal Audit Department may upon request meet privately with the Audit Committee, without the presence of members of the Company s management or the independent accounting firm. The Internal Audit Department consists of members of the Company s management team.

**Risk Management Committee**

The Risk Management Committee identifies, analyzes, and assesses enterprise-wide risks, monitors the Company s risk management efforts, and reports on the effectiveness of the Company s enterprise risk management programs. The Risk Management Committee is responsible for developing the Company s risk management strategy; establishing, reviewing, and approving policies and procedures to control risks as well as to prevent fraud; determining risk tolerances for measurement; preparing a risk management implementation plan and assigning responsibilities; and designing and preparing education and awareness programs and its implementation plans. Such risks can include without limitation, legal risks, credit risks, market risks, operational risks, environmental risks, and systemic risks. The Risk Management Committee consists of members of the Company s management team, including three executive officers of the Company.

The Risk Management Committee reports to the Chief Executive Officer periodically, and to the Audit Committee on a quarterly basis. If requested, the chair of the Risk Management Committee will report to the Board on major issues of the enterprise risk management programs.

The Board, through the Audit Committee, has reviewed the effectiveness of the Company s system of internal control and believes that the system of internal controls in place at December 31, 2006 and at the date of this annual report, is effective and adequate.

**Disclosure Committee**

The Disclosure Committee oversees all information disseminated by the Company, including regulatory filings and submissions made pursuant to the Exchange Act or the Listing Rules, being properly recorded, processed, summarized, and reported to the management of the Company to allow timely decisions regarding the required disclosure. Accordingly, the Disclosure Committee has established a disclosure policy and procedure, which establishes the procedures for the handling and disseminating of price-sensitive information.

With respect to the Company s periodic filings pursuant to the Exchange Act or the Listing Rules, the Disclosure Committee identifies and communicates the extent and nature of all disclosures to be made in such filings, reviews the filings, with a particular focus on Management s Discussion and Analysis of Financial Conditions and Results of Operations ; reviews and discusses with the Chief Financial Officer whether the Company s filings provide a fair representation of the Company s financial condition, results of operation, and cash flows, assesses the materiality of specific events and developments to the Company; and reviews financial reporting issues that are significant to the Company and other material reporting matters.

The Disclosure Committee consists of members of the Company s management team, including two executive officers of the Company.

**Compliance Office**

The Compliance Office monitors the Company s compliance under applicable corporate governance laws and regulations. In particular, the Compliance Office monitors and implements the Company s anti-fraud policy and investigates any reported cases of breach; and monitors the Company s compliance with the Code of Business Conduct and Ethics (as described and defined below) and the Insider Trading Policy. The anti-fraud policy sets forth the Company s policy regarding the prevention, detection and management of fraud and fair dealing in matters pertaining to fraud. The Company has established an email address for the Compliance Officers and the Audit Committee, dedicated to respond to any allegations of fraud and breaches of the Code of Business Conduct and Ethics or the Insider Trading Policy of the Company. The Code of Business Conduct and Ethics provides employees with guidelines pertaining to proper behavior in the workplace and appropriate representation of the Company when outside the workplace. The Insider Trading Policy sets forth the policy and procedures governing the dealing in the Company s securities by employees, including the Chief Executive Officer and members of the Company s management, and members of the Board (and their associates).

On at least a quarterly basis, the Compliance Office will report to the Audit Committee regarding any breaches of any of these policies.

The Compliance Office consists of members of the Company s management team, including an executive officer of the Company

*Shareholder Rights*

The Company s shareholders may put forth proposals at an annual general meeting of the Company s shareholders by written notice of those proposals being submitted by shareholders, addressed to the Company Secretary at the principal executive offices of the Company. In order for a shareholder to put a proposal before the Company s shareholders, such shareholder must (a) be a member of record on both the date of giving of the notice by such shareholder and the record date for the determination of members entitled to vote at such meeting and (b) comply with the notice requirements, in each case, as specified in the Articles. The notice requirements include requirements regarding the timing of delivery of the notice as well as the contents of such notice. The detailed procedures for the notice requirements vary depending on whether the proposal constitutes an ordinary resolution or a special resolution or whether the proposal relates to a nomination for election of a Director. The procedures for shareholders to put forward proposals at an annual general meeting are available upon request of the Company Secretary.

Enquiries may be submitted to the Board by contacting either the Company Secretary at the principal executive offices of the Company or directly by questions at an annual general meeting or an extraordinary general meeting. Questions on the procedures for putting forward proposals at an annual general meeting may also be put to the Company Secretary by the same means.

*Shareholder Communications and Investor Relations*

The Company and the Board recognizes the importance of maintaining open and frequent communications with its shareholders. At the 2006 AGM, the President of the Company, as well as the Company s outside auditors, were present to answer questions from the shareholders. Together with this annual report, an annual general meeting circular is distributed to all shareholders within the prescribed time period required by the Listing Rules, notifying the shareholders about the AGM. The circular and the accompanying materials set forth the procedures for demanding and conducting a poll, including applicable notice requirements, and other relevant information relating to the proposed resolutions. Separate resolutions are proposed at these annual general meetings on each substantially separate issue, including the election of individual Directors. The Chairman reveals how many proxies for and against have been filed in respect to each resolution. The results of the poll are published in newspapers with circulation in Hong Kong and on the web sites of the Company and HKSE.

On the first business day after the 2006 AGM, which was held on May 30, 2006 at the Company s headquarters in Shanghai, China, the results of the poll were published in two newspapers with circulation in Hong Kong and on the web sites of the Company and HKSE. During the 2006 AGM, the Company s shareholders:

- received and considered the audited financial statements and the reports of the Directors and Auditors of the Company for the year ended December 31, 2005;
- elected Albert Y. C. Yu as Class I Director to hold office until 2008 AGM and authorized the Board to fix his remuneration;
- re-elected Ta-Lin Hsu and Lip-Bu Tan as Class II Directors and elected Jiang Shang Zhou as Class II Director for terms of three years and authorised the Board to fix their remuneration;
- re-elected Fang Yao as Class III Director to hold office until 2007 AGM and authorised the Board to fi x his remuneration;
- re-elected Deloitte Tohmatsu as Auditors of the Company and authorised the Audit Committee to fix their remuneration;
- approved the general mandate to Directors to allot, issue, grant, distribute, and otherwise deal with additional shares in the Company not exceeding 20% of the issued share capital of the Company as of the date of the 2006 AGM;
- approved the general mandate to Directors to repurchase shares in the Company not exceeding 10% of the issued share capital of the Company as of the date of the 2006 AGM;
- approved amendments to the 2004 Stock Option Plan;
- approved amendments to the 2004 EIP;

approved amendments to the 2004 ESPP; and

approved a standard form of stock option plan for subsidiaries of the Company.

A key element of effective communication with shareholders and investors is the timely dissemination of information relating to the Company. In addition to announcing annual and interim reports, the Company announces its quarterly financial results approximately one month after the end of each quarter. In connection with such announcement, the Company holds conference calls which are open and available to the Company s shareholders. During these conference calls, the President and Chief Executive Officer and the Acting Chief Financial Officer report about the latest developments in the Company and answer questions from participants. The members of the Company s Investor Relations Department and senior members of the Company s management also hold regular meetings with equity research analysts and other institutional shareholders and investors.

In addition to the 2006 AGM and the above referenced conference calls, the Company s shareholders were invited to gatherings in Hong Kong to meet members of the management of the Company.

A table setting forth information regarding the beneficial ownership as of December 31, 2006 of the ordinary shares, of each shareholder who is known by the Company to beneficially own more than 5% of the Company s outstanding shares, is contained on page 51.

The market capitalization of the Company as of December 31, 2006 was HK$18,617,084,027.6 (issued share capital of 18,432,756,463 ordinary shares at the closing market price of HK$1.01 per ordinary share). The public float as of such date was approximately 84.59%.

The AGM is scheduled to be held at the Company s headquarters at 18 Zhangjiang Road, PuDong New Area, Shanghai, China 201203 on May 23, 2007 at 3:00 p.m. All shareholders are invited to attend.

*Code of Business Conduct and Ethics*

The Board has adopted a code of business conduct and ethics (the Code of Conduct ) which provides guidance about doing business with integrity and professionalism. The Code of Conduct addresses issues including among others, fraud, conflicts of interest, corporate opportunities, protection of intellectual property, transactions in the Company s securities, use of the Company s assets, and relationships with customers and third parties. Any violation of the Code of Conduct is reported to the Compliance Office, which will subsequently report such violation to the Audit Committee.

*US Corporate Governance Practices*

Companies listed on the New York Stock Exchange must comply with certain corporate governance standards under Section 303A of the New York Stock Exchange Listed Company Manual. However, foreign private issuers such as the Company are permitted to follow home country practices in lieu of the provisions of Section 303A, except that such companies are required to comply with the rules relating to the audit committee. Please refer to the following website at http:/www.smics.com/website/enVersion/IR/ corporateGovernance.htm for a summary of the significant differences between the Company s corporate governance practices and those required of U.S. companies under New York Stock Exchange listing standards.

## Social Responsibility

*Social Responsibility at SMIC*

SMIC in the Community

SMIC has a tradition of supporting the communities in which we operate, both through the involvement of our employees and through philanthropic donations. SMIC has built extensive housing, education, and service communities near our manufacturing sites and has significantly helped the local communities to grow and prosper with us.

**Support for Education**

In addition to building kindergartens and schools for our employee s children, SMIC is also dedicated to support education initiatives in impoverished areas in China. SMIC s Chief Executive Officer, Dr. Richard Chang has helped to build dozens of schools in China s inland provinces such as Yunnan and Gansu. SMIC also has supported Enyou Foundation s Teacher Training Program for the past three years. SMIC provides accommodations, classrooms, volunteer teachers and staff, and other facilities in support of this training program aimed to empower rural educators with modernized teaching skills, methodologies and know-how.

**Support for the Environment**

As a reflection of SMIC s dedication to protecting the environment, SMIC achieved ISO14001 certification from the British Standards Institute in 2002. The ISO14001 is a voluntary international standard that establishes requirements for a world-class environmental management system. With this system in place, SMIC can ensure its responsible use of energy and materials through improvements in recycling, waste reduction and pollution prevention.

SMIC goes through great lengths to recycle, reduce, and reuse energy and materials used in our manufacturing facilities and offices. Our manufacturing plants feature state of the art water recycling systems in which we have multiple applications to recycle and reuse wastewater. At every fab, we have wastewater treatment plants and up to 70% of wastewater can be recycled back into the fabs. The rest of the wastewater is reused in our office toilets and sprinkler systems. At our wafer fab in Beijing, we have large rain water collection facilities as well as air cooling systems to take advantage of the cold air in the winter to help cool the manufacturing facilities through renewable resources. In all office buildings, recycling bins are strategically located near bathrooms, walkways, and cafeterias to promote employee participation in recycling waste materials.

SMIC s core belief in renewable energy is embedded directly in the future direction of our business as evidenced by our Fab 10 that is used to manufacture solar cell panels and modules. We believe that not only the solar power market will be beneficial to our business, but more importantly, we believe that we can contribute in aiding the migration to renewable energy sources through technological advances, increase in manufacturing capacity, and reduction of manufacturing costs.

**Employee Well-Being**

At SMIC, we focus on quality control and product innovation while placing emphasis on preventing environmental pollution, conserving energy and natural resources, protecting our human resources, and preventing property loss. We hope to improve employee well-being, protect the environment, and raise environmental protection, safety, and health ( ESH ) standards for all SMIC employees and the environment we operate in. Through continuous improvement, we strive to be environmentally responsible and aim to strengthen our operational risk management.

To achieve these goals, SMIC is committed to:

- ensuring employee health and safety and improving environmental quality for employees and lands we operate are the primary responsibilities of every SMIC manager;
- establishing a culture of ownership by distilling ESH values into each SMIC employee, process, product, and service;
- providing regular ESH training to increase employees knowledge and communication levels;
- exploring and developing new technologies to reclaim, reduce, reuse and recycle;
- following ESH regulations and international protocols while fulfilling customer requirements;
- strengthening new equipment and material auditing and change-management;
- communicating ESH regulations to all SMIC suppliers and contractors; and
- implementing preventative measures and emergency response capabilities to prevent accidents.

**Employee Health & Safety**

SMIC s safety management philosophy is based on accident prevention and frequent safety audits. Accident prevention is achieved through:

mandatory staff and vendor safety training;

compliance of equipment and facilities to international safety standards set by: Semiconductor Equipment and Materials International (SEMI), National Fire Protection Association (NFPA) and Factory Mutual Research Corporation (FMRC);

continuous improvement in service and product quality and reliability through the implementation of our PDCA (plan, do, check, act) steps, together with internal and external customer feedback;

regularly scheduled safety audits that are performed in accordance with established world standards to achieve an AAA audit rating, OHSAS18001 internal audit, and self-check rules; and

establishment of the Emergency Response Center to centralize emergency response at SMIC.

At SMIC, we provide occupational health and hygiene management for the welfare of our employees. This includes the monitoring of indoor air quality (IAQ), illumination, radiation, noise, and drinking water.

In addition, we have on-site health surveillance and primary care services such as:

- 24-hour on-site health center services;
- medical emergency response & disaster planning;
- occupational physical examination and record keeping;
- general physical examination and record keeping;
- injury and illness case management;
- vaccination services; and
- international travel health program.

**OHSAS18001 Certification**

SMIC attained OHSAS18001 (Occupation Health and Safety Assessment Series) certification from the British Standard Institute in September 2003. The OHSAS18001 standard is a key component of a corporation s total health and safety management, and is based on international safety and health standards. It aims to reduce work environment risks, protect company assets, and provide employees a safer and healthier working environment.

With this certification, SMIC has achieved a new milestone in safety and risk management. By creating a safer and healthier environment for our employees, it exemplifies to our customers and investors that we are dedicated to lowering risk and building confidence and demonstrates our spirit of continuous development and improvement .

**Employee Care**

In addition to health and safety considerations for our employees, SMIC is also keen on taking care of our employees through on the job training and graduate degree opportunities, on-campus housing, social clubs and activities, employee athletic and recreational facilities, primary and secondary education for employee children, and numerous other facilities and services dedicated to enriching the lives of our employees and their families.

Some notable facilities and programs include:

- graduate education and degree programs with Tongji University, Jiaotong University, Fudan University, and Shanghai University;
- more than 500 training classes offered within the Company annually;
- the Company s living quarters features top-quality apartments and houses built by SMIC and rented or purchased by its employees;
- recreation facilities include: swimming pools, in-door gymnasiums, lighted tennis courts, 400m rubberized track, multi-use athletic fields, sauna rooms, ping-pong tables, pool tables, etc.;
- on-campus services: hair salon, massage parlor, supermarket, restaurants, cafes, bookstore, bakery, etc.;
- SMIC Private School: K-12 bilingual education on par with some of the leading international schools in Shanghai;
- SMIC Sports Day features a number of organized games and athletic competitions among SMIC employees and departments. The day is designed to foster teamwork and cooperation between a wide range of employees who might have not worked together on a daily basis;
- Senior Citizen Club: established to care for senior members of the SMIC family by providing arts and craft activities, field trips, support groups and other recreational and educational activities; and
- Sports and Recreation Clubs: A number of clubs encouraging a healthy and active lifestyle. For example the SMIC Triathlon Club sends employee-athletes to a variety of events, ranging from the Shanghai International Marathon to triathlons to local road races.

*Report by Management on Internal Control over Financial Reporting*

The management of Semiconductor Manufacturing International Corporation ( SMIC ) is responsible for establishing and maintaining adequate internal control over financial reporting. SMIC s internal control system was designed to provide reasonable assurance to our management and board of directors regarding the reliability of financial reporting and the preparation and fair presentation of financial statements issued for external purposes in accordance with generally accepted accounting principles.

All internal control systems, no matter how well designed, have inherent limitations and may not prevent or detect misstatements. Therefore, even those systems determined to be effective can only provide reasonable assurance with respect to financial reporting reliability and financial statement preparation and presentation.

SMIC management assessed the effectiveness of internal control over financial reporting as of December 31, 2006. In making this assessment, we used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria) in *Internal Control Integrated Framework*. Based on our assessment we believe that, as of December 31, 2006, our internal control over financial reporting is effective based on the COSO criteria.

SMIC s independent registered public accounting firm, Deloitte Touche Tohmatsu, has issued an audit report on our assessment of internal control over financial reporting, which immediately follows this report.

March 29, 2007

## Report of Independent Registered Public Accounting Firm

**To the Stockholders of Semiconductor Manufacturing International Corporation:**

We have audited the accompanying consolidated balance sheets of Semiconductor Manufacturing International Corporation and its subsidiaries (the Company ) as of December 31, 2006, 2005 and 2004 and the related consolidated statements of operations, stockholders equity and comprehensive income (loss), and cash flows for each of the three years in the period ended December 31, 2006. We also have audited management s assessment, included in the accompanying *Report by Management on Internal Control over Financial Reporting*, that the Company maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company s management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on these consolidated financial statements, an opinion on management s assessment, and an opinion on the effectiveness of the Company s internal control over financial reporting 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 and whether effective internal control over financial reporting was maintained in all material respects. Our audit of financial statements included 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, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, evaluating management s assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

As discussed in Note 3(v) to the financial statements, in 2006 the Company changed its method of accounting for share-based compensation to conform to Statement of Financial Accounting Standard No. 123 (R), Share-Based Compensation , and recorded a cumulative effect of a change in accounting principle.

As discussed in Note 31, the consolidated financial statements as of and for the years ended December 31, 2005 and 2004 have been restated.

A company s internal control over financial reporting is a process designed by, or under the supervision of the company s principal executive and principal financial officers, or persons performing similar functions, and effected by the company s board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with the authorization of Management and Directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls my become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2006, 2005 and 2004 and the results of its operations and cash flows for each of the three years in the period ended December 31, 2006, in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, management s assessment that the Company maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Furthermore, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

**Deloitte Touche Tohmatsu**

*Certified Public Accountants*

Hong Kong

April 24, 2007

## Consolidated Balance Sheets

(In US dollars, except share data)

| | Notes | 2006 | December 31, 2005 (As Restated, see Note 31) | 2004 (As Restated, see Note 31) |
|---|---|---|---|---|
| **ASSETS** | | | | |
| Current assets: | | | | |
| Cash and cash equivalents | | **$ 363,619,731** | $ 585,796,887 | $ 607,172,570 |
| Short-term investments | 6 | **57,950,603** | 13,795,859 | 20,364,184 |
| Accounts receivable, net of allowances of $4,048,845 in 2006, $1,091,340 in 2005 and $1,105,165 in 2004 | 5 | **252,184,975** | 241,333,914 | 169,188,287 |
| Inventories | 7 | **275,178,952** | 191,237,636 | 144,017,852 |
| Prepaid expense and other current assets | | **20,766,945** | 9,810,591 | 12,842,994 |
| Receivable for sale of manufacturing equipments | | **70,544,560** | 5,490,000 | |
| Assets held for sale | 8 | **9,420,729** | | 1,831,972 |
| Total current assets | | **1,049,666,495** | 1,047,464,887 | 955,417,859 |
| Land use rights, net | 9 | **38,323,333** | 34,767,518 | 39,197,774 |
| Plant and equipment, net | 10 | **3,244,400,822** | 3,285,631,131 | 3,311,924,599 |
| Acquired intangible assets, net | 11 | **71,692,498** | 80,667,737 | 77,735,299 |
| Deferred cost, net | 24 | **94,183,034** | 117,728,792 | |
| Equity investment | 12 | **13,619,643** | 17,820,890 | |
| Other long-term prepayments | | **4,119,433** | 2,552,407 | |
| Deferred tax assets | 17 | **25,286,900** | | |
| TOTAL ASSETS | | **$ 4,541,292,158** | $ 4,586,633,362 | $ 4,384,275,531 |
| **LIABILITIES AND STOCKHOLDERS EQUITY** | | | | |
| Current liabilities: | | | | |
| Accounts payable | 13 | **$ 309,129,199** | $ 262,318,432 | $ 364,333,613 |
| Accrued expenses and other current liabilities | | **97,121,231** | 92,916,030 | 76,399,187 |
| Short-term borrowings | 15 | **71,000,000** | 265,481,082 | 91,000,000 |
| Current portion of promissory note | 14 | **29,242,001** | 29,242,001 | |
| Current portion of long-term debt | 15 | **170,796,968** | 246,080,580 | 191,986,372 |
| Income tax payable | | **72,417** | | 152,000 |
| Total current liabilities | | **677,361,816** | 896,038,125 | 723,871,172 |

Consolidated Balance Sheets

(In US dollars, except share data)

| | Notes | 2006 | December 31, 2005 (As Restated, see Note 31) | 2004 (As Restated, see Note 31) |
|---|---|---|---|---|
| Long-term liabilities: | | | | |
| Promissory note | 14 | **77,601,657** | 103,254,436 | |
| Long-term debt | 15 | **719,570,905** | 494,556,385 | 544,462,074 |
| Long-term payables relating to license agreements | 16 | **16,992,950** | 24,686,398 | |
| Other long term liabilities | | **3,333,333** | | |
| Deferred tax liabilities | 17 | **210,913** | | |
| Total long-term liabilities | | **817,709,758** | 622,497,219 | 544,462,074 |
| Total liabilities | | **1,495,071,574** | 1,518,535,344 | 1,268,333,246 |
| Commitments | 21 | | | |
| Minority interest | | **38,800,666** | 38,781,863 | |
| Stockholders equity: | | | | |
| Ordinary shares, $0.0004 par value, 50,000,000,000 authorised in 2006, 2005 and 2004, shares issued and outstanding 18,432,756,463 in 2006, 18,301,680,867 in 2005 and 18,232,179,139 in 2004, respectively | 18 | **7,373,103** | 7,320,673 | 7,292,872 |
| Warrants | 19 | **32,387** | 32,387 | 32,387 |
| Additional paid-in capital | | **3,288,733,078** | 3,291,407,448 | 3,289,724,885 |
| Notes receivable from stockholders | 19 | | | (391,375) |
| Accumulated other comprehensive income | | **91,840** | 138,978 | 387,776 |
| Deferred share-based compensation | | | (24,881,919) | (51,177,675) |
| Accumulated deficit | | **(288,810,490)** | (244,701,412) | (129,926,585) |
| Total stockholders equity | | **3,007,419,918** | 3,029,316,155 | 3,115,942,285 |
| **TOTAL LIABILITIES AND STOCKHOLDERS EQUITY** | | **$ 4,541,292,158** | $ 4,586,633,362 | $ 4,384,275,531 |
| Net current assets | | **$ 372,304,679** | $ 151,426,762 | $ 231,546,687 |
| Total assets less current liabilities | | **$ 3,863,930,342** | $ 3,690,595,237 | $ 3,660,404,359 |

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

## Consolidated Statements of Operations

(In US dollars, except share data)

| | Notes | 2006 | Year ended December 31, 2005 (As Restated, see Note 31) | 2004 (As Restated, see Note 31) |
|---|---|---|---|---|
| Sales | 22 | **$ 1,465,322,867** | $ 1,171,318,735 | $ 974,664,696 |
| Cost of sales | 2 | **1,338,155,004** | 1,105,133,544 | 716,225,372 |
| Gross profit | | **127,167,863** | 66,185,191 | 258,439,324 |
| Operating expenses and income: | | | | |
| Research and development | 2 | **94,170,750** | 78,865,306 | 74,113,116 |
| General and administrative | 2 | **47,364,533** | 35,700,768 | 54,038,382 |
| Selling and marketing | 2 | **18,231,048** | 17,713,228 | 10,383,794 |
| Litigation settlement | 24 | | | 16,694,741 |
| Amortization of acquired intangible assets | 2 | **24,393,561** | 20,946,051 | 14,368,025 |
| Income from sale of plant and equipment and other fixed assets | 10 | **(43,121,929)** | | |
| Total operating expenses (income), net | | **141,037,963** | 153,225,353 | 169,598,058 |
| (Loss) income from operations | 27 | **(13,870,100)** | (87,040,162) | 88,841,266 |
| Other income (expense): | | | | |
| Interest income | | **14,916,323** | 11,355,972 | 10,587,244 |
| Interest expense | | **(50,926,084)** | (38,784,323) | (13,697,894) |
| Foreign currency exchange (loss) gain | | **(21,912,234)** | (3,355,279) | 8,217,567 |
| Others, net | | **1,821,337** | 4,461,925 | 2,441,057 |
| Total other (expense) income, net | | **(56,100,658)** | (26,321,705) | 7,547,974 |
| (Loss) income before income tax | | **(69,970,758)** | (113,361,867) | 96,389,240 |
| Income tax credit (expense) | 17 | **24,927,744** | (284,867) | (186,044) |
| Minority interest | | **(18,803)** | 251,017 | |
| Loss from equity investment | 12 | **(4,201,247)** | (1,379,110) | |
| Net (loss) income before cumulative effect of a change in accounting principle | | **(49,263,064)** | (114,774,827) | 96,203,196 |
| Cumulative effect of a change in accounting principle | 3 | **5,153,986** | | |

Consolidated Statements of Operations

(In US dollars, except share data)

| | Notes | 2006 | Year ended December 31, 2005 (As Restated, see Note 31) | 2004 (As Restated, see Note 31) |
|---|---|---|---|---|
| Net (loss) income | | **$ (44,109,078)** | $ (114,774,827) | $ 96,203,196 |
| Deemed dividends on preference shares | 29 | | | 18,839,426 |
| (Loss) income attributable to holders of ordinary shares | | **$ (44,109,078)** | $ (114,774,827) | $ 77,363,770 |
| On the basis of net loss before accounting change per share, basic | 20 | **$ (0.00)** | $ (0.01) | $ 0.01 |
| On the basis of net loss before accounting change per share, diluted | 20 | **$ (0.00)** | $ (0.01) | $ 0.00 |
| Cumulative effect of an accounting change per share, basic and diluted | 20 | **$ 0.00** | $ | $ |
| (Loss) income per share, basic | 20 | **$ (0.00)** | $ (0.01) | $ 0.01 |
| (Loss) income per share, diluted | 20 | **$ (0.00)** | $ (0.01) | $ 0.00 |
| Shares used in calculating basic (loss) income per share | 20 | **18,334,498,923** | 18,184,429,255 | 14,199,163,517 |
| Shares used in calculating diluted (loss) income per share | 20 | **18,334,498,923** | 18,184,429,255 | 17,934,393,066 |

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

## Consolidated Statements of Stockholders Equity and Comprehensive Income (Loss)

(In US dollars, except share data)

| | Preference shares | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Series A convertible shares | | Series A-1 non-convertible shares | | Series A-2 convertible shares | | Series B convertible shares | | Series C convertible shares | | Series D convertible shares | | Ordinar |
| | Share | Amount | Share | Amount | Share | Amount | Share | Amount | Share | Amount | Share | Amount | Share |
| , | 954,977,374 | 381,990 | 219,499,674 | 2,195 | 42,373,000 | 16,949 | 2,350,000 | 940 | 181,718,858 | 72,688 | 7,142,857 | 2,857 | 242,595,000 |
| d | | | | | | | | | | | 95,714,286 | 38,286 | |
| | | | | | | | | | | | 914,285 | 365 | |
| | | | | | | | 750,000 | 300 | | | | | |
| | | | | | | | 12,343 | 5 | | | | | |
| of res ng | (954,922,624) | (381,968) | | | (42,373,000) | (16,949) | (3,112,343) | (1,245) | (181,718,858) | (72,688) | (103,771,428) | (41,508) | 14,927,787,480 |
| res ng . | | | | | | | | | | | | | 3,030,303,000 |
| of | | | (219,499,674) | (2,195) | | | | | | | | | |
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| s nts | | | | | | | |
| , | $ | $ | $ | $ | $ | $ | 18,432,756,463 |

| | Warrants | Additional Paid-in capital | Subscription receivable from stockholders | Notes receivables from stockholders | Accumulated other Comprehensive income (loss) | Deferred stock compensation, net | Accumulated deficit | Total Stockholders equity | Comprehensive income (loss) |
|---|---|---|---|---|---|---|---|---|---|
| Balance at December 31, 2003 | 37,839,931 | 1,835,820,085 | (105,420,031) | (36,026,073) | 199,827 | (40,582,596) | (207,290,355) | 1,485,115,445 | (65,974,677) |
| Issuance of Series D convertible preference shares and Series D warrants to Motorola and MCEL | 27,663,780 | 308,141,738 | | | | | | 335,843,804 | |
| Issuance of Series D preference shares in exchange for software licenses | | 5,059,891 | | | | | | 5,060,256 | |
| | | 2,739,553 | | | | | | 2,739,853 | |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Issuance of series B convertible preference shares in exchange for intangible assets | | | | | | | | |
| Issuance of Series B convertible preference shares to a service provider | | 45,085 | | | | | 45,090 | |
| Conversion of preference share to ordinary shares upon initial public offering | (65,373,769) | 59,917,012 | | | | | | |
| Issuance of ordinary shares upon initial public offering (net of issuance cost of US$ 37,007,406) | | 1,015,647,030 | | | | | 1,016,859,151 | |
| Redemption of Series A-1 preference shares | | | | | | | (2,195) | |
| Shares and warrants issued to a service provider | (97,555) | 17,910 | | | | | (79,590) | |
| Issuance of ordinary shares in exchange for equipment | | 5,212,597 | | | | | 5,222,180 | |
| Exercise of stock options | | 1,590,804 | | | | | 1,599,111 | |
| Repurchase of restricted ordinary shares | | (851,592) | | | | | (856,939) | |
| Repurchase of restricted preference shares | | (60,811) | | | | | (60,833) | |
| Collection of subscription receivable from stockholders | | | 105,420,031 | | | | 105,420,031 | |
| Collection of note receivables from employees | | | | 35,634,698 | | | 35,634,698 | |
| Deferred stock compensation, net | | 37,606,157 | | | (10,595,079) | | 27,011,078 | |
| Deemed dividend on preference shares | | 18,839,426 | | | | (18,839,426) | | |
| Net income <1> | | | | | | 96,203,196 | 96,203,196 | $ 96,203,196 |

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| Foreign currency translation adjustments | | | | | 256,391 | | | 256,391 | 256,391 |
| Unrealized loss on investments | | | | | (68,442) | | | (68,442) | (68,442) |
| Balance at December 31, 2004 | 32,387 | 3,289,724,885 | | (391,375) | 387,776 | (51,177,675) | (129,926,585) | 3,115,942,285 | $ 96,391,145 |
| Net profit of a subsidiary attributable to minority interest upon injection | | (32,880) | | | | | | (32,880) | |
| Exercise of stock options | | 2,371,933 | | | | | | 2,402,180 | |
| Repurchase of restricted ordinary shares | | (96,583) | | | | | | (99,029) | |
| Collection of note receivables from employees | | | | 391,375 | | | | 391,375 | |
| Deferred stock compensation, net | | (559,907) | | | | 26,295,756 | | 25,735,849 | |
| Net loss <1> | | | | | | | (114,774,827) | (114,774,827) | $ 114,774,827) |
| Foreign currency translation adjustments | | | | | (192,246) | | | (192,246) | (192,246) |
| Unrealized loss on investments | | | | | (56,552) | | | (56,552) | (56,552) |
| Balance at December 31, 2005 | $ 32,387 | $ 3,291,407,448 | $ | $ | $ 138,978 | $ (24,881,919) | $ (244,701,412) | $ 3,029,316,155 | $ (115,023,625) |
| Exercise of stock options | | 3,912,210 | | | | | | 3,965,308 | |
| Repurchase of restricted ordinary shares | | (57,522) | | | | | | (58,190) | |
| Deferred stock compensation adjustment | | (24,881,919) | | | | 24,881,919 | | | |
| Amortization of stock compensation | | 23,506,847 | | | | | | 23,506,847 | |
| Cumulative effect of a change in accounting principle | | (5,153,986) | | | | | | (5,153,986) | |
| Net loss <1> | | | | | | | (44,109,078) | (44,109,078) | (44,109,078) |
| Foreign currency translation adjustments | | | | | (16,885) | | | (16,885) | (16,885) |
| Realized loss on investments | | | | | (30,253) | | | (30,253) | (30,253) |

| | | | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Balance at December 31, 2006 | $ | 32,387 | $ 3,288,733,078 | $ | | $ | | $ | 91,840 | $ | | $ (288,810,490) | $ 3,007,419,918 | $ | (44,156,216) |

<1> As restated. See Note 31, Restatements in the notes to consolidated financial statements for related discussions.
The accompanying notes are an integral part of these consolidated financial statements.

## Consolidated Statements of Cash Flows

(In US dollars, except share data)

| | 2006 | Year ended December 31, 2005 (As Restated, see Note 31) | 2004 (As Restated, see Note 31) |
|---|---|---|---|
| Operating activities: | | | |
| (Loss) income attributable to holders of ordinary shares | **$ (44,109,078)** | $ (114,774,827) | $ 77,363,770 |
| Less: Cumulative effect of a change in accounting principle | **(5,153,986)** | | |
| Add: Deemed dividends on preference shares | | | 18,839,426 |
| Net (loss) income | **(49,263,064)** | (114,774,827) | 96,203,196 |
| Adjustments to reconcile net (loss) income to net cash provided by operating activities: | | | |
| Minority interest | **18,803** | (251,017) | |
| Gain on disposal of plant and equipment | **(43,121,929)** | (3,001,881) | (733,822) |
| Depreciation and amortization | **919,616,493** | 769,471,853 | 456,960,522 |
| Non-cash interest expense on promissory note and long-term payable relating to license agreements | **5,702,607** | 5,395,177 | |
| Amortization of acquired intangible assets | **24,393,561** | 20,946,051 | 14,368,025 |
| Share-based compensation | **23,506,847** | 25,735,849 | 27,011,078 |
| Loss from equity investment | **4,201,247** | 1,379,110 | |
| Changes in operating assets and liabilities: | | | |
| Accounts receivable, net | **(10,851,061)** | (72,145,627) | (78,649,770) |
| Inventories | **(83,941,316)** | (47,219,784) | (74,093,973) |
| Prepaid expense and other current assets | **(8,926,442)** | (5,172,942) | 2,551,664 |
| Accounts payable | **24,705,615** | 26,425,817 | 49,235,998 |
| Accrued expenses and other current liabilities | **(14,722,249)** | 41,469,028 | 25,657,519 |
| Income tax payable | **72,417** | (152,000) | 152,000 |
| Other long term liabilities | **3,333,333** | | |
| Deferred tax assets | **(25,286,900)** | | |
| Deferred tax liabilities | **210,913** | | |
| Net cash provided by operating activities | **769,648,875** | 648,104,807 | 518,662,437 |
| Investing activities: | | | |
| Purchase of plant and equipment | **(882,580,833)** | (872,519,397) | (1,838,773,389) |
| Proceeds from government grant to purchase plant and equipment | **2,208,758** | 18,538,886 | |
| Proceeds from disposal of plant and equipment | **4,044,702** | 11,750,109 | 1,343,003 |
| Proceeds received from sale of assets held for sale | **12,716,742** | 6,434,115 | 8,215,128 |
| Purchase of acquired intangible assets | **(9,573,524)** | (11,167,883) | (7,307,996) |
| Purchase of short-term investments | **(135,058,817)** | (19,817,525) | (66,224,919) |
| Purchase of equity investment | | (19,200,000) | |
| Sale of investments held to maturity | | | 3,004,297 |
| Sale of short-term investments | **90,873,820** | 26,329,298 | 72,957,324 |
| Net cash used in investing activities | **(917,369,152)** | (859,652,397) | (1,826,786,552) |

Consolidated Statements of Cash Flows

(In US dollars, except share data)

| | Year ended December 31, 2006 | 2005 (As Restated, see Note 31) | 2004 (As Restated, see Note 31) |
|---|---|---|---|
| **Financing activities:** | | | |
| Proceeds from short-term borrowings | **255,003,999** | 394,158,994 | 91,000,000 |
| Repayment of short-term borrowings | **(449,485,081)** | (219,677,912) | |
| Repayment of note payable to stockholder for land use rights | | | (12,778,797) |
| Proceeds from long-term debt | **785,344,546** | 253,432,612 | 256,487,871 |
| Repayment of long-term debt | **(635,613,638)** | (249,244,093) | |
| Repayment of promissory note | **(30,000,000)** | (30,000,000) | (15,000,000) |
| Payment of loan initiation fee | **(3,596,938)** | | |
| Proceeds from issuance of Series D convertible preference shares | | | 30,000,000 |
| Proceeds from issuance of ordinary shares from initial public offering | | | 1,016,859,151 |
| Collection of subscription receivables, net | | | 105,420,031 |
| Proceeds from exercise of employee stock options | **3,907,118** | 2,303,151 | 681,339 |
| Collection of notes receivables from employees | | 391,376 | 35,245,774 |
| Change in deposits received from stockholders | | | (38,151,407) |
| Proceeds from minority investor (note 1) | | 39,000,025 | |
| Net cash (used in) provided by financing activities | **(74,439,994)** | 190,364,153 | 1,469,763,962 |
| Effect of exchange rate changes | **(16,885)** | (192,246) | 256,389 |
| **NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS** | **(222,177,156)** | (21,375,683) | 161,896,236 |
| CASH AND CASH EQUIVALENTS, beginning of year | **585,796,887** | 607,172,570 | 445,276,334 |
| CASH AND CASH EQUIVALENTS, end of year | **$ 363,619,731** | $ 585,796,887 | $ 607,172,570 |
| SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION: | | | |
| Income taxes paid | **$ 164,409** | $ 436,867 | $ 34,044 |
| Interest paid | **$ 46,808,533** | $ 47,113,456 | $ 20,104,223 |

Consolidated Statements of Cash Flows

(In US dollars, except share data)

| | Year ended December 31, 2006 | 2005 (As Restated, see Note 31) | 2004 (As Restated, see Note 31) |
|---|---|---|---|
| **SUPPLEMENTAL DISCLOSURES OF NON-CASH INVESTING AND FINANCING ACTIVITIES** | | | |
| Note payable waived by stockholder in exchange for land use rights | **$** | $ | $ (14,239,246) |
| Series D convertible preference shares issued to acquireassets and assume liabilities from Motorola and MCEL | **$** | $ | $ 278,180,024 |
| Issuance of Series D convertible preference share warrants | **$** | $ | $ 27,663,780 |
| Series D convertible preference shares issued in exchange for certain software licenses | **$** | $ | $ 5,060,256 |
| Series B convertible preference shares issued in exchange for acquired intangible assets | **$** | $ | $ 2,739,853 |
| Series B convertible preference shares issued to a service provider | **$** | $ | $ 45,090 |
| Conversion of preference shares into ordinary shares upon initial public offering | **$** | $ | $ 5,971,115 |
| Ordinary shares and warrants issued to a service provider | **$** | $ | $ (79,590) |
| Ordinary shares issued in exchange for equipment | **$** | $ | $ 5,222,180 |
| Ordinary and preference shares issued in exchange for employee note receivable | **$** | $ | $ (388,924) |
| Inception of accounts payable for plant and equipment | **$ (165,828,795)** | $ (143,723,643) | $ (272,164,643) |
| Issuance of promissory note for acquired intangible assets | **$** | $ (132,496,437) | $ |
| Inception of long-term payable for acquired intangible assets | **$ (16,992,950)** | $ (24,686,398) | $ |
| Inception of other receivable for sales of manufacturing equipment | **$ 70,544,560** | $ 5,490,000 | $ |

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

## Notes to the Consolidated Financial Statements

**For the years ended December 31, 2006, 2005 and 2004**

**(In U.S. dollars, except where otherwise stated)**

1. Organization and Principal Activities

Semiconductor Manufacturing International Corporation was incorporated under the laws of the Cayman Islands on April 3, 2000 and its subsidiaries as of December 31, 2006 include the following:

| Name of company | Place and date of incorporation/ establishment | Attributable equity interest held | Principal activity |
|---|---|---|---|
| Garrison Consultants Limited ( Garrison ) | Samoa April 5, 2000 | 100% | Provision of consultancy services |
| Better Way Enterprises Limited ( Better Way ) | Samoa April 5, 2000 | 100% | Provision of marketing related activities |
| Semiconductor Manufacturing International (Shanghai) Corporation ( SMIS #)* | The People s Republic of China (the PRC ) December 21, 2000 | 100% | Manufacturing and trading of semiconductor products |
| SMIC, Americas | United States of America June 22, 2001 | 100% | Provision of marketing related activities |
| Semiconductor Manufacturing International (Beijing) Corporation ( SMIB )* | The PRC July 25, 2002 | 100% | Manufacturing and trading of semiconductor products |
| SMIC Japan Corporation | Japan October 8, 2002 | 100% | Provision of marketing related activities |
| SMIC Europe S.R.L | Italy July 3, 2003 | 100% | Provision of marketing related activities |
| SMIC Commercial Shanghai Limited Company (formerly SMIC Consulting Corporation)* | The PRC September 30, 2003 | 100% | Operation of a convenience store |
| Semiconductor Manufacturing International (Tianjin) Corporation ( SMIT #)* | The PRC, November 3, 2003 | 100% | Manufacturing and trading of semiconductor products |
| Semiconductor Manufacturing International (AT) Corporation ( AT ) | Cayman Islands July 26, 2004 | 56.67% | Investment holding |
| Semiconductor Manufacturing International (Chengdu) Corporation ( SMICD )* | The PRC August 16, 2004 | 56.67% | Manufacturing and trading of semiconductor products |

| | | | |
|---|---|---|---|
| Semiconductor Manufacturing International (Solar Cell) Corporation ( Solar Cell ) | Cayman Island<br><br>June 30, 2005 | 100% | Investment holding |
| SMIC Energy Technology (Shanghai) Corporation ( Energy Science )#* | The PRC<br><br>September 9, 2005 | 100% | Manufacturing and trading of solar cell related semiconductor products |
| SMIC (Chengdu) Development Corporation*# | The PRC<br><br>December 29, 2005 | 100% | Construction, operation, management of SMICD s and quarter, schools, living and supermarket |
| Magnificent Tower Limited | British Virgin Islands,<br><br>January 5, 2006 | 100% | Investment holding |

* Companies registered as wholly foreign-owned enterprises in the PRC.
\# For identification purposes only

1. Organization and Principal Activities (Continued)

Semiconductor Manufacturing International Corporation and its subsidiaries (hereinafter collectively referred to as the Company or SMIC ) are mainly engaged in the computer-aided design, manufacturing, packaging, testing and trading of integrated circuits and other semiconductor services, and manufacturing design of semiconductor masks.

In 2004, the Company incorporated AT and SMICD, a wholly owned subsidiary of AT. In 2005, AT issued redeemable convertible preference shares to a third party for cash consideration of US$39 million, representing 43.33% equity interest of AT.

2. Reclassifications of Certain Accounts

(a) In 2005, the Company has reclassified the amortization of share-based compensation in the same lines as cash compensation paid to the same employees in accordance with SAB 107, Share-Based Payment. The comparative figures of the prior years have been reclassified to conform to this presentation.

(b) Commencing with the first quarter ended March 31, 2005, the Company reclassified the amortization expenses related to acquired intangible assets into a separate line item. The comparative figures of the prior years have been reclassified to conform to this presentation.

3. Summary of Significant Accounting Policies

**(a) Basis of presentation**

The consolidated financial statements of the Company are prepared in accordance with accounting principles generally accepted in the United States of America ( US GAAP ).

**(b) Principles of consolidation**

The consolidated financial statements include the accounts of the Company and its majority owned subsidiaries. All inter-company transactions and balances have been eliminated upon consolidation. Minority interest is recorded as a reduction of the reported income or expense unless the amount would result in a reduction of expense for which the minority partner would not be responsible.

**(c) Use of estimates**

The preparation of financial statements in conformity with US GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and revenue and expenses in the financial statements and accompanying notes. Significant accounting estimates reflected in the Company s financial statements include valuation allowance for deferred tax assets, allowance for doubtful accounts, inventory valuation, useful lives and commencement of productive use for plant and equipment and acquired intangible assets, impairment on long- lived assets, accruals for sales adjustments, other liabilities, contingencies and share-based compensation expenses.

3. Summary of Significant Accounting Policies (Continued)

**(d) Certain significant risks and uncertainties**

The Company participates in a dynamic high technology industry and believes that changes in any of the following areas could have a material adverse effect on the Company s future financial position, results of operations, or cash flows: changes in the overall demand for semiconductor manufacturing services; competitive pressures due to excess capacity or price reductions; advances and trends in new technologies and industry standards; changes in key suppliers; changes in certain strategic relationships or customer relationships; regulatory or other factors; risks associated with the ability to obtain necessary raw materials; and risks associated with the Company s ability to attract and retain employees necessary to support its growth.

**(e) Cash and cash equivalents**

Cash and cash equivalents consist of cash on hand and highly liquid investments which are unrestricted as to withdrawal or use, and which have maturities of three months or less when purchased.

**(f) Investments**

Short-term investments consisting primarily of mutual funds, corporate notes and corporate bonds are classified either as available for sale or trading securities.

Available for sale securities have been recorded at fair market value. Unrealized gains and losses are recorded as accumulated other comprehensive income (loss). Unrealized losses, which are deemed other than temporary, are recorded in the statement of operations as other expenses. The unrealized gains and losses are reclassified to earnings once the available-for-sale investments are settled.

Trading securities are recorded at fair value with unrealized gains and losses classified as earnings.

Debt securities with original maturities greater than one year are classified as long-term investments held to maturity.

**(g) Concentration of credit risk**

Financial instruments that potentially expose the Company to concentrations of credit risk consist primarily of cash and cash equivalents, shot-term investments, accounts receivable and receivable for sale of manufacturing equipments. The Company places its cash and cash equivalents with reputable financial institutions.

The Company conducts credit evaluations of customers and generally does not require collateral or other security from its customers. The Company establishes an allowance for doubtful accounts based upon estimates, factors surrounding the credit risk of specific customers and other information.

**(h) Inventories**

Inventories are stated at the lower of cost (weighted average) or market. Cost comprises direct materials and where applicable, direct labors costs and those overheads that have been incurred in bringing the inventories to their present location and condition.

Adjustments are recorded to write down the cost of obsolete and excess inventory to the estimated market value based on historical and forecast demand. In 2006, 2005 and 2004, inventory was written down by US$16,106,471, US$13,808,698 and US$10,506,374, respectively, to reflect the lower of coat or market.

3. Summary of Significant Accounting Policies (Continued)

**(i) Land use rights, net**

Land use rights are recorded at cost less accumulated amortization. Amortization is provided over the term of the land use right agreement on a straight-line basis over the term of the agreements, which range from 50 to 70 years.

**(j) Plant and equipment, net**

Plant and equipment are carried at cost less accumulated depreciation and are depreciated on a straight-line basis over the following estimated useful lives:

| | |
|---|---|
| Buildings | 25 years |
| Facility, machinery and equipment | 10 years |
| Manufacturing machinery and equipment | 5 years |
| Furniture and office equipment | 3-5 years |
| Transportation equipment | 5 years |

The Company constructs certain of its plant and equipment. In addition to costs under the construction contracts, external costs directly related to the construction of such facilities, including duties and tariffs, equipment installation and shipping costs, are capitalized. Depreciation is recorded at the time assets are ready for their intended use.

**(k) Acquired intangible assets**

Acquired intangible assets, which consist primarily of technology, licenses and patents, are carried at cost less accumulated amortization and impairment. Amortization is computed using the straight-line method over the expected useful lives of the assets of 5 to 10 years. The Company has determined that its intangible assets were not impaired at December 31, 2006. The Company had no goodwill as of December 31, 2006, 2005 and 2004.

**(l) Impairment of long-lived assets**

The Company reviews its long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may no longer be recoverable. When these events occur, the Company measures impairment by comparing the carrying value of the long-lived assets to the estimated undiscounted future cash flows expected to result from the use of the assets and their eventual disposition. If the sum of the expected undiscounted cash flow is less than the carrying amount of the assets, the Company would recognize an impairment loss based on the fair value of the assets.

**(m) Revenue recognition**

The Company manufactures semiconductor wafers for its customers based on the customers designs and specifications pursuant to manufacturing agreements and/or purchase orders. The Company also sells certain semiconductor standard products to customers. The Company recognizes revenue to customers upon shipment and title transfer. The Company also provides certain services, such as mask making, testing and probing, and revenue is recognized when the services are completed.

3. Summary of Significant Accounting Policies (Continued)

**(m) Revenue recognition (Continued)**

Customers have the rights of return within one year pursuant to warranty and sales return provisions, which has been minimal. The Company typically performs tests of its products prior to shipment to identify yield rate per wafer. Occasionally, product tests performed after shipment identify yields below the level agreed with the customer. In those circumstances, the customer arrangement may provide for a reduction to the price paid by the customer or for its costs to ship replacement products to the customer. The Company estimates the amount of sales returns and the cost of replacement products based on the historical trend of returns and warranty replacements relative to sales as well as a consideration of any current information regarding specific known product defects at customers that may exceed historical trends.

**(n) Capitalization of interest**

Interest incurred on funds used to construct plant and equipment during the active construction period is capitalized, net of government subsidies received. The interest capitalized is determined by applying the borrowing interest rate to the average amount of accumulated capital expenditures for the assets under construction during the period. Capitalized interest is added to the cost of the underlying assets and is amortized over the useful life of the assets. Capitalized interest of US$4,798,002, US$7,617,123 and US$7,531,038, net of government subsidies of US$22,396,613, US$3,990,606 and US$nil in 2006, 2005 and 2004, respectively, has been added to the cost of the underlying assets during the year and is amortized over the respective useful life of the assets.

| | For the year ended December 31 | | |
|---|---|---|---|
| | **2006** | **2005** | **2004** |
| Total actual interest expense | **$ 78,120,699** | $ 50,392,052 | $ 21,228,932 |
| Less: Government subsidy | **22,396,613** | 3,990,606 | |
| Less: Capitalized interest | **4,798,002** | 7,617,123 | 7,531,038 |
| Net interest expense | **$ 50,926,084** | $ 38,784,323 | $ 13,697,894 |

**(o) Government subsidies**

The Company receives government subsidies in the following five forms:

*(1) Reimbursement of certain interest costs incurred on borrowings*

The Company received government subsidies of US$13,878,353, US$12,390,652 and US$nil in 2006, 2005 and 2004, respectively, which were calculated based on the interest expense on the Company s budgeted borrowings. The Company recorded government subsidies as a reduction of interest expense.

*(2) Value added tax refunds*

The Company received subsidies of US$82,960, US$3,747,951 and US$1,949,265 in 2006, 2005 and 2004, respectively, for value added taxes paid by the Company in respect of export sales of semiconductor products. The value added tax refunds have been recorded as a reduction of the cost of sales.

*(3) Sales tax refunds*

The Company received sales tax refunds of US$97,079, US$609,461 and US$573,992 in 2006, 2005 and 2004, respectively, which were recorded as an offset of the general and administrative expenses.

3. Summary of Significant Accounting Policies (Continued)

**(o) Government subsidies (Continued)**

*(4) Government awards*

The Company received government awards of US$11,886,551 and US$3,270,242 in the form of reimbursement of certain expenses in 2006 and 2005, respectively. Accordingly these awards were recorded as reduction of expenses.

The Company received US$1,449,888 in 2004 in recognition of the Company s efforts to attract and retain talents with overseas experience in the high technology industry. The government recognition awards were recorded as other income in 2004 since the Company was awarded for its overall effort in attraction and retention of such talents but not for specific projects.

*(5) Government subsidy for fab construction*

Certain local governments provided subsidies to encourage the Company to participate and manage new plants relating to the integrated circuit industry.

The Company received a subsidy of US$2,208,758 in 2006 as reimbursement of land use right payment, which has been used to offset the cost of the land use right.

The Company received a subsidy of US$18,538,886 in 2005, which was used to offset the account of plant and equipment as they were strictly related to the construction of an assembly and testing plant.

**(p) Research and development costs**

Research and development costs are expensed as incurred.

**(q) Start-up costs**

In accordance with Statement of Position No. 98-5, Reporting on the costs of start-up activities, the Company expenses all costs incurred in connection with start-up activities, including preproduction costs associated with new manufacturing facilities and costs incurred with the formation of the Company such as organization costs. Preproduction costs including the design, formulation and testing of new products or process alternatives are included in research and development expenses. Preproduction costs including facility and employee costs incurred in connection with constructing new manufacturing plants are included in general and administrative expenses.

3. Summary of Significant Accounting Policies (Continued)

**(r) Foreign currency translation**

The United States dollar ( US dollar ), the currency in which a substantial portion of the Company s transactions are denominated, is used as the functional and reporting currency of the Company. Monetary assets and liabilities denominated in currencies other than the US dollar are translated into US dollar at the rates of exchange ruling at the balance sheet date. Transactions in currencies other than the US dollar during the year are converted into the US dollar at the applicable rates of exchange prevailing on the day transactions occurred. Transaction gains and losses are recognized in the statements of operations.

The financial records of certain of the Company s subsidiaries are maintained in local currencies other than the US dollar, such as Japanese Yen, which are their functional currencies. Assets and liabilities are translated at the exchange rates at the balance sheet date, equity accounts are translated at historical exchange rates and revenues, expenses, gains and losses are translated using the average rate for the year. Translation adjustments are reported as cumulative translation adjustments and are shown as a separate component of other comprehensive income (loss) in the statement of stockholders equity.

**(s) Income taxes**

Deferred income taxes are recognized for temporary differences between the tax bases of assets and liabilities and their reported amount in the financial statements, net operating loss carry forwards and credits by applying enacted statutory tax rates applicable to future years. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized.

Current income taxes are provided for in accordance with the laws of the relevant taxing authorities.

**(t) Comprehensive income (loss)**

Comprehensive income (loss) includes such items as foreign currency translation adjustments and unrealized gains/ losses on short-term investments. Comprehensive income (loss) is reported in the statement of stockholders equity.

**(u) Fair value of financial instruments**

Financial instruments include cash and cash equivalents, short-term investments, short-term borrowings, promissory note, long-term payables relating to license agreements, long-term debt, accounts payables, accounts receivables and receivables for sale of equipments. The carrying values of cash and cash equivalents, short-term investments and short-term borrowings approximate their fair values based on quoted market values or due to their short-term maturities. The carrying value of long-term payables relating to license agreements, long-term debt and payables approximates fair value due to variable interest rates that approximate market rates.

3. Summary of Significant Accounting Policies (Continued)

**(v) Share-based compensation**

The Company grants stock options to its employees and certain non-employees. Prior to January 1, 2006, the Company accounted for share-based compensation in accordance with Accounting Principles Board Opinion No. 25, ( APB 25 ), Accounting for Stock Issued to Employees, and related interpretations. The Company also followed the disclosure requirements of SFAS No. 123, Accounting for Stock-Based Compensation , as amended by SFAS 148, Accounting for Stock-Based Compensation-Transition and Disclosure. As a result, no expense was recognized for options to purchase the Company s ordinary shares that were granted with an exercise price equal to fair market value at the day of the grant prior to January 1, 2006. Effective January 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standards No. 123(R), ( SFAS 123(R) ) Share-Based Payment, which establishes accounting for equity instruments exchanged for services.

Under the provisions of SFAS 123(R), share-based compensation cost is measured at the grant date, based on the fair value of the award, and is recognized as an expense over the employee s requisite service period (generally the vesting period of the equity grant). The Company elected to adopt the modified prospective transition method as provided by SFAS 123(R) and, accordingly, financial statement amounts for the prior periods presented in this report have not been restated to reflect the fair value method of expensing share-based compensation.

As a result of adopting SFAS 123(R) on January 1, 2006, the Company recognized a benefit of US$5.2 million as a result of the cumulative effect of a change in accounting principle, in relating to the forfeiture rate applied on the unvested portion of the stock options. Basic and diluted net loss per share for the year ended December 31, 2006 would have been US$0.0025.

The Company s total actual share-based compensation expense for the year ended December 31, 2006, 2005 and 2004 was US$23,506,847 and US$25,735,849 and US$27,011,078, respectively.

3. Summary of Significant Accounting Policies (Continued)

**(v) Share-based compensation (Continued)**

Had compensation cost for options granted to employees under the Company s stock option plans been determined based on the fair value at the grant date, as prescribed in SFAS No. 123, for the periods prior to January 1, 2006, the Company s pro forma loss would have been as follows:

| | Year ended December 31, 2005 | 2004 |
|---|---|---|
| (Loss) income attributable to holders of ordinary shares | $ (114,774,827) | $ 77,363,770 |
| Add: Stock compensation as reported | 25,735,849 | 27,011,078 |
| Less: Stock compensation determined using the fair value method | (32,997,627) | (37,486,703) |
| Pro forma (loss) income attributable to holders of ordinary shares | $ (122,036,605) | $ 66,888,145 |
| (Loss) income per share: | | |
| Basic pro forma | $ (0.01) | $ 0.00 |
| Diluted pro forma | $ (0.01) | $ 0.00 |
| Basic as reported | $ (0.01) | $ 0.01 |
| Diluted as reported | $ (0.01) | $ 0.00 |

The weighted-average grant-date fair value of options granted during the year 2006, 2005 and 2004 was US$0.05, US$0.05 and US$0.17, respectively.

The fair value of each option and share grant are estimated on the date of grant using the Black-Scholes option pricing model with the following assumptions:

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| Average risk-free rate of return | **4.72%** | 4.16% | 2.64% |
| Weighted average expected term | **2-4 years** | 1-4 years | 0.5-4 years |
| Volatility rate | **32.69%** | 30.39% | 52.45% |
| Expected dividend | | | |

3. Summary of Significant Accounting Policies (Continued)

**(w) Derivative financial instruments**

The Company s primary objective for holding derivative financial instruments is to manage currency and interest rate risks. The Company records derivative instruments as assets or liabilities, measured at fair value. The recognition of gains or losses resulting from changes in the values of those derivative instruments is based on the use of each derivative instrument and whether it qualifies for hedge accounting.

The Company has the following notional amount of derivative instruments:

| | | December 31, | |
|---|---|---|---|
| | **2006** | **2005** | **2004** |
| Forward foreign exchange contracts | **$ 35,660,177** | $ 245,622,512 | $ 61,034,335 |
| Interest rate swap contracts | **265,947,874** | 340,000,000 | |
| | **$ 301,608,051** | $ 585,622,512 | $ 61,034,335 |

The Company purchases foreign-currency forward exchange contracts with contract terms expiring within one year to protect against the adverse effect that exchange rate fluctuations may have on foreign-currency denominated purchase activities, principally the Reminbi, the Japanese Yen and the European Euro. The foreign-currency forward exchange contracts do not qualify for hedge accounting. In 2006, 2005 and 2004, gains and losses on the foreign currency forward exchange contracts were recognized in the statement of operations. Notional amounts are stated in the US dollar equivalents at spot exchange rates at the respective dates.

| **Settlement currency** | **Notional amount** | **US dollar equivalents** |
|---|---|---|
| **As of December 31, 2006** | | |
| Japanese Yen | **4,235,537,500** | **$ 35,660,177** |
| As of December 31, 2005 | | |
| Japanese Yen | 22,097,665,000 | $ 188,659,310 |
| European Euro | 47,900,000 | 56,881,250 |
| Renminbi | 661,400 | 81,952 |
| | | $ 245,622,512 |
| As of December 31, 2004 | | |
| Japanese Yen | 2,915,714,899 | $ 28,111,405 |
| European Euro | 20,042,037 | 27,313,288 |
| USD | 46,428,200 | 5,609,642 |
| | | $ 61,034,335 |

3. Summary of Significant Accounting Policies (Continued)

**(w) Derivative financial instruments (Continued)**

In 2006 and 2005, the Company entered into various interest rates swap contracts to protect against volatility of future cash flows caused by the changes in interest rates associated with the outstanding debts. The interest rate swap contracts do not qualify for hedge accounting. In 2006 and 2005, hedging gains or losses on the interest rate swap contracts were recognized in the statement of operations. As of December 31, 2006 and 2005, the Company had outstanding interest rate swap contracts with notional amounts of US$250,000,000 and US$340,000,000, respectively.

In addition to the abovementioned interest rate swap contracts, in 2006, the Company entered into a cross-currency interest rate swap agreement to protect against volatility of future cash flows caused by the changes in both interest rate and exchange rate associated with the outstanding long-term debts that are denominated in a currency other than US dollar. The cross-currency interest rate swap agreement does not qualify for hedge accounting. In 2006, hedging gains or losses on the interest rate swap contracts were recognized in the statement of operations. As of December 31, 2006, the Company had outstanding cross-currency interest rate swap contracts with notional amounts of US$15,947,874.

The fair values of each derivative instrument are as follows:

| | | December 31 | |
|---|---|---|---|
| | **2006** | **2005** | **2004** |
| Forward foreign exchange contracts | **$ (2,694,415)** | $ (2,607,714) | $ (283,344) |
| Interest rate swap contracts | **(5,317,837)** | (1,270,811) | |
| | **$ (8,012,252)** | $ (3,878,525) | $ (283,344) |

As of December 31, 2006, 2005 and 2004, the fair value of these derivative instruments was recorded in accrued expenses and other current liabilities, with the change of fair value of forward foreign exchange contracts recorded as part of other income (expense), the change of fair value of interest rate swap contract and cross currency interest rate swap contracts recorded as part of interest expense.

3. Summary of Significant Accounting Policies (Continued)

**(x) Recently issued accounting standards**

In February 2006, FASB issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statement No. 133 and 140, which simplifies accounting for certain hybrid financial instruments by permitting fair value re-measurement for any hybrid instrument that contains an embedded derivative that otherwise would require bifurcation and eliminates a restriction on the passive derivative instruments acquired, issued or subject to re- measurement (new basis) event occurring after the beginning of an entity s fiscal year that begins after September 15, 2006. The Company is currently evaluating the impact of SFAS No. 155 on its consolidated financial statements.

In June 2006, FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109 (FIN 48). This interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and the measurement of a tax position taken or expected to be taken in a tax return. This interpretation also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. This Interpretation is effective for fiscal years beginning after December 15, 2006. Earlier application is encouraged. The Company is currently evaluating the impact, if any, of FIN 48 on its consolidated financial statements.

In September 2006, FASB issued SFAS No.157, Fair Value Measurements , which defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurement. This Statement clarifies that the exchange price is the price in an orderly transaction between market participants to sell the asset or transfer the liability in the market in which the reporting entity would transact for the asset or liability, that is, the principal or most advantageous market for the asset or liability. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Earlier application is encouraged. The Company is currently evaluating the impact, if any, of SFAS157 on its consolidated financial statements.

In June 2006, the Emerging Issues Task Force ( EITF ) reached a consensus on Issue No. 06-3, How Taxes Collected from Customers and Remitted to Governmental Authorities Should be Presented in the Income Statement (That is Gross Versus Net Presentation) ( EITF 06-3 ). The scope of EITF 06-3 includes sales, use, value added and some excise taxes that are assessed by a governmental authority on specific revenue-producing transactions between a seller and customer. EITF 06-3 states that a company should disclose its accounting policy (i.e. gross or net presentation) regarding the presentation of taxes within its scope, and if significant, these disclosures should be applied retrospectively to the financial statements for all periods presented. EITF 06-3 is effective for interim and annual reporting periods beginning after December 15, 2006. The Company is currently evaluating the impact, if any, of this statement on its consolidated financial statements and related disclosures.

3. Summary of Significant Accounting Policies (Continued)

**(y) Income (loss) per share**

Basic income (loss) per share is computed by dividing income (loss) attributable to holders of ordinary shares by the weighted average number of ordinary shares outstanding (excluding shares subject to repurchase) for the year. Diluted income (loss) per ordinary share reflects the potential dilution that could occur if securities or other contracts to issue ordinary shares were exercised or converted into ordinary shares. Ordinary share equivalents are excluded from the computation in loss periods as their effects would be antidilutive.

**(z) Share split**

On March 18, 2004, the Company effected a 10-for-1 share split immediately after the conversion of preference shares into ordinary shares. All share information relating to ordinary shares of the Company in the accompanying financial statements, including the conversion price relating to such ordinary shares and stock options, have been adjusted retroactively, which gives effect to the share split.

4. Motorola Asset Purchase and License Agreements

On September 23, 2003, the Company entered into an agreement to acquire certain assets and assume certain obligations from Motorola, Inc. ( Motorola ) and Motorola (China) Electronics Limited ( MCEL ), a wholly owned subsidiary of Motorola in exchange for 82,857,143 Series D convertible preference shares convertible into ordinary shares at a conversion price of US$0.2087 per share and a warrant to purchase 8,285,714 Series D convertible preference shares for US$0.01 per share (the Asset Purchase ). In addition, the Company issued 8,571,429 Series D convertible preference shares convertible into ordinary shares at a conversion price of US$0.2087 per share and a warrant to purchase 857,143 Series D convertible preference shares for US$0.01 per share in exchange for US$30,000,000. The Company and Motorola completed the Asset Purchase on January 16, 2004.

In conjunction with the Asset Purchase, the Company and Motorola entered into an agreement to license certain technology and intellectual property. In exchange for these licenses, the Company agreed to issue Motorola an aggregate of 11,428,571 Series D convertible preference shares convertible into ordinary shares at a conversion price of US$0.2087 per share and a warrant to purchase 1,142,857 Series D convertible preference shares for US$0.01 per share. On December 5, 2003, the Company partially closed this license agreement with Motorola and issued to Motorola 7,142,857 Series D convertible preference shares and a warrant to purchase 714,286 Series D convertible preference shares at US$0.01 per share. On January 16, 2004, the Company closed the license agreement with Motorola and issued to Motorola 4,285,714 series D convertible preference share and a warrant to purchase 428,571 Series D convertible preference shares at US$0.01 per share.

5. Accounts Receivable, Net of Allowances

The Company determines credit terms for each customer on a case by case basis, based on its assessment of such customer s financial standing and business potential with the Company.

In addition, for certain customers with long-established relationship and good past repayment histories, a longer credit period may be granted.

5. Accounts Receivable, Net of Allowances (Continued)
An aging analysis of trade debtors is as follows:

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| Current | **$ 213,539,198** | $ 192,303,054 | $ 148,502,815 |
| Overdue: | | | |
| Within 30 days | **31,611,729** | 38,017,540 | 15,901,323 |
| Between 31 to 60 days | **5,879,705** | 2,528,249 | 2,656,964 |
| Over 60 days | **1,154,343** | 8,485,071 | 2,127,185 |
| | **$ 252,184,975** | $ 241,333,914 | $ 169,188,287 |
| Net of Allowance for doubtful accounts | **$ (4,048,845)** | $ (1,091,340) | $ (1,105,165) |

The change in the allowance for doubtful accounts is as follows:

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| Balance, beginning of year | **$ 1,091,340** | $ 1,105,165 | $ 114,473 |
| Provision for the year | **2,957,505** | | 990,692 |
| Reversal in the year | | (13,825) | |
| Balance, end of year | **$ 4,048,845** | $ 1,091,340 | $ 1,105,165 |

6. Investments
**Available-for-sale security**

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

| | December 31, 2006 | | | |
|---|---|---|---|---|
| | Cost | Gross unrealized gains | Gross unrealized losses | Fair value |
| **Mutual fund** | **$ 52,866,825** | **$ 0** | **$** | **$ 52,866,825** |

| | December 31, 2005 | | | |
|---|---|---|---|---|
| | Cost | Gross unrealized gains | Gross unrealized losses | Fair value |
| Commercial paper | $ 3,482,033 | $ 9,450 | $ | $ 3,491,483 |
| Mutual fund | 10,283,573 | 20,803 | | 10,304,376 |
| | $ 13,765,606 | $ 30,253 | $ | $ 13,795,859 |

6. Investments (Continued)

| | December 31, 2004 | | | |
|---|---|---|---|---|
| | Cost | Gross unrealized gains | Gross unrealized losses | Fair value |
| Corporate note | $ 10,000,000 | $ | $ | $ 10,000,000 |
| Mutual fund | 10,277,379 | 86,805 | | 10,364,184 |
| | $ 20,277,379 | $ 86,805 | $ | $ 20,364,184 |

**Trading security**

As of December 31, 2006, the Company also held certain trading securities with costs of US$5,000,000 and fair value of US$5,083,778.

7. Inventories

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| Raw materials | **$ 89,431,781** | $ 55,697,982 | $ 39,336,929 |
| Work in progress | **150,506,509** | 115,210,052 | 83,953,481 |
| Finished goods | **35,240,662** | 20,329,602 | 20,727,442 |
| | **$ 275,178,952** | $ 191,237,636 | $ 144,017,852 |

8. Assets Held for Sale

Assets held for sale represent residential real estate that the Company has constructed for its employees. In 2004, the Company had sold residential real estate with a carrying value of US$12,089,113 to employees for US$12,778,062, which resulted in a gain on disposition of US$688,949. The Company has reclassified the majority of the unsold residential real estate units of US$18,670,278 to land use rights, plant and equipment and recorded a cumulative adjustment for depreciation expense of US$1,155,623, representing depreciation that would have been recognized had the unsold real estate units been continuously classified as land use rights, plant and equipment. The remaining balance of assets held for sale as of December 31, 2004 was US$1,831,972, representing 44 sets of the residential real estate units.

In 2005, the Company sold residential real estate units with a carrying value of US$1,679,818 for US$2,322,409, which resulted in a gain on disposal of US$642,591. Meanwhile, the Company has reclassified the remaining unsold real estate units of US$152,154 to land use rights, plant and equipment. Accordingly, the Company recorded a cumulative adjustment for depreciation expense of US$7,352, representing depreciation that would have been recognized had the unsold real estate units been continuously classified as land use rights, plant and equipment. No residential real estate was classified as assets held for sale as of December 31, 2005.

In 2006, the Company decided to offer employees additional residual real estate, and classified the US$17,097,675 carrying value as assets held for sale. Meanwhile, the Company sold residential real estate units with a carrying value of US$7,676,946 for US$8,934,560, which resulted in a gain on disposal of US$1,257,614. The remaining balances of assets held for sale as of December 31, 2006 was US$9,420,729, representing 213 sets of residential real estate units.

9. Land Use Rights, Net

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| Land use rights (50 70 years) | **$ 42,485,856** | $ 38,504,311 | $ 42,412,453 |
| Less: accumulated amortization | **(4,162,523)** | (3,736,793) | (3,214,679) |
| | **$ 38,323,333** | $ 34,767,518 | $ 39,197,774 |

10. Plant and Equipment, Net

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| Buildings | **$ 269,721,109** | $ 212,205,753 | $ 203,375,644 |
| Facility, machinery and equipment | **435,112,058** | 382,928,570 | 339,852,626 |
| Manufacturing machinery and equipment | **4,539,566,491** | 3,810,671,778 | 2,838,231,084 |
| Furniture and office equipment | **61,979,029** | 75,696,024 | 51,932,370 |
| Transportation equipment | **1,666,185** | 1,581,493 | 1,324,144 |
| | **5,308,044,872** | 4,483,083,618 | 3,434,715,868 |
| Less: accumulated depreciation and amortization | **(2,314,667,455)** | (1,515,923,860) | (772,416,194) |
| Construction in progress | **251,023,405** | 318,471,373 | 649,624,925 |
| | **$ 3,244,400,822** | $ 3,285,631,131 | $ 3,311,924,599 |

In 2006, the Company sold plant, equipment and other fixed assets with a carrying value of US$34,231,116 for US$77,353,045, which resulted in a gain on disposal of US$43,121,929.

The plant and equipment were sold to a government-owned foundry based in Chengdu, Sichuan province, to which SMIC is also contracted to provide management services.

11. Acquired Intangible Assets, Net

| | 2006 | 2005 (As Restated, see Note 31) | 2004 (As Restated, see Note 31) |
|---|---|---|---|
| Cost: | | | |
| Technology | **$ 20,256,328** | $ 17,406,681 | $ 15,674,853 |
| Licenses | **49,308,145** | 36,739,470 | 12,768,057 |
| Patent licenses | **65,297,639** | 65,297,639 | 67,122,391 |
| | **$ 134,862,112** | $ 119,443,790 | $ 95,565,301 |
| Accumulated Amortization: | | | |
| Technology | **(13,712,517)** | (9,065,285) | (5,232,801) |
| Licenses | **(12,135,592)** | (5,618,381) | (1,702,470) |
| Patent licenses | **(37,321,505)** | (24,092,387) | (10,894,731) |
| | **(63,169,614)** | (38,776,053) | (17,830,002) |

| | | | |
|---|---|---|---|
| Acquired intangible assets, net | **$ 71,692,498** | $ 80,667,737 | $ 77,735,299 |

11. Acquired Intangible Assets, Net (Continued)

**2006**

The Company entered into several technology, patent and license agreements with third parties whereby the Company purchased intangible assets for US$15,418,322.

**2005**

In addition, the Company entered into several technology, patent, and license agreements with third parties whereby the Company purchased licenses for US$23,878,489.

**2004**

The Company issued 4,285,714 Series D convertible preference shares and a warrant to purchase 428,571 Series D convertible preference shares at US$0.01 per share in exchange for certain licenses from Motorola, which was valued at US$15,000,000 (see Note 4).

The Company issued 914,285 Series D convertible preference shares to a strategic technology partner in exchange for certain software licenses, which was valued at US$5,060,256.

The Company entered into various other license agreements with third parties whereby the Company purchased licenses for US$28,217,249.

All acquired technology intangible assets are generally amortized over a period of 5 years. Occasionally, licenses for advanced technologies are amortized over longer periods up to 10 years. The Company recorded amortization expense of US$24,393,561, US$20,946,051 (As Restated, See Note 31) and US$14,368,025 in 2006, 2005 and 2004 respectively. The Company will record amortization expenses related to the acquired intangible assets of US$23,291,713, US$19,194,945, US$8,864,510, US$3,106,196, and US$366,459 for 2007, 2008, 2009, 2010 and 2011 respectively.

12. Equity Investment

| | December 31, 2006 | |
|---|---|---|
| | **Carrying Amount** | **% of Ownership** |
| Toppan SMIC Electronics (Shanghai) Co., Ltd. | **$ 13,619,643** | **30** |

On July 6, 2004, the Company and Toppan Printing Co., Ltd ( Toppan ) entered into an agreement to form Toppan SMIC Electronics (Shanghai) Co., Ltd. ( Toppan SMIC ) in Shanghai, to manufacture on-chip color filters and micro lenses for CMOS image sensors.

In 2005, the Company injected cash of US$19,200,000 into Toppan SMIC, representing its 30% ownership. In 2006 and 2005, the Company recorded US$4,201,247 and US$1,379,110, respectively, as its share of the net loss of the equity investment. As of December 31, 2006, the share of net loss of the equity investment balance to be carried forward amounted to US$5,580,357.

13. Accounts Payable

An aging analysis of the accounts payable is as follows:

| | **2006** | **2005** | **2004** |
|---|---|---|---|
| Current | **$ 238,864,239** | $ 209,142,167 | $ 307,396,991 |
| Overdue: | | | |
| Within 30 days | **43,364,820** | 22,479,945 | 38,803,625 |
| Between 31 to 60 days | **9,594,873** | 4,593,542 | 4,351,844 |
| Over 60 days | **17,305,267** | 26,102,778 | 13,781,153 |
| | **$ 309,129,199** | $ 262,318,432 | $ 364,333,613 |

14. Promissory Note

In 2005, the Company reached a settlement and license agreement with TSMC as detailed in Note 11 and Note 24. Under this agreement, the Company issued thirteen non-interest bearing promissory notes with an aggregate amount of US$175,000,000 as the settlement consideration. The Company has recorded a discount of US$17,030,709 for the imputed interest on the notes, which was calculated using an effective interest rate of 3.45% and has been recorded as a reduction of the face amounts of the promissory notes. The Company repaid US$30,000,000 and US$30,000,000 in 2006 and 2005 respectively, and the outstanding promissory notes are as follows:

| | December 31, 2006 | |
|---|---|---|
| **Maturity** | **Face value** | **Discounted value** |
| 2007 | **$ 30,000,000** | **$ 29,242,001** |
| 2008 | **30,000,000** | **28,259,668** |
| 2009 | **30,000,000** | **27,310,335** |
| 2010 | **25,000,000** | **22,031,654** |
| | **115,000,000** | **106,843,658** |
| Less: Current portion of promissory notes | **30,000,000** | **29,242,001** |
| Long-term portion of promissory notes | **$ 85,000,000** | **$ 77,601,657** |

| | December 31, 2005 | |
|---|---|---|
| **Maturity** | **Face value** | **Discounted value** |
| 2006 | $ 30,000,000 | $ 29,242,001 |
| 2007 | 30,000,000 | 28,259,668 |
| 2008 | 30,000,000 | 27,310,335 |
| 2009 | 30,000,000 | 26,392,893 |
| 2010 | 25,000,000 | 21,291,540 |
| | 145,000,000 | 132,496,437 |
| Less: Current portion of promissory notes | 30,000,000 | 29,242,001 |
| Long-term portion of promissory notes | $ 115,000,000 | $ 103,254,436 |

The promissory note was interest free, and the present value was discounted using the weighted-average of the Company s borrowing rate.

In 2006 and 2005, the Company recorded interest expense of US$4,347,221 and US$4,527,146 respectively, relating to the amortization of the discount.

15. Indebtedness

Short-term and long-term debts are as follows:

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| Short-term borrowings from commercial banks (a) | **$ 71,000,000** | $ 265,481,082 | $ 91,000,000 |
| | | | |
| Long-term debt by contracts (b): | | | |
| Shanghai phase I USD syndicate loan | **$** | $ 259,200,000 | $ 432,000,000 |
| Shanghai phase I RMB syndicate loan | | | 47,966,446 |
| Shanghai phase II USD syndicate loan | | 256,481,965 | 256,482,000 |
| Shanghai new USD syndicate loan | **274,420,000** | | |
| Beijing USD syndicate loan | **600,000,000** | 224,955,000 | |
| EUR syndicate loan | **15,947,873** | | |
| | **$ 890,367,873** | $ 740,636,965 | $ 736,448,446 |
| | | | |
| Long-term debt by repayment schedule: | | | |
| 2005 | **$** | $ | $ 191,986,372 |
| 2006 | | 246,080,580 | 265,267,355 |
| 2007 | **170,796,968** | 197,173,071 | 169,273,861 |
| 2008 | **290,446,968** | 148,265,571 | 73,280,572 |
| 2009 | **290,446,968** | 111,625,243 | 36,640,286 |
| 2010 | **138,676,969** | 37,492,500 | |
| | **890,367,873** | 740,636,965 | 736,448,446 |
| Less: current maturities of long-term debt | **170,796,968** | 246,080,580 | 191,986,372 |
| Non-current maturities of long-term debt | **$ 719,570,905** | $ 494,556,385 | $ 544,462,074 |

**(a) Short-term borrowings from commercial banks**

As of December 31, 2004, the Company had seven short-term credit agreements that provided total credit facilities up to US$253,000,000 on a revolving credit basis. As of December 31, 2004, the Company had drawn down US$91,000,000 under these credit agreements and US$162,000,000 is available for future borrowings. The outstanding borrowings under the credit agreements were unsecured. The interest expense incurred in 2004 was US$360,071. The interest rate on the loan ranged from 1.77% to 3.57% in 2004.

As of December 31, 2005, the Company had fifteen short-term credit agreements that provided total credit facilities up to approximately US$431 million on a revolving credit basis. As of December 31, 2005, the Company had drawn down approximately US$265 million under these credit agreements and approximately US$166 million is available for future borrowings. The outstanding borrowings under the credit agreements are unsecured. The interest expense incurred in 2005 was US$8,987,676. The interest rate on the loan ranged from 2.99% to 5.73% in 2005.

15. Indebtedness (Continued)

**(a) Short-term borrowings from commercial bank (Continued)**

As of December 31, 2006, the Company had fifteen short-term credit agreements that provided total credit facilities up to US$474 million on a revolving credit basis. As of December 31, 2006, the Company had drawn down US$71 million under these credit agreements and US$403 million is available for future borrowings. The outstanding borrowings under the credit agreements are unsecured. The interest expense incurred in 2006 was US$8,471,823. The interest rate on the loan ranged from 3.62% to 6.52% in 2006.

**(b) Long-term debt**

*Shanghai Phase I USD syndicate loan*

In December 2001, the SMIS entered into a long-term debt agreement with a syndicate of financial institutions based in the P.R.C. for US$432,000,000. The withdrawal period of the facility was 18 months starting from the loan agreement date. As of December 31, 2004, SMIS had fully utilized the loan amount. The interest payment is due on a semi-annual basis. The principal amount is repayable starting from March 2005 in five semi-annual installments of US$86,400,000. In 2006, the interest rate on the loan ranged from 6.16% to 7.05%. As of December 31, 2006, the borrowing was fully repaid by draw down of the new syndicate loan as detailed below. The interest expense incurred in 2006, 2005 and 2004 was US$6,587,140, US$16,499,858 and US$14,014,698, respectively, of which US$783,538, US$3,631,872 and US$6,396,254 was capitalized as additions to assets under construction in 2006, 2005 and 2004, respectively.

*Shanghai Phase I RMB syndicate loan*

SMIS had a RMB denominated line of credit of RMB 396,960,000 (approximately US$48 million) in 2001, with the same financial institutions. As of December 31, 2004, SMIS had fully drawn down on the line of credit. The interest rate for the loan was calculated based on the basic rate of a five-year term loan published by the People s Bank of China. The annual interest rate on the loan ranged from 5.02% to 5.27% in 2005. The interest expense incurred in 2005 and 2004 was US$1,649,858 and US$2,451,885, respectively, of which US$362,172 and US$1,134,784 was capitalized as additions to assets under construction in 2005 and 2004, respectively. As of December 31, 2006 and 2005, the borrowing was fully repaid.

*Shanghai Phase II USD syndicate loan*

In January 2004, the SMIS entered into the second phase long-term facility arrangement for US$256,481,965 with the same financial institutions. As of December 31, 2005 and 2004, SMIS had fully utilized the loan. The interest payment is due on a semi-annual basis. The principal amount is repayable starting from March 2006 in seven semi- annual installments of US$36,640,286. In 2006, the interest rate on the loan ranged from 6.16% to 7.05%. The interest expense incurred in 2006, 2005 and 2004 was US$7,185,813, US$12,470,302 and US$3,890,105, of which US$854,749, US$2,743,173 and $nil was capitalized as additions to assets under construction in 2006, 2005 and 2004, respectively. As of December 31, 2006, the borrowing was fully repaid by draw down of the new syndicate loan as detailed below.

In connection with the second phase long-term facility arrangement, SMIS has a RMB denominated line of credit of RMB 235,678,000 (US$28,476,030). As of December 31, 2004, SMIS had no borrowings on this line of credit. In 2005, SMIS fully utilized the facility and then repaid in full prior to December 31, 2005. The interest expense incurred in 2005 was US$25,625.

15. Indebtedness (Continued)

**(b) Long-term debt (Continued)**

*Shanghai New USD syndicate loan*

In June, 2006, SMIS entered into a new long-term facility agreement with the aggregate principal amount of US$600,000,000, with a consortium of international and PRC banks. Of this principal amount, US$393,000,000 was used to repay the principal amount outstanding under SMIS s phase I and phase II bank facilities. The remaining principal amount will be used to finance future expansion and general corporate requirement for SMIS. The remaining facility balance is available for drawdown until December 2007. As of December 31, 2006, SMIS had drawn down US$393,000,000 from this facility. The principle amount is repayable starting from December 2006 in ten semi- annual installments. In December 2006, SMIS had repaid the first installment of US$23,580,000 according to the repayment schedule and had repaid an additional US$95,000,000. As of December 31, 2006, the remaining balance of this borrowing is US$274,420,000. In 2006, the interest rate on the loan ranged from 6.46% to 6.72%. The interest expense incurred in 2006 was US$13,522,886, of which US$1,624,224 was capitalized as additions to assets under construction in 2006.

The total outstanding balance of SMIS s long-term debt is collateralized by certain plant and equipment at the original cost of US$1,899 million as of December 31, 2006. The registration of the mortgage was in process as of December 31, 2006.

*Beijing USD syndicate loan*

In May 2005, SMIB entered into a five-year loan facility in the aggregate principal amount of US$600,000,000, with a syndicate of financial institutions based in the PRC. This five-year bank loan was used to expand the capacity of SMIB s fabs. The withdrawal period of the facility was twelve months from date of signing the agreement. As of December 31, 2006 and 2005, the outstanding balance was US$600,000,000 and US$224,955,000, respectively, on this loan facility. The principal amount is repayable starting from December 2007 in six equal semi-annual installments. In 2006, the interest rate range on the loan ranged from 6.26% to 7.17%. The interest expense incurred in 2006 and 2005 was US$28,525,628 and US$3,991,080, of which US$450,516 and US$879,906 was capitalized as additions to assets under construction in 2006 and 2005 respectively.

The total outstanding balance of Beijing USD syndicate loan is collateralized by certain plant and equipment at the original cost of US$1,058 million as of December 31, 2006.

*EUR syndicate loan*

On December 15, 2005, the Company entered into a long-term loan facility agreement in the aggregate principal amount of EUR85 million with a syndicate of banks and ABN Amro Bank N.V. Commerz Bank (Nederland) N.V. as the leading bank. The proceeds from the facility were used to purchase lithography equipment to support the expansion of the Company s manufacturing facilities. The drawdown period of the facility ends on the earlier of (i) twenty months after the agreement sign off date or (ii) the date which the loans have been fully drawn down. Each drawdown made under the facility shall be repaid in full by the Company in ten equal semi-annual instalments starting from May 6, 2006. In 2006, SMIT had drawn down EUR15,122,775, which was equal to US$19,934,841, and repaid the first two installments with an aggregated amount of EUR3,024,555, which was equal to US$3,986,968. As of December 31, 2006, the remaining balance is EUR12,098,220, with the US dollar equivalent of US$15,947,873. In 2006, the interest rate loan ranged from 3.41% to 3.95%. The interest expense incurred in 2006 was US$279,908, of which US$65,072 was capitalized as additions to assets under construction in 2006.

The total outstanding balance of the facility is collateralized by certain plant and equipment at the original cost of EUR17.8 million as of December 31, 2006.

The long-term debt arrangements contain financial covenants as defined in the loan agreements. The Company met these covenants as of December 31, 2006.

16. Long-term Payables Relating to License Agreements

The Company entered into several license agreements for acquired intangible assets to be settled by installment payments. Installments payable under the agreements as of December 31, 2006 and 2005 are as follows:

| | December 31, 2006 | |
|---|---|---|
| **Maturity** | **Face value** | **Discounted value** |
| 2007 | **$ 13,000,000** | **$ 12,690,471** |
| 2008 | **10,000,000** | **9,322,990** |
| 2009 | **8,500,000** | **7,669,960** |
| | **31,500,000** | **29,683,421** |
| Less: Current portion of long-term payables | **13,000,000** | **12,690,471** |
| Long-term portion of long-term payables | **$ 18,500,000** | **$ 16,992,950** |

| | December 31, 2005 | |
|---|---|---|
| **Maturity** | **Face value** | **Discounted value** |
| 2006 | $ 7,000,000 | $ 6,791,990 |
| 2007 | 9,000,000 | 8,381,854 |
| 2008 | 10,000,000 | 8,941,284 |
| 2009 | 8,500,000 | 7,363,260 |
| | 34,500,000 | 31,478,388 |
| Less: Current portion of long-term payables | 7,000,000 | 6,791,990 |
| Long-term portion of long-term payables | $ 27,500,000 | $ 24,686,398 |

These long-term payables were interest free, and the present value was discounted using the weighted-average of the Company s borrowing rate.

The current portion of other long-term payables is recorded as part of accrued expenses and other current liabilities in the balance sheet.

In 2006 and 2005, the Company recorded interest expense of US$1,355,386 and US$868,032 relating to the amortization of the discount.

17. Income Taxes

The Company is a tax exempted company incorporated in the Cayman Islands. The subsidiaries incorporated in the PRC are governed by the Income Tax Law of the PRC Concerning Foreign Investment and Foreign Enterprises and various local income tax laws (the Income Tax Laws ). Pursuant to the relevant regulation and upon approval by the governmental agency, the Company s Shanghai, Beijing and Tianjin subsidiaries are entitled to a full exemption from Foreign Enterprise Income Tax ( FEIT ) for five years starting with the first year of positive accumulated earnings and a 50% reduction for the following five years. SMIC Shanghai is in the third year of receiving exemption from FEIT. While as of December 31, 2006, SMIC Beijing and Tianjin are still in a cumulative operating loss.

According to PRC tax regulations, the Company s Chengdu subsidiary is entitled to a full exemption from FEIT for two years starting with the first year of positive accumulated earnings and a 50% reduction for the following three years. Up to December 31, 2006, Chengdu subsidiary is still in the process of applying for the tax holiday. As of December 31, 2006, the Chengdu subsidiary is still in a cumulative operating loss.

The Company s other subsidiaries are subject to respective local country s income tax law, including those of Japan, the United States of America and Europe. In 2006, 2005 and 2004, the Company s US subsidiary had recorded current income tax expense of US$31,030, US$223,846 and US$186,044, respectively. In 2006, 2005 and 2004, the Company s Europe subsidiary had recorded current income tax expense of US$112,671, US$46,981 and US$nil, respectively. The Company had minimal taxable income in Japan.

As part of the process of preparing financial statements, the Company is required to estimate its income taxes in each of the jurisdictions in which it operates. The Company accounts for income taxes by the liability method. Under this method, deferred income taxes are recognized for tax consequences in future years of differences between the tax bases of assets and liabilities and their financial reporting amounts at each year-end, based on enacted laws and statutory tax rates applicable for the difference that are expected to affect taxable income. Valuation allowances are provided if based upon the weight of available evidence, it is more likely than not that some or all of the deferred tax assets will not be realized.

The provision for income taxes by location of the tax jurisdiction for the year ended December 31, 2006, 2005 and 2004 are as follows:

| | December 31 | | |
|---|---|---|---|
| | **2006** | **2005** | **2004** |
| Domestic | | | |
| Current | **$ 4,542** | $ 14,040 | $ |
| Deferred | **(25,075,987)** | | |
| Foreign | | | |
| Current | **$ 143,701** | $ 270,827 | $ 186,044 |
| Deferred | | | |
| | **$ (24,927,744)** | $ 284,867 | $ 186,044 |

17. Income Taxes (Continued)

Temporary differences and carry forwards that give rise to deferred tax assets and liabilities are as follows:

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| Deferred tax assets: | | | |
| Allowances and reserves | **$ 1,962,410** | $ 1,682,244 | $ 967,968 |
| Start-up costs | **958,105** | 1,844,170 | 2,566,628 |
| Net operating loss carry forwards | **5,201,545** | 5,172,687 | |
| Unrealized exchange loss | **47,860** | 295,646 | |
| Depreciation of fixed assets | **33,715,867** | | |
| Subsidy on long lived assets | **295,654** | | |
| Accrued sales return | **137,719** | 23,764 | |
| Total deferred tax assets | **$ 42,319,160** | $ 9,018,511 | $ 3,534,596 |
| Deferred tax liability: | | | |
| Capitalized interest | **$ (210,913)** | $ (113,490) | $ (92,032) |
| Unrealized exchange gain | | | (9,937) |
| Valuation allowance | **(17,032,260)** | (8,905,021) | (3,432,627) |
| Net deferred tax assets non-current | **$ (25,075,987)** | $ | $ |

As a result of strategic tax planning that became effective in 2006, a temporary difference between the tax and book bases of certain assets was created. Under FAS109 (Accounting for Income Taxes), the Company recognized a deferred tax asset of US$33.7 million and assessed a valuation allowance of US$8.4 million. Accordingly, an income tax benefit of US$25.3 million was recorded in 2006.

In 2006, the Company also recognized a deferred tax liability of US$0.2 million, which was relating to the timing differences generated from capitalized interest.

As of December 31, 2006, the Company s Shanghai, Beijing, Tianjin and Chengdu subsidiaries have net operating losses carried forward of US$334.4 million, of which US$32.2 million, US$129.7 million and US$172.5 million will expire in 2009, 2010 and 2011.

17. Income Taxes (Continued)

Reconciliation between the total income tax expense computed by applying the application enterprise income tax rate 15% to the income before income taxes and minority interest in the consolidated statements of operations were as follows:

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| Applicable enterprise income tax rate | **15.0%** | 15.0% | 15.0% |
| Expenses not deductible for tax purpose | **3.1%** | (1.4)% | 0.2% |
| Effect of tax holiday and tax concession | **25.0%** | 12.0% | (39.4)% |
| Expense (credit) to be recognized in future periods | **29.3%** | (5.2)% | 6.6% |
| Changes in valuation allowances | **(11.9)%** | (4.9)% | 3.7% |
| Effect of different tax rate of subsidiaries operating in other jurisdictions | **(24.9)%** | (15.8)% | 14.1% |
| Effective tax rate | **35.6%** | (0.3)% | 0.2% |

18. Capital Stock

In 2004, the Company issued:

(1) 95,714,286 Series D convertible preference shares and a warrant to purchase 9,571,429 Series D convertible preference shares to acquire certain assets and assume certain obligations from Motorola with a fair value of US$335,843,804. The accounting treatment requires a beneficial conversion feature on the Series D convertible preference shares to be calculated. The consideration received in the Series D offering was first allocated between the convertible instrument and the Series D warrant on a relative fair value basis. A calculation was then performed to determine the difference between the effective conversion price and the fair market value of the ordinary shares at the commitment date resulting in the recognition of a deemed dividend of US$18,839,426.

(2) 914,285 Series D convertible preference shares to acquire certain software licenses with a fair value of US$5,060,256 from a strategic technology partner. (see Note 11)

(3) 750,000 Series B convertible preference shares to a strategic partner with a fair value of US$2,739,853. (see Note 11)

(4) 12,343 Series B convertible preference shares to a service provider which was valued at US$45,090.

(5) 3,030,303,000 ordinary shares in connection with the Initial Public Offering (the IPO )

(6) 136,640 ordinary shares to a service provider with a fair value of US$17,965.

(7) 23,957,830 ordinary shares to a supplier in exchange for certain equipment with a fair value of US$5,222,180. (see Note 11)

19. Stock Options and Warrants

The Company s employee stock option plans (the Plans ) allow the Company to offer a variety of incentive awards to employees, consultants or external service advisors of the Company. In 2004, the Company adopted the 2004 Stock Option Plan ( 2004 Option Plan ) whereby the Company grants stock options to attract, retain and motivate employees, directors and service providers. Following the completion of the IPO, the Company began issuing stock options solely through the 2004 Option Plan. Options to purchase 1,317,000,000 ordinary shares are authorized under the 2004 Option Plan. Under the terms of the 2004 Option Plan options are granted at the fair market value of the Company s ordinary shares and expire 10 years from the date of grant and vest over a requisite service period of 4 years. Any compensation expense is recognized on a straight-line basis over the employee service period. As of December 31, 2006, options to purchase 510,225,118 ordinary shares were outstanding, and options to purchase 806,274,882 ordinary shares were available for future grants.

In 2001, the Company adopted the 2001 Stock Option Plan ( 2001 Option Plan ). Options to purchase 998,675,840 ordinary shares and 536,566,500 of Series A convertible preference shares are authorized under the 2001 Option Plan. Options to purchase Series A convertible preference shares were converted into options to purchase ordinary shares immediately prior to the completion of the IPO. Under the terms of the plans, options are generally granted at prices equal to the fair market value as estimated by the Board of Directors, expire 10 years from the date of grant and vest over a requisite service period of 4 years. Following the IPO, the Company no longer issues stock options under the 2001 plan. As of December 31, 2006, options to purchase 487,799,975 ordinary shares were outstanding, and options to purchase 368,139,728 ordinary shares were available for future grant.

A summary of the stock option activity is as follows:

| | Ordinary shares | | Weighted Average Remaining Contractual Term | Aggregated Intrinsic Value |
|---|---|---|---|---|
| | Number of options | Weighted average exercise price | | |
| Options outstanding at December 31, 2005 | 1,045,963,402 | $ 0.13 | | |
| Granted | 165,863,560 | $ 0.14 | | |
| Exercised | (95,328,832) | $ 0.04 | | |
| Cancelled | (118,473,037) | $ 0.17 | | |
| **Options outstanding at December 31, 2006** | **998,025,093** | **$ 0.14** | **7.43** | **46,407,772** |
| **Vested or expected to vest at December 31, 2006** | **830,627,032** | **$ 0.13** | **7.27** | **37,243,894** |
| **Exercisable at December 31, 2006** | **421,826,973** | **$ 0.12** | **6.31** | **24,277,264** |

The total intrinsic value of option exercised in the year ended December 31, 2006, 2005 and 2004 was US$5,240,221, US$2,725,661 and US$885,504, respectively.

19. Stock Options and Warrants (Continued)
Certain options were granted to non-employees that resulted in a share-based compensation expense of US$584,283, US$828,498 and US$765,557 in 2006, 2005 and 2004, respectively.

**Restricted share units**

In January 2004, the Company adopted the 2004 Equity Incentive Plan ( 2004 EIP ) whereby the Company provided additional incentives to the Company s employees, directors and external consultants through the issuance of restricted shares, restricted share units and stock appreciation rights to the participants at the discretion of the Board of Directors. Under the 2004 EIP, the Company was authorized to issue up to 2.5% of the issued and outstanding ordinary shares immediately following the closing of its initial public offering in March 2004, which were 455,409,330 ordinary shares. As of December 31, 2006, 140,295,146 restricted share units were outstanding and 249,481,557 ordinary shares were available for future grant through the issuance of restricted shares, restricted share units and stock appreciation rights. The RSUs vest over a requisite service period of four years and expire 10 years from the date of grant. Any compensation expense is recognized on a straight-line basis over the employee service period.

A summary of restricted share units activities is as follows:

| | Restricted share units | | Weighted Average Remaining Contractual Term | Aggregated Fair Value |
|---|---|---|---|---|
| | **Number of share units** | **Weighted average fair value** | | |
| Outstanding at December 31, 2005 | 189,739,191 | $ 0.14 | | |
| Granted | 16,058,864 | $ 0.13 | | |
| Exercised | (38,041,285) | $ 0.12 | | |
| Cancelled | (27,461,624) | $ 0.13 | | |
| **Outstanding at December 31, 2006** | **140,295,146** | **$ 0.14** | **8.47** | **19,574,050** |
| **Vested or expected to vest at December 31, 2006** | **49,555,883** | **$ 0.12** | **8.52** | **5,998,033** |
| **Exercisable at December 31, 2006** | **272,500** | **$ 0.15** | **8.84** | **40,880** |

Pursuant to the 2004 EIP, the Company granted 16,058,864, 122,418,740 and 118,190,824 restricted share units in 2006, 2005 and 2004, respectively, most of which vest over a period of 4 years. The fair value of the restricted share units at the date of grant was US$2,055,597, US$23,348,378 and US$26,001,981 in 2006, 2005 and 2004, respectively, which is expensed over the vesting period. As a result, the Company has recorded a compensation expense of US$5,452,148, US$7,051,688 and US$3,080,312 in 2006, 2005 and 2004 respectively.

19. Stock Options and Warrants (Continued)

**Unrecognized compensation cost related to non-vested share-based compensation**

As of December 31, 2006, there was US$32,406,172 of total unrecognized compensation cost related to non-vested share- based compensation arrangements granted under the 2001 Stock Option Plan, Stock Option Plan and 2004 EIP. The cost is expected to be recognized over a weighted-average period of 1.14 years.

**Notes receivable from employees**

At December 31, 2005 and 2004, the Company had notes receivable from employees related to the early exercise of employee stock options in the aggregate amount of US$nil and US$391,375, respectively. In 2005, the Company fully collected US$391,375 through the repayment of notes receivable by certain employees and the sale of the notes receivable to a third party bank. The notes are full recourse and are secured by the underlying ordinary shares and preference shares. The notes are due at various dates from year 2006 to 2008 and payable at varying rates from 3.02% to 4.28% per annum.

In 2006, 2005 and 2004, the notes earned interest in the aggregate amount of US$nil, US$40,238 and US$641,173, respectively.

As of December 31, 2006, 2005 and 2004 the Company had the following shares subject to repurchase:

| | **2006** | **2005** | **2004** |
|---|---|---|---|
| Ordinary shares | **16,498,871** | 35,964,021 | 203,973,224 |

20. Reconciliation of Basic and Diluted (Loss) Income per Share

The following table sets forth the computation of basic and diluted (loss) income per share for the years indicated:

| | | 2006 | | 2005 | | 2004 |
|---|---|---|---|---|---|---|
| (Loss) income attributable to holders of ordinary shares | **$** | **(44,109,078)** | $ | (114,774,827) | $ | 77,363,770 |
| Less: Cumulative effect of a change in accounting principle | | **(5,153,986)** | | | | |
| (Loss) income before cumulative effect of a change in accounting principle | | **(49,263,064)** | | (114,774,827) | | 77,363,770 |
| Basic and diluted: | | | | | | |
| Weighted average ordinary shares outstanding | | **18,361,910,033** | | 18,264,791,383 | | 14,441,917,246 |
| Less: Weighted average ordinary shares outstanding subject to repurchase | | **(27,411,110)** | | (80,362,128) | | (242,753,729) |
| Weighted average shares used in computing basic income per share | | **18,334,498,923** | | 18,184,429,255 | | 14,199,163,517 |
| Effect of dilutive securities: | | | | | | |
| Weighted average preference shares outstanding | | | | | | 3,070,765,738 |
| Weighted average ordinary shares outstanding subject to repurchase | | | | | | 242,753,729 |
| Warrants | | | | | | 102,323,432 |
| Stock options | | | | | | 264,409,484 |
| Restricted shares units | | | | | | 54,977,166 |
| Weighted average shares used in computing diluted income per share | | **18,334,498,923** | | 18,184,429,255 | | 17,934,393,066 |
| On the basis of income per share before cumulative effect of a change in accounting principle, basic | **$** | **(0.00)** | $ | (0.01) | $ | 0.01 |
| On the basis of income per share before cumulative effect of a change in accounting principle, diluted | **$** | **(0.00)** | $ | (0.01) | $ | 0.00 |
| Cumulative effect of a change in accounting principle per share, basic | **$** | **0.00** | $ | | $ | |
| Cumulative effect of a change in accounting principle per share, diluted | **$** | **0.00** | $ | | $ | |
| Basic (loss) income per share | **$** | **(0.00)** | $ | (0.01) | $ | 0.01 |
| Diluted (loss) income per share | **$** | **(0.00)** | $ | (0.01) | $ | 0.00 |

20. Reconciliation of Basic and Diluted (Loss) Income per Share (Continued)

Ordinary share equivalents of warrant and stock options are calculated using the treasury stock method. Under the treasury stock method, the proceeds from the assumed conversion of options and warrants are used to repurchase outstanding ordinary shares using the average fair value for the periods.

As of December 31, 2006 and 2005, the Company had 223,818,877 and 306,419,133, respectively, ordinary share equivalents outstanding, that could have potentially diluted loss per share in the future, but which were excluded in the computation of diluted loss per share in 2006 and 2005, as their effect would have been antidilutive due to the net loss reported in such period.

As of December 31, 2004, the Company had 75,769,953 ordinary share equivalents outstanding that could have potentially diluted income per share in the future, but which were excluded in the computation of diluted income per share in 2004, as their exercise prices were above the average market values in that year.

The following table sets forth the securities comprising of these antidilutive ordinary share equivalents for the years indicated:

| | | **December 31** | |
|---|---|---|---|
| | **2006** | **2005** | **2004** |
| Warrants to purchase ordinary shares | | | 9,584,403 |
| Outstanding options to purchase ordinary shares | **62,339,207** | 177,325,981 | 66,185,550 |
| Outstanding unvested restricted share units to purchase ordinary shares | **161,479,670** | 129,093,152 | |
| | **223,818,877** | 306,419,133 | 75,769,953 |

21. Commitments

**(a) Purchase commitments**

As of December 31, 2006 the Company had the following commitments to purchase machinery, equipment and construction obligations. The machinery and equipment is scheduled to be delivered at the Company s facility by December 31, 2007.

| | |
|---|---|
| Facility construction | $ 75,101,000 |
| Machinery and equipment | 536,442,000 |
| | $ 611,543,000 |

**(b) Investment commitments**

As of December 31, 2006, the Company had an outstanding commitment of US$29,260,000 in a 56.67% owned subsidiary. The Company expects to pay this amount in 2007.

**(c) Royalties**

Beginning in 2002, the Company has entered into several license and technology agreements with third parties. The terms of the contracts range from 3 to 10 years. The Company is subject to royalty payments based on a certain percentage of product sales, using the third parties technology or license. In 2006, 2005 and 2004, the Company incurred royalty expense of US$7,724,704, US$8,710,935 and US$6,258,709, respectively, which is included as part of cost of sales in the statement of operations.

Beginning in 2003, the Company has entered into several license agreements with third parties where the Company provides access to certain licensed technology. The Company will receive royalty payments based on a certain percentage of product sales using the Company s licensed technology. In 2006, 2005 and 2004, the Company earned royalty income of US$1,384,137, US$705,217 and US$336,216, respectively, which was included as part of sales in the statement of operations.

**(d) Operating lease as lessor**

The Company owns apartment facilities that are leased to the Company s employees at negotiated prices. The apartment rental agreement is renewed on an annual basis. The Company also leases office space to non-related third parties. Office lease agreements are renewed on an annual basis as well. The total amount of rental income recorded in 2006, 2005 and 2004 was US$6,142,692, US$6,952,946 and US$1,740,283, respectively.

21. Commitments (Continued)

**(e) Operating lease as lessee**

The Company has various operating leases including land use rights under non-cancellable leases expiring at various times through 2053. Future minimum lease payments under these leases as of December 31, 2006 are as follows:

| **Year ending** | |
|---|---|
| 2007 | $ 377,612 |
| 2008 | 162,757 |
| 2009 | 90,628 |
| 2010 | 61,500 |
| 2011 | 61,500 |
| Thereafter | 2,706,006 |
| | $ 3,460,003 |

22. Segment and Geographic Information

The Company is engaged principally in the computer-aided design, manufacturing and trading of integrated circuits. In accordance with SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information, the Company s chief operating decision maker has been identified as the Chief Executive Officer, who reviews consolidated results of manufacturing operations when making decisions about allocating resources and assessing performance of the Company. The Company believes it operates in one segment, and all financial segment information required by SFAS No. 131 can be found in the consolidated financial statements.

| | **2006** | **2005** | **2004** |
|---|---|---|---|
| Total sales: | | | |
| United States | **$ 602,506,213** | $ 478,162,160 | $ 391,433,443 |
| Europe | **440,327,872** | 316,576,024 | 125,596,424 |
| Asia Pacific (Excluding Japan and Taiwan) | **168,607,598** | 175,846,284 | 201,881,809 |
| Taiwan | **153,057,616** | 138,153,755 | 120,652,255 |
| Japan | **100,823,568** | 62,580,512 | 135,100,765 |
| | **$ 1,465,322,867** | $ 1,171,318,735 | $ 974,664,696 |

Revenue is attributed to countries based on headquarter of operation.

Substantially all of the Company s long lived assets are located in the PRC.

23. Significant Customers

The following table summarizes net revenue and accounts receivable for customers which accounted for 10% or more of our accounts receivable and net sales:

| | Net revenue | | | Accounts receivable | | |
|---|---|---|---|---|---|---|
| | Year ended December 31, | | | December 31, | | |
| | 2006 | 2005 | 2004 | 2006 | 2005 | 2004 |
| A | **28%** | 26% | 11% | **29%** | 32% | 15% |
| B | **17%** | 15% | 13% | **14%** | 17% | 8% |
| C | **8%** | 9% | 10% | **8%** | 6% | 6% |
| D | **2%** | 8% | 12% | **%** | 6% | 7% |
| E | **4%** | 7% | 6% | **7%** | 7% | 15% |
| F | **3%** | 5% | 13% | **3%** | 3% | 10% |
| G | **1%** | 2% | 4% | **1%** | 2% | 12% |

24. Litigation

**Overview of TSMC Litigation:**

Beginning in December 2003 through August 2004, the Company became subject to several lawsuits brought by Taiwan Semiconductor Manufacturing Company, Limited ( TSMC ) relating to alleged infringement of certain patents and misappropriation of alleged trade secrets relating to methods for conducting semiconductor fab operations and manufacturing integrated circuits.

On January 31, 2005, the Company entered into a settlement agreement, without admission of liability, which provided for the dismissal of all pending legal actions without prejudice between the two companies (the Settlement Agreement ). The terms of the Settlement Agreement also included:

1) The Company and TSMC agreed to cross-license each other s patent portfolio for all semiconductor device products, effective from January 2005 through December 2010.

2) TSMC covenanted not to sue the Company for trade secret misappropriation as alleged in TSMC s legal actions as it related to 0.15μm and larger processes subject to certain conditions ( TSMC Covenant ). The TSMC Covenant did not cover 0.13μm and smaller technologies after 6 months following execution of the Settlement Agreement (July, 31, 2005). Excluding the 0.13μm and smaller technologies, the TSMC Covenant remains in effect indefinitely, terminable upon a breach by the Company.

3) The Company is required to deposit certain Company materials relating to 0.13μm and smaller technologies into an escrow account until December 31, 2006 or under certain circumstances for a longer period of time.

4) The Company agreed to pay TSMC an aggregate of US$175 million in installments of US$30 million for each of the first five years and US$25 million in the sixth year.

**Accounting under the Settlement Agreement:**

In accounting for the Settlement Agreement, the Company determined that there were several components of the Settlement Agreement settlement of litigation, covenant not to sue, patents licensed by us to TSMC and the use of TSMC s patent license portfolio both prior and subsequent to the settlement date.

The Company does not believe that the settlement of litigation, covenant not to sue or patents licensed by us to TSMC qualify as accounting elements. In regard to the settlement of litigation, the Company cites the following:

The settlement agreement reached between TSMC and SMIC clearly stated that there was no admission of liability by either party;

The settlement agreement required all parties to bear their own legal costs;

24. Litigation (Continued)

**Accounting under the Settlement Agreement:** *(Continued)*

- There were no other damages associated with the Settlement Agreement;
- There was a provision in the Settlement Agreement for a grace period to resolve any misappropriation issues had they existed;
- Albeit a complaint had been filed by TSMC on trade secret infringement, TSMC has never identified which trade secrets it claimed were being infringed upon by the Company;
- The Settlement Agreement was concluded when the litigation process was still at a relatively early stage and the outcome of the litigation was therefore highly uncertain.

The TSMC covenant not to sue for alleged trade secrets misappropriation does not qualify as a separable asset in accordance with either SFAS 141 or SFAS 142 as TSMC had never specified the exact trade secrets that it claimed were misappropriated, the Company s belief that TSMC s trade secrets may be obtained within the marketplace by other legal means and the Company never obtained the legal right to use TSMC s trade secrets.

In addition, the Company did not attribute any value to the patents licensed to TSMC under the Settlement Agreement due to the limited number of patents held by the Company at the time of the Settlement Agreement.

As a result, the Company determined that only the use of TSMC s patent license portfolio prior and subsequent to the settlement date were considered elements of an arrangement for accounting purposes. In attributing value to these two elements, the Company first discounted the payment terms of the US$175 million settlement amount using an annual 3.4464% interest rate to arrive at a net present value of US$158 million. This amount was then allocated to the pre-and post-settlement periods based on relative fair value, as further described below.

Based on this approach, US$16.7 million was allocated to the pre-settlement period, reflecting the amount that the Company would have paid for use of the patent license portfolio prior to the date of the Settlement Agreement. The remaining US$141.3 million, representing the relative fair value of the licensed patent license portfolio, was recorded on the Company s consolidated balance sheets as a deferred cost and is being amortized over a six-year period, which represents the life of the licensed patent license portfolio. The amortization of the deferred cost is included as a component of cost of sales in the consolidated statements of operations.

**Valuation of Deferred Cost:**

The fair value of the patent license portfolio was calculated by applying the estimated royalty rate to the specific revenue generated and expected to be generated from the specific products associated with the patent license portfolio.

The selected royalty rate was based on the review of median and mean royalty rates for the following categories of licensing arrangements:

a) Existing third-party license agreements with SMIC;

b) The analysis of comparable industry royalty rates related to semiconductor chip/integrated circuit ( IC ) related technology; and

c) The analysis of comparable industry royalty rates related to semiconductor fabrication.

On an annualized basis, the amounts allocated to past periods was lower than that allocated to future periods as the Company assumed increases in revenues relating to the specific products associated with the patent license portfolio.

As the total estimated fair value of the patent license portfolio exceeded the present value of the settlement amount, the Company allocated the present value of the settlement amount based on the relative fair value of the amounts calculated prior and subsequent to the settlement date.

24. Litigation (Continued)
**Recent TSMC Legal Developments:**

On August 25, 2006, TSMC filed a lawsuit against the Company and certain subsidiaries (SMIC (Shanghai), SMIC (Beijing) and SMIC (Americas) in the Superior Court of the State of California, County of Alameda for alleged breach of the Settlement Agreement, alleged breach of promissory notes and alleged trade secret misappropriation by the Company. TSMC seeks, among other things, damages, injunctive relief, attorneys fees, and the acceleration of the remaining payments outstanding under the Settlement Agreement.

In the present litigation, TSMC alleges that the Company has incorporated TSMC trade secrets in the manufacture of the Company s 0.13 micron or smaller process products. TSMC further alleges that as a result of this claimed breach, TSMC s patent license is terminated and the covenant not to sue is no longer in effect with respect to the Company s larger process products.

The Company has vigorously denied all allegations of misappropriation. Moreover, TSMC has not yet proven, nor produced evidence of, any misappropriation by the Company. At present, the claims rest as unproven allegations, denied by the Company. The Court has made no finding that TSMC s claims are valid, nor has it set a trial date.

On September 13, 2006, the Company announced that in addition to filing a response strongly denying the allegations of TSMC in the United States lawsuit, it filed on September 12, 2006, a cross-complaint against TSMC seeking, among other things, damages for TSMC s breach of contract and breach of implied covenant of good faith and fair dealing.

On November 16, 2006, the High Court in Beijing, the People s Republic of China, accepted the filing of a complaint by the Company and its wholly-owned subsidiaries, SMIC (Shanghai) and SMIC (Beijing), regarding the unfair competition arising from the breach of bona fide (i.e. integrity, good faith) principle and commercial defamation by TSMC ( PRC Complaint ). In the PRC Complaint, the Company is seeking, among other things, an injunction to stop TSMC s infringing acts, public apology from TSMC to the Company and compensation from TSMC to the Company, including profits gained by TSMC from their infringing acts.

Under the provisions of SFAS 144, the Company is required to make a determination as to whether or not this pending litigation represents an event that requires a further analysis of whether the patent license portfolio has been impaired. We believe that the lawsuit is at a very early stage and we are still evaluating whether or not the litigation represents such an event. The Company expects further information to become available to us which will aid us in making a determination. The outcome of any impairment analysis performed under SFAS 144 might result in a material impact to our financial position and results of operations. Because the case is in its early stages, the Company is unable to evaluate the likelihood of an unfavourable outcome or to estimate the amount or range of potential loss.

25. Retirement Benefit
The Company s local Chinese employees are entitled to a retirement benefit based on their basic salary upon retirement and their length of service in accordance with a state-managed pension plan. The PRC government is responsible for the pension liability to these retired staff. The Company is required to make contributions to the state-managed retirement plan equivalent to 20-22.5% of the monthly basic salary of current employees. Employees are required to make contributions equivalent

to 6%-8% of their basic salary. The employer s contribution of such an arrangement was approximately US$5,452,660, US$4,128,059 and US$2,502,521 for the years ended December 31, 2006, 2005 and 2004, respectively. The retirement benefits do not apply to expatriate employees.

26. Distribution of Profits
As stipulated by the relevant laws and regulations applicable to China s foreign investment enterprise, the Company s PRC subsidiaries are required to make appropriations from net income as determined under accounting principles generally accepted in the PRC ( PRC GAAP ) to non distributable reserves which include a general reserve, an enterprise expansion reserve and a staff welfare and bonus reserve. Wholly-owned PRC subsidiaries are not required to make appropriations to the enterprise expansion reserve but appropriations to the general reserve are required to be made at not less than 10% of the profit after tax as determined under PRC GAAP. The staff welfare and bonus reserve is determined by the board of directors.

The general reserve is used to offset future extraordinary losses. The subsidiaries may, upon a resolution passed by the stockholders, convert the general reserve into capital. The staff welfare and bonus reserve is used for the collective welfare of the employee of the subsidiaries. The enterprise expansion reserve is for the expansion of the subsidiaries operations and can be converted to capital subject to approval by the relevant authorities. These reserves represent appropriations of the retained earnings determined in accordance with Chinese law. Appropriations to general reserve by the Company s PRC subsidiaries were US$11,956,185, US$10,432,239 and US$12,655,906 in 2006, 2005 and 2004, respectively.

27. Components of loss (income) from operations

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| Loss (income) from operations is arrived at after charging (crediting): | | | |
| Auditors remuneration | **$ 1,577,928** | $ 1,121,131 | $ 695,990 |
| Depreciation and amortization | **919,038,915** | 768,586,770 | 455,947,253 |
| Amortization of land use rights | **577,578** | 885,083 | 1,013,269 |
| Foreign currency exchange loss (gain) | **3,939,745** | (5,198,253) | 1,446,113 |
| (Income) loss on disposal of plant and equipment | **(43,121,929)** | | |
| (Reversal of) bad debt expense | **2,957,505** | (13,825) | 990,692 |
| Inventory write-down | **2,297,773** | 3,088,238 | 10,506,374 |
| Staff costs inclusive of directors remuneration | **$ 108,742,094** | $ 102,163,244 | $ 88,417,658 |

28. Directors Remuneration and Five Highest Paid Individuals

**Directors**

Details of emoluments paid by the Company to the directors of the Company in 2006, 2005 and 2004 are as follows:

| | Richard Chang | Kawanishi Tsuyoshi | Wang Yang Yuan | Hsu Ta-Lin | Lip-Bu Tan | Henry Shaw | Fang Yao | Jou Yen-Pong | Albert Y.C. | Lai Xing Cai | Jiang Shang zhou | Total |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **2006** | | | | | | | | | | | | |
| **Salaries and other benefits** | **192,727** | | | | | | | | | | | **192,727** |
| **Stock option benefits** | **156,241** | **12,951** | **12,951** | **12,951** | **12,951** | **12,951** | | | **37,742** | | | **258,736** |
| **Total emoluments** | **348,968** | **12,951** | **12,951** | **12,951** | **12,951** | **12,951** | | | **37,742** | | | **451,463** |
| 2005 | | | | | | | | | | | | |
| Salaries and other benefits | 190,724 | | | | | | | | | | | 190,724 |
| Stock option benefits | 97,664 | 49,026 | 8,608 | 8,608 | 8,608 | 8,608 | | 8,608 | | | | 189,730 |
| Total emoluments | 288,388 | 49,026 | 8,608 | 8,608 | 8,608 | 8,608 | | 8,608 | | | | 380,454 |
| 2004 | | | | | | | | | | | | |
| Salaries and other benefits | 190,343 | | | | | | | | | | | 190,343 |
| Stock option benefits | | 221,464 | | | | | | | | | | 221,464 |
| Total emoluments | 190,343 | 221,464 | | | | | | | | | | 411,807 |

28. Directors Remuneration and Five Highest Paid Individuals (Continued)
The emoluments of the directors were within the following bands:

| | 2006 Number of directors | 2005 Number of directors | 2004 Number of directors |
|---|---|---|---|
| HK$nil to HK$1,000,000 ($ 128,620) | **10** | 7 | 6 |
| HK$1,000,001 ($128,620) to HK$1,500,000 ($ 192,930) | | | 1 |
| HK$1,500,001 ($192,930) to HK$2,000,000 ($ 257,240) | | | 1 |
| HK$2,000,001 ($257,240) to HK$2,500,000 ($ 321,550) | | 1 | |
| HK$2,500,001 ($321,550) to HK$3,000,000 ($ 385,860) | **1** | | |

The Company granted 3,500,000, 15,000,000 and 5,100,000 options to purchase ordinary shares of the Company to the directors in 2006, 2005 and 2004, respectively. During the year ended December 31, 2006, nil stock options were exercised and 500,000 stock options were cancelled.

The Company granted 500,000, nil and 2,000,000 restricted share units to purchase ordinary shares of the Company to the directors in 2006, 2005 and 2004, respectively. During the year ended December 31, 2006, 1,000,000 restricted share units were exercised and nil restricted share units were cancelled.

In 2006, 2005 and 2004, no emoluments were paid by the Company to any of the directors as an inducement to join or upon joining the Company or as compensation for loss of office. In 2005, one director has declined an option to purchase 500,000 Ordinary Shares which the Board granted in November 2004. In 2006, two directors have declined an option to purchase 500,000 Ordinary Shares for each director which the Board granted in September 2006.

**Five highest paid employees emoluments**

Of the five individuals with the highest emoluments in the Group, one (2005: one; 2004: one) is director of the Company whose emoluments is included in the disclosure above. The emoluments of the remaining four in 2006, 2005 and 2004 are as follows:

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| Salaries and other benefits | **$ 518,198** | $ 513,570 | $ 430,144 |
| Bonus | **233,662** | 92,455 | 105,665 |
| Stock option benefits | **268,528** | 325,880 | 620,060 |
| Total emoluments | **$ 1,020,388** | $ 931,905 | $ 1,155,869 |

The bonus is determined on the basis of the basic salary and the performance of the Company and the individual.

28. Directors Remuneration and Five Highest Paid Individuals (Continued)
Their emoluments were within the following bands:

| | 2006 Number of individuals | 2005 Number of individuals | 2004 Number of individuals |
|---|---|---|---|
| HK$nil to HK$1,000,000 ($ 128,620) | | | |
| HK$1,000,001 ($128,620) to HK$1,500,000 ($ 192,930) | | | 3 |
| HK$1,500,001 ($192,930) to HK$2,000,000 ($ 257,240) | **3** | 3 | |
| HK$2,000,001 ($257,240) to HK$2,500,000 ($ 321,550) | **1** | 1 | |
| HK$4,500,001 ($578,790) to HK$5,000,000 (643,100) | | | 1 |

29. Dividend
Deemed dividend represents beneficial conversion feature relating to the preferential price of certain convertible equity instrument investor receives when the effective conversion price of the equity instruments is lower than the fair market value of the common stock to which the convertible equity instrument would have converted at the date of issuance. Accordingly, deemed dividend on preference shares represents the price difference between the effective conversion price of the convertible equity instrument and the ordinary share.

Other than the deemed dividend on preference shares as described above, no dividend has been paid or declared by the Company in 2006, 2005 and 2004.

30. Differences between US GAAP and International Financial Reporting Standards
The consolidated financial statements are prepared in accordance with US GAAP, which differ in certain significant respects from International Financial Reporting Standards ( IFRS ). The significant difference relates principally to share-based payments to employees and non-employees, presentation of minority interest, convertible financial instruments and assets held for sale.

(i) In respect of accounting treatment for stock option, IFRS 2, Share Based Payment , was issued to specify recognition, measurement and disclosure for equity compensation. IFRS 2 requires all share-based payment to be recognized in the financial statements using a fair value measurement basis. An expense should be recognised when good or services received are consumed. IFRS 2 was effective for periods beginning on or after January 1, 2005.

Under US GAAP, prior to the adoption of the SFAS 123(R), the Company can account for stock-based compensation issued to employees using one of the two following methods,

30. Differences between US GAAP and International Financial Reporting Standards (Continued)

**(a) Intrinsic value based method**

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

**(b) Fair value based method**

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

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

The Company has adopted the intrinsic value method of accounting for its stock options to employees in 2005 and 2004 and the share-based compensation recorded by the Company was US$25,735,849 and US$27,011,078, respectively. The fair value of the stock options is presented for disclosure purpose (see Note 3(v)).

Had the Company prepared the financial statements under IFRS, the Company would have adopted IFRS 2 retrospectively for the fiscal year began on January 1, 2005 and compensation expenses on share-based payments to employees would be calculated using fair value based method for the years prior to January 1, 2006. The additional share-based compensation under fair value method was US$7,261,778 and US$10,475,625, respectively, for year ended December 31, 2005 and 2004.

Meanwhile, the Company would not recognize the share-based payment in relating to the unvested portion since the adoption of IFRS 2.

Effective January 1, 2006, the Company adopted the provision of SFAS 123(R), Share-Based Payment . Under the provisions of SFAS 123(R), share-based compensation cost is measured at the grant date, based on the fair value of the award. The measurement of share-based compensation has no longer significant difference from IFRS 2.

(ii) Under IFRS, minority interest should be presented in equity section while under US GAAP minority interest should be presented outside of equity, between liability and equity.

Under IFRS, the portion of profit and loss attributable to the minority interest and to the parent entity is separately disclosed on the face of the income statement. While under US GAAP, amounts attributable to the minority interest are presented as a component of net income or loss.

30. Differences between US GAAP and International Financial Reporting Standards (Continued)

(iii) IFRS requires an issuer of convertible debt instrument to classify and recognize separately the instrument s liability and equity elements. Under IAS 32, which has been effective for annual periods beginning on or after January 1, 2005, an issuer of such instrument creates a financial liability (a contractual arrangement to deliver cash or other fi nancial assets) and has issued an equity instrument (a call option granting the holder the right to convert into preferred stock of the issuer). Under US GAAP, the entire instruments are classified as liability. The convertible debt instrument was issued in exchange for plant and equipment. Accordingly, adjustments are made to discount on the convertible promissory note, cost of plant and equipment and to stockholder s equity. In January 2004, the Company redeemed the convertible promissory note in cash. The increment in the costs allocated to plant and equipment was fully amortized in 2004.

(iv) Under US GAAP, beneficial conversion feature refers to the preferential price of certain convertible equity instruments an investor receives when the effective conversion price of the equity instruments in lower than the fair market value of the common stock to which the convertible equity instrument is convertible into at the date of issuance. US GAAP requires the recognition of the difference between the effective conversion price of the convertible equity instrument and the fair market value of the common stock as a deemed dividend.

Under IFRS, this deemed dividend is not required to be recorded.

(v) Prior to the issuance of IFRS 5, plant and equipment is initially measured at cost under IFRS. Under a cost model, plant and equipment are accounted for at cost less accumulated depreciation and accumulated impairment losses. Plant and equipment will continue to be depreciated even though the Company has determined that it will be disposed of within specified period.

Under US GAAP, a long-lived asset (disposal group) to be sold is classified as held for sale in the period in which certain specified criteria are met. A long-lived asset (disposal group) classified as held for sale is measured at the lower of its carrying amount or fair value less cost to sell and is not depreciated (amortized) while it is classified as held for sale. A long-lived asset that is reclassified as held and used shall be measured individually at the lower of its (a) carrying amount before the asset (disposal group) was classified as held for sale, adjusted for any depreciation (amortization) expense that would have been recognized had the asset (disposal group) been continuously classified as held and used, or (b) fair value at the date of the subsequent decision not to sell.

In 2004, International Accounting Standards Board issued IFRS 5 Non-current Assets Held for Sale and Discontinued Operation . Pursuant to IFRS 5, assets or disposal groups that are classified as held for sale are carried at the lower of carrying amount and fair value less costs to sell and are not depreciated. IFRS 5 should be applied prospectively for annual periods beginning on or after January 1, 2005. The Company early adopted IFRS 5 and the accumulated difference between IFRS and US GAAP was reversed in 2004.

30. Differences between US GAAP and International Financial Reporting Standards (Continued)

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

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

The adjustments necessary to restate net (loss) income attributable to holders of ordinary shares and stockholders equity in accordance with IFRS are shown in the tables set out below.

| | **2006** | **2005 (As Restated, see Note 31)** | **2004 (As Restated, see Note 31)** |
|---|---|---|---|
| Net (loss) income attributable to holders of ordinary shares as reported under US GAAP | **$ (44,109,078)** | $ (114,774,827) | $ 77,363,770 |
| IFRS adjustments: | | | |
| i) Recognizing an expense for share-based payment | | (7,261,778) | (10,475,625) |
| i) Reverse of cumulative effect of a change in accounting principal | **(5,153,986)** | | |
| iii) Depreciation of incremental costs allocated to plant and equipment | | | (124,944) |
| iv) Deemed dividend | | | 18,839,426 |
| v) Depreciation related to reclassification of unsold assets held for sale | | | 674,117 |
| Net (loss) income attributable to holders of ordinary shares under IFRS | **$ (49,263,064)** | $ (122,036,605) | $ 86,276,744 |
| Net (loss) income per share under IFRS | **$ (0.00)** | $ (0.01) | $ 0.01 |
| Stockholders equity as reported under US GAAP | **$ 3,007,419,918** | $ 3,029,316,155 | $ 3,115,942,285 |
| ii) Presentation of minority interest | **38,800,666** | 38,781,863 | |
| iii) Depreciation of incremental costs allocated to plant and equipment | | | (124,944) |
| iii) Accumulated amortization of discount on promissory notes | | | 124,944 |
| Stockholders equity under IFRS | **$ 3,046,220,584** | $ 3,068,098,018 | $ 3,115,942,285 |

30. Differences between US GAAP and International Financial Reporting Standards (Continued)

| | 2006 | 2005 (As Restated, see Note 31) | 2004 (As Restated, see Note 31) |
|---|---|---|---|
| Land use rights, net current portion as reported under US GAAP | | | |
| IFRS adjustment | | | |
| vi) Current portion adjustment for land use right | **712,521** | 650,581 | 522,114 |
| Under IFRS | **712,521** | 650,581 | 522,114 |
| Land use rights, net | | | |
| As reported | **38,323,333** | 34,767,518 | 39,197,774 |
| IFRS adjustments | | | |
| vi) Current portion adjustment for land use right | **(712,521)** | (650,581) | (522,114) |
| Under IFRS | **37,610,812** | 34,116,937 | 38,675,660 |
| Plant and equipment, net as reported under US GAAP | **3,244,400,822** | 3,285,631,131 | 3,311,924,599 |
| IFRS adjustments | | | |
| iii) Depreciation of incremental costs allocated to plant and equipment | | | (124,944) |
| iii) Incremental costs allocated to plant and equipment | | | 124,944 |
| Under IFRS | **3,244,400,822** | 3,285,631,131 | 3,311,924,599 |

30. Differences between US GAAP and International Financial Reporting Standards (Continued)

| | 2006 | 2005 (As Restated, see Note 31) | 2004 (As Restated, see Note 31) |
|---|---|---|---|
| Additional paid-in capital as reported under US GAAP | **3,288,733,078** | 3,291,407,448 | 3,289,724,885 |
| IFRS adjustments | | | |
| i) Recognizing an expense for share-based payment | | (17,620,141) | |
| i) Retrospective adjustment on adoption of IFRS 2 | **30,388,316** | 23,126,538 | (28,051,137) |
| i) Reverse of cumulative effect of a change in accounting principal | **5,153,986** | | |
| iv) Deemed dividend | | | (18,839,426) |
| iv) Carry forward prior year s adjustment on deemed dividend | **(55,956,051)** | (55,956,051) | (37,116,625) |
| Under IFRS | **$ 3,268,319,329** | $ 3,240,957,794 | $ 3,205,717,697 |
| Share-based compensation as reported under US GAAP | | (24,881,919) | (51,177,675) |
| IFRS adjustments | | | |
| i) Recognizing an expense for share-based payment | | 24,881,919 | |
| i) Retrospective adjustment on adoption of IFRS 2 | | | 51,177,675 |
| Under IFRS | **$** | $ | $ |
| Accumulated deficit as reported under US GAAP | **(288,810,490)** | (244,701,412) | (129,926,585) |
| IFRS adjustments | | | |
| i) Additional share-based compensation under IFRS 2 | | (7,261,778) | (10,475,625) |
| i) Carried over impact under IFRS 2 | **(17,737,403)** | (10,475,625) | |
| i) Impact on the adoption of IFRS 2 | **(12,650,913)** | (12,650,913) | (12,650,913) |
| i) Reverse of cumulative effect of a change in accounting principal | **(5,153,986)** | | |
| iii) Accumulated amortization of discount on promissory notes | | | (124,944) |
| iii) Depreciation of incremental costs allocated to plant and equipment | | | 124,944 |
| iv) Deemed dividend | | | 18,839,426 |
| iv) Carry forward prior year s adjustment on deemed dividend | **55,956,051** | 55,956,051 | 37,116,625 |
| Under IFRS | **$ (268,396,741)** | $ (219,133,677) | $ (97,097,072) |
| Cost of sales as reported under US GAAP | **$ 1,338,155,004** | $ 1,105,133,544 | $ 716,225,372 |
| IFRS adjustments | | | |
| i) Recognizing an expense for share-based payment | | 3,366,722 | |
| i) Retrospective adjustment on adoption of IFRS 2 | | | 4,496,905 |
| Under IFRS | **$ 1,338,155,004** | $ 1,108,500,266 | $ 702,722,277 |

30. Differences between US GAAP and International Financial Reporting Standards (Continued)

| | 2006 | 2005 (As Restated, see Note 31) | 2004 (As Restated, see Note 31) |
|---|---|---|---|
| Operating expenses as reported under US GAAP | **141,037,963** | 153,225,353 | 169,598,058 |
| IFRS adjustments | | | |
| i) Recognizing an expense for share-based payment | | 3,895,056 | |
| i) Retrospective adjustment on adoption of IFRS 2 | | | 5,978,720 |
| Under IFRS | **$ 141,037,963** | $ 157,120,409 | $ 175,576,778 |
| Other income, net as reported under US GAAP | **(56,100,658)** | (26,321,705) | 7,547,974 |
| IFRS adjustments | | | |
| v) Depreciation related to reclassification of unsold assets held for sale | | | 674,117 |
| Under IFRS | **$ (56,100,658)** | $ (26,321,705) | $ 8,222,091 |

In addition to the above, there are also other differences between US GAAP and IFRS relevant to the accounting policies of the Company. These differences have not led to any material differences in 2006, 2005 and 2004, and details of which are set out as below:

**(a) Inventory valuation**

Inventories are carried at cost under both US GAAP and IFRS. However, if there is evidence that the net realisable value of goods, in their disposal in the ordinary course of business, will be less than cost, whether due to physical obsolescence, changes in price levels, or other causes, the difference should be recognized as a loss of the current period. This is generally accomplished by stating such goods at a lower level commonly known as market .

Under US GAAP, a write-down of inventories to the lower of cost or market at the close of a fiscal period creates a new cost basis that subsequently cannot be reversed based on changes in underlying facts and circumstances. Market under US GAAP is the lower of the replacement cost and net realizable value minus normal profit margin.

Under IFRS, a write-down of inventories to the lower of cost or market at the close of a fiscal period is a valuation allowance that can be subsequently reversed if the underlying facts and circumstances changes. Market under IFRS is net realizable value.

No significant GAAP difference was noted in 2006, 2005 and 2004.

30. Differences between US GAAP and International Financial Reporting Standards (Continued)

**(b) Deferred income taxes**

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

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

With respect to the measurement of the deferred tax, IFRS requires recognition of the effects of a change in tax laws or rates when the change is substantively enacted . US GAAP requires measurement using tax laws and rates enacted at the balance sheet date.

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

No significant GAAP difference was noted in 2006, 2005 and 2004.

**(c) Segment reporting**

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

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

No significant difference on reportable segment was noted.

30. Differences between US GAAP and International Financial Reporting Standards (Continued)

**(d) Borrowing costs**

IFRS and US GAAP requires capitalization of borrowing costs for those borrowings that are directly attributable to acquisition, construction or production of assets that necessarily take a substantial period of time to get ready for their intended use or sale. The amount to be capitalized is the borrowing cost which could theoretically have been avoided if the expenditure on the qualifying asset were not made. Under IFRS, borrowing costs are defined as interest and any other costs incurred by an enterprise in connection with the borrowing of funds, while under the US GAAP, borrowing costs are defined as interest only.

Under IFRS, to the extent that funds are borrowed specifically for the purpose of obtaining a qualified asset, the amount of borrowing costs eligible for capitalization is determined as the actual borrowing costs incurred on the borrowing during the period less any investment income on the temporary investment of those borrowing. The amount of borrowing costs to be capitalized under US GAAP is based solely on actual interest incurred related to actual expenditure incurred.

No significant GAAP difference was noted in 2006, 2005 and 2004.

**(e) Impairment of asset**

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

Under US GAAP, long-lived assets and certain identifiable intangibles (excluding goodwill) held and used by an entity are reviewed for impairment whenever events or changes in circumstances indicate that the carrying value of a long-lived asset and certain identifiable intangibles (excluding goodwill) may not be recoverable. An impairment loss is recognized if the expected future cash flows (undiscounted) are less than the carrying amount of the assets. The impairment loss is measured based on the fair value of the long-lived assets and certain identifiable intangibles (excluding goodwill). Subsequent reversal of the loss is prohibited. Long-lived assets and certain identifiable intangibles (excluding goodwill) to be disposed of are reported at the lower of carrying amount or fair value less cost to sell.

The Company had no impairment loss under either US GAAP or IFRS in 2006, 2005 and 2004.

30. Differences between US GAAP and International Financial Reporting Standards (Continued)

**(f) Research and development costs**

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

- the technical feasibility of completing the intangible asset so that it will be available for use or sale;
- its intention to complete the intangible asset and use or sell it;
- its ability to use or sell the intangible asset;
- how the intangible asset will generate probable future economic benefits. Among other things, the enterprise should demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset;
- the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset; and
- its ability to measure the expenditure attributable to the intangible asset during the development phase.

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

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

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

No significant difference was noted in 2006, 2005 and 2004.

**(g) Statements of cash flows**

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

31. Re-statement

As a result of review of the accounting treatment for the Settlement Agreement reached with TSMC on January 31, 2005 (See note 24), the Company determined that errors were made in the identification and classification of the components of settlement payment. The Company previously recorded US$23.2 million of the settlement amount as an expense in 2004 and US$134.8 million of intangible assets associated with the patent license portfolio and covenant not to sue. The Company determined that the payment was made solely for the right to use the licensed patent license portfolio both prior and subsequent to the settlement date.

The TSMC covenant not to sue for alleged trade secrets misappropriation does not qualify as a separable asset in accordance with either SFAS 141 or SFAS 142 as TSMC had never specified the exact trade secrets that it claimed were misappropriated, the Company s belief that TSMC s trade secrets may be obtained within the marketplace by other legal means and the Company never obtained the legal right to use TSMC s trade secrets. As a result, the Company has determined that no value should have been allocated to the covenant not to sue.

31. Re-statement (Continued)

This determination impacted the allocation of the settlement amount to its various components, which resulted in the Company decreasing the amount of expense recognized in its 2004 financial statements from US$23.2 million to US$16.7 million in 2004 and increased the deferred cost associated with the patent license portfolio from US$134.8 million to US$141.3 million. This correction also affected the amount of expense recorded in periods subsequent to the settlement date given the higher asset value being recorded and the shorter amortization period of the patent license portfolio as compared to the covenant not to sue.

In addition, the Company corrected the classification of the payment for the patent license portfolio from an intangible asset to a deferred cost and has also reclassified the amortization of the deferred asset from amortization of intangibles to a component of cost of sales. The effects of correcting these errors is shown below:

**Consolidated Balance Sheets**

| | As of December 31, | | | |
|---|---|---|---|---|
| | 2005 | | 2004 | |
| | As Previously Reported | As restated | As Previously Reported | As restated |
| Acquired intangible assets, net | $ 195,178,898 | $ 80,667,737 | | |
| Deferred cost | | 117,728,792 | | |
| Total assets | 4,583,415,731 | 4,586,633,362 | | |
| Accrued expense and other current liabilities | | | 82,857,551 | 76,399,187 |
| Total current liabilities | | | 730,329,536 | 723,871,172 |
| Total liabilities | | | 1,274,791,610 | 1,268,333,246 |
| Accumulated deficit | (247,919,043) | (244,701,412) | (136,384,949) | (129,926,585) |
| Total stockholders equity | 3,026,098,524 | 3,029,316,155 | 3,109,483,921 | 3,115,942,285 |
| Total liabilities and stockholders equity | 4,583,415,731 | 4,586,633,362 | | |

**Consolidated Statements of Operations**

| | As of December 31, | | | |
|---|---|---|---|---|
| | 2005 | | 2004 | |
| | As Previously Reported | As restated | As Previously Reported | As restated |
| Sales | 1,171,318,735 | 1,171,318,735 | | |
| Cost of sales | 1,081,587,786 | 1,105,133,544 | | |
| Gross Profit | 89,730,949 | 66,185,191 | | |
| Operating expenses: | | | | |
| Litigation settlement | | | 23,153,105 | 16,694,741 |
| Amortization of intangible assets | 41,251,077 | 20,946,052 | | |
| Total operating expenses | 173,530,378 | 153,225,353 | 176,056,422 | 169,598,058 |
| Income (loss) from operations | (83,799,429) | (87,040,162) | 82,382,902 | 88,841,266 |
| (Loss) income before income tax | (110,121,134) | (113,361,867) | 89,930,876 | 96,389,240 |
| Net (loss) income before cumulative effect of a change in accounting principle | (111,534,094) | (114,774,827) | 89,744,832 | 96,203,196 |
| Net income (loss) | (111,534,094) | (114,774,827) | 89,744,832 | 96,203,196 |
| Net income (loss) loss attributable to common stockholders | (111,534,094) | (114,774,827) | 70,905,406 | 77,363,770 |
| Income (loss) per share, basic | $ (0.01) | $ (0.01) | $ 0.00 | $ 0.01 |
| Income (loss) per share, diluted | $ (0.01) | $ (0.01) | $ 0.00 | $ 0.00 |

31. Re-statement (Continued)

**Consolidated Statements of Cash Flows**

| | 2005 | | 2004 | |
|---|---|---|---|---|
| | As Previously Reported | As restated | As Previously Reported | As restated |
| (Loss) income attributable to holders of ordinary shares | (111,534,094) | (114,774,827) | 70,905,406 | 77,363,770 |
| Net (loss) income | (111,534,094) | (114,774,827) | 89,774,832 | 96,203,196 |
| Depreciation and amortization | 745,926,095 | 769,471,853 | | |
| Amortization of intangible assets | 41,251,077 | 20,946,052 | | |
| Accrued expenses and other current liabilities | | | 32,115,883 | 25,657,519 |

32. Subsequent Events

On April 10, 2007, Cension Semiconductor Manufacturing Corporation ( Cension ) entered into an Asset Purchase Agreement (the Agreement ) with Elpida Memory, Inc. ( Elpida ), a Japan based memory chip manufacturer, for the purchase of Elpida s 200mm wafer processing equipment currently located in Hiroshima, Japan for the total price of US$320 million. The Company has the contract to manage Cension s 200-millimeter fab in Chengdu.

As part of the Agreement, the Company will provide a corporate guarantee for a maximum guarantee liability of US$163.2 million on behalf of Cension in favor of Elpida. The Company s guarantee liability will terminate upon full payment of the purchase price by Cension to Elpida. In return for providing the above corporate guarantee, the Company would receive a guarantee fee from Cension.

In conjunction with the Agreement, the Company will be entitled to the net profit (loss) associated with the production in Hiroshima during the transitional period (estimated to be no longer than 24 months) when the equipment acquired by Cension is being relocated in stages from Hiroshima to Chengdu.