



中芯國際集成電路製造有限公司\*  
Semiconductor Manufacturing International Corporation  
(Incorporated in the Cayman Islands with limited liability)  
(Stock Code: 981)

THE  
**FOUNDRY**  
FOR YOUR VISION



Annual Report 2005

\* For identification purposes only

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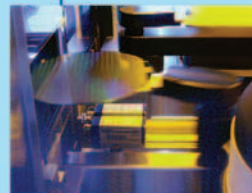
<http://www.smics.com>



Design Service Support



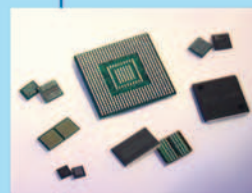
Mask Making



Wafer Manufacturing



Wafer Bumping

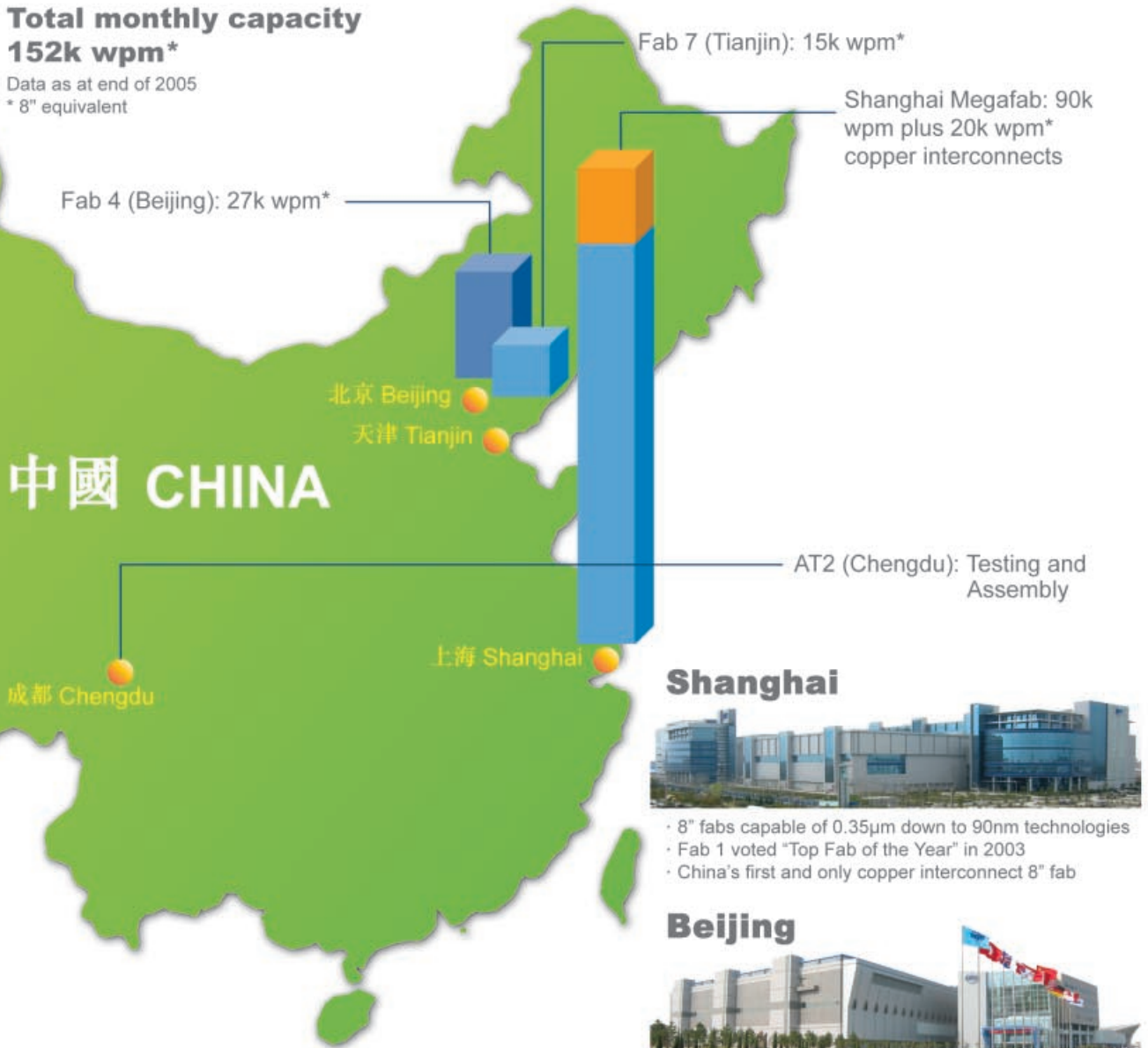


Assembly & Testing

# SMIC - The largest and most advanced foundry in China

**Total monthly capacity**  
**152k wpm\***

Data as at end of 2005  
\* 8" equivalent



**“SMIC became the third largest dedicated foundry in the world in 2005. It occupied over 50% of China's foundry market.”**

source: leading technology market research

## Shanghai



- 8" fabs capable of 0.35 $\mu$ m down to 90nm technologies
- Fab 1 voted "Top Fab of the Year" in 2003
- China's first and only copper interconnect 8" fab

## Beijing



- The first 12" fab in China
- 0.15 $\mu$ m to 90nm technologies
- China's first and only copper interconnect 12" fab

## Tianjin



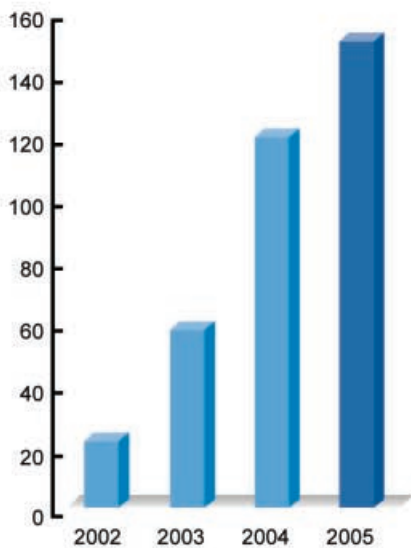
- 8" fab offering 0.35 $\mu$ m to 0.15 $\mu$ m technologies

## Chengdu



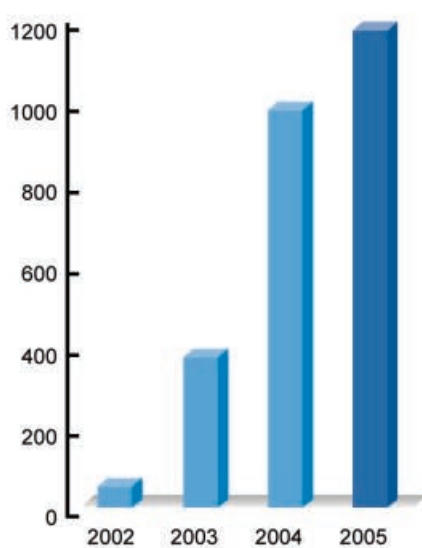
- In-house testing & assembly for a "turn-key" solution in China
- Now entered production

**Monthly Capacity**  
(thousands) \*



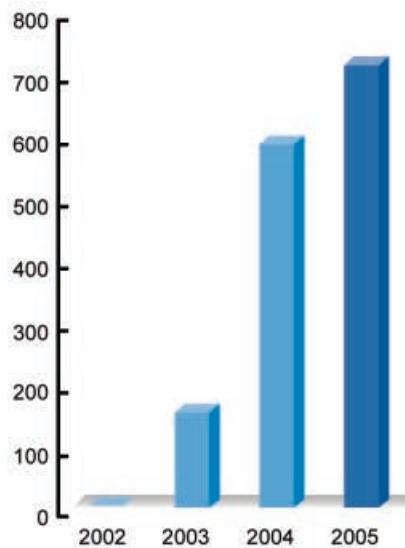
\* 8" equivalent

**Sales**  
(US\$m) \*\*



\*\* Audited

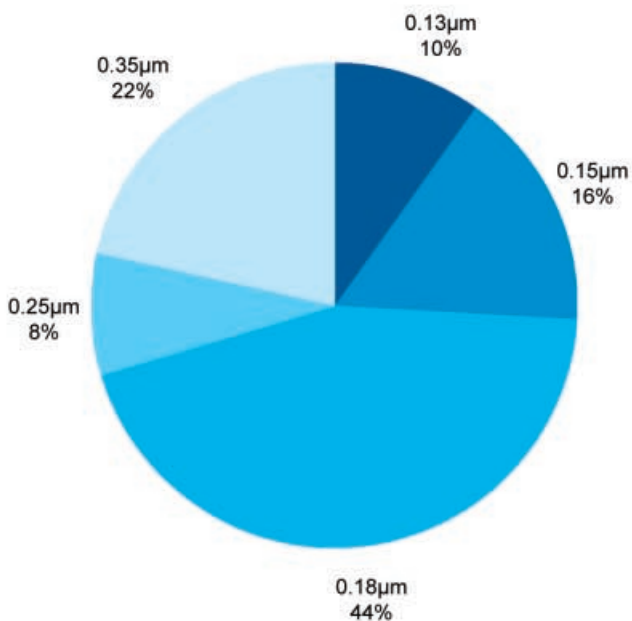
**EBITDA**  
(US\$m) \*\*\*



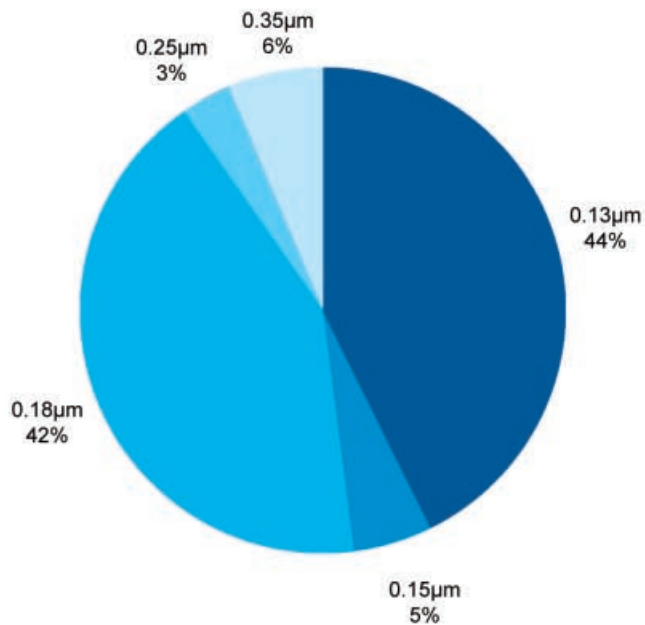
\*\*\* EBITDA (Earnings Before Interests, Taxes, Depreciation and Amortization)

***“ We have upgraded our wafer capacity to generate more revenue from advanced technology nodes. ”***

**Beginning of 2004 (1Q04)**



**End of 2005 (4Q05)**





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### **CAUTIONARY STATEMENT FOR PURPOSES OF THE "SAFE HARBOR" PROVISIONS OF THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995**

This annual report may contain, in addition to historical information, "forward-looking statements" within the meaning of the "safe harbor" provisions of the U.S. Private Securities Litigation Reform Act of 1995. These forward-looking statements are based on SMIC's current assumptions, expectations and projections about future events. SMIC uses words like "believe," "anticipate," "intend," "estimate," "expect," "project" and similar expressions to identify forward-looking statements, although not all forward-looking statements contain these words. These forward-looking statements are necessarily estimates reflecting the best judgment of SMIC's senior management and involve significant risks, both known and unknown, uncertainties and other factors that may cause SMIC's actual performance, financial condition or results of operations to be materially different from those suggested by the forward-looking statements including, among others, risks associated with cyclicity and market conditions in the semiconductor industry, intense competition, timely wafer acceptance by SMIC's customers, timely introduction of new technologies, SMIC's ability to ramp new products into volume, supply and demand for semiconductor foundry services, industry overcapacity, shortages in equipment, components and raw materials, availability of manufacturing capacity and financial stability in end markets.

Except as required by law, SMIC undertakes no obligation and does not intend to update any forward-looking statement, whether as a result of new information, future events or otherwise.



## The most advanced foundry in China

SMIC is a pure-play foundry that offers 0.35 micron to advanced 90 nanometer IC manufacturing services. SMIC is headquartered in Shanghai and has four 8-inch fabs including a dedicated copper interconnect line. SMIC also has a 12-inch fab in Beijing, the first of its kind in China. SMIC's joint ventures, a testing and assembly facility in Chengdu with UTAC and the manufacturing of on-chip color filters and micro lenses in Shanghai with Toppan, are also in production



## The local advantage

With economic growth at close to 10% in 2005, China offers tremendous market opportunities. Its booming economy and the production shift to China are the main drivers for the strong semiconductor demand, resulting in China having the largest demand for IC chips in 2005. Less than 10% of this demand can be met locally

Since 2000, SMIC has been doing business in China and is well placed to take advantage of the tremendous opportunities in this fast growing market





## Technology for the masses

SMIC is helping China to prepare for a world that is permeated with technology

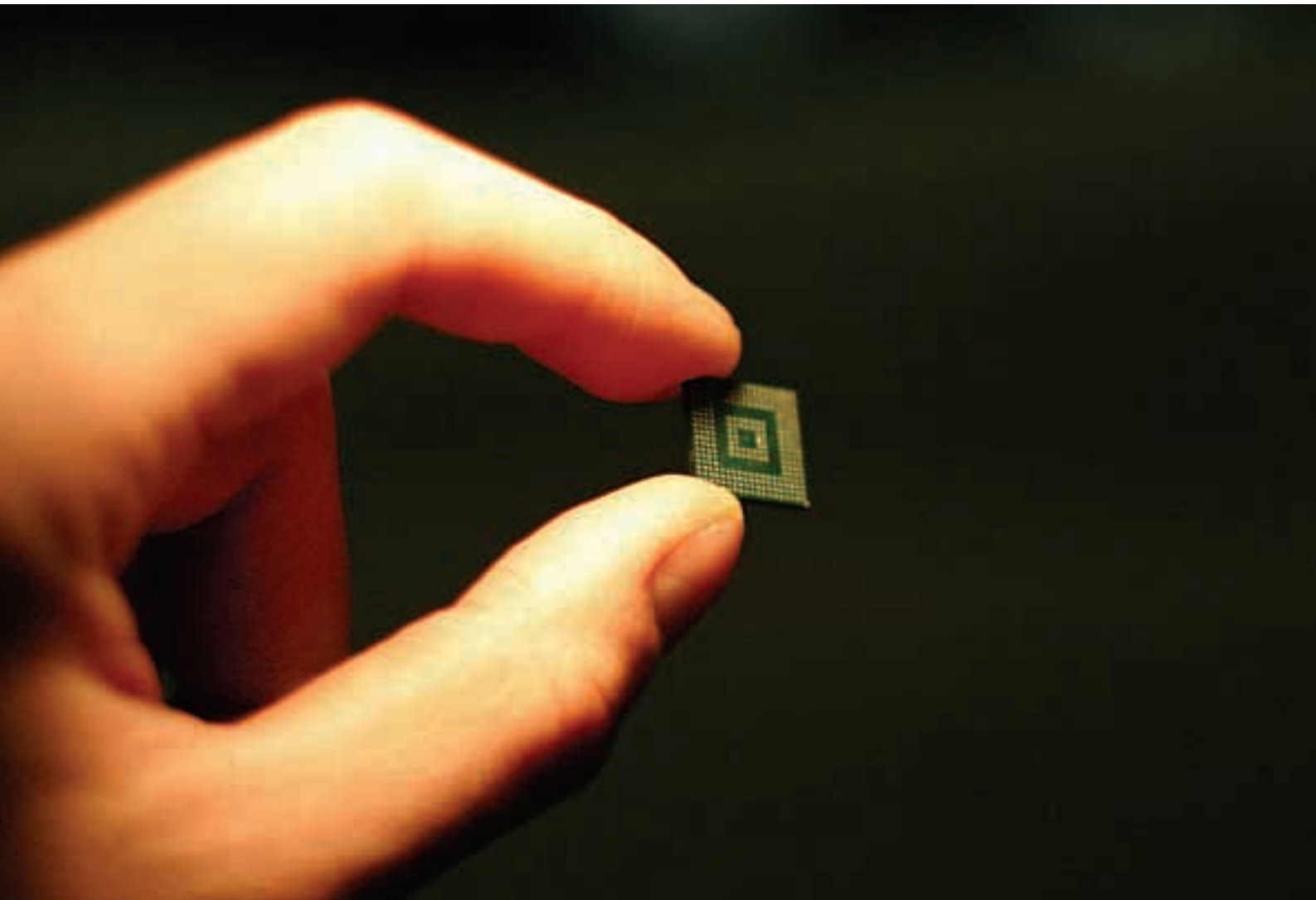
SMIC helped its customer manufacture the world's smallest 3G baseband chip based on TD-SCDMA, China's first 3G industrial standard


SMIC is the first to bring advanced wafer manufacturing into China



## Complete “Turn-Key” solution

To help our customers do business in China, SMIC provides a complete IC manufacturing solution within China. In addition to wafer fabrication, SMIC also provides by itself or through its partners a range of complementary services, from circuit design support and mask making, to wafer level probing and testing



A photograph of a desk with a laptop, a camera, a mobile phone, and a RAM module. The laptop is in the top right, the camera in the top left, the mobile phone in the bottom right, and the RAM module in the bottom left. The desk surface has a wood grain pattern.

## Broad range of applications

SMIC currently provides semiconductor fabrication services for the following devices:

- Logic technologies, including standard logic, mixed-signal, RF and high voltage circuits
- Memory technologies, including DRAM, SRAM, flash, EEPROM and mask ROM
- Specialty technologies, including LCOS, CMOS image sensors, and system-on-chip

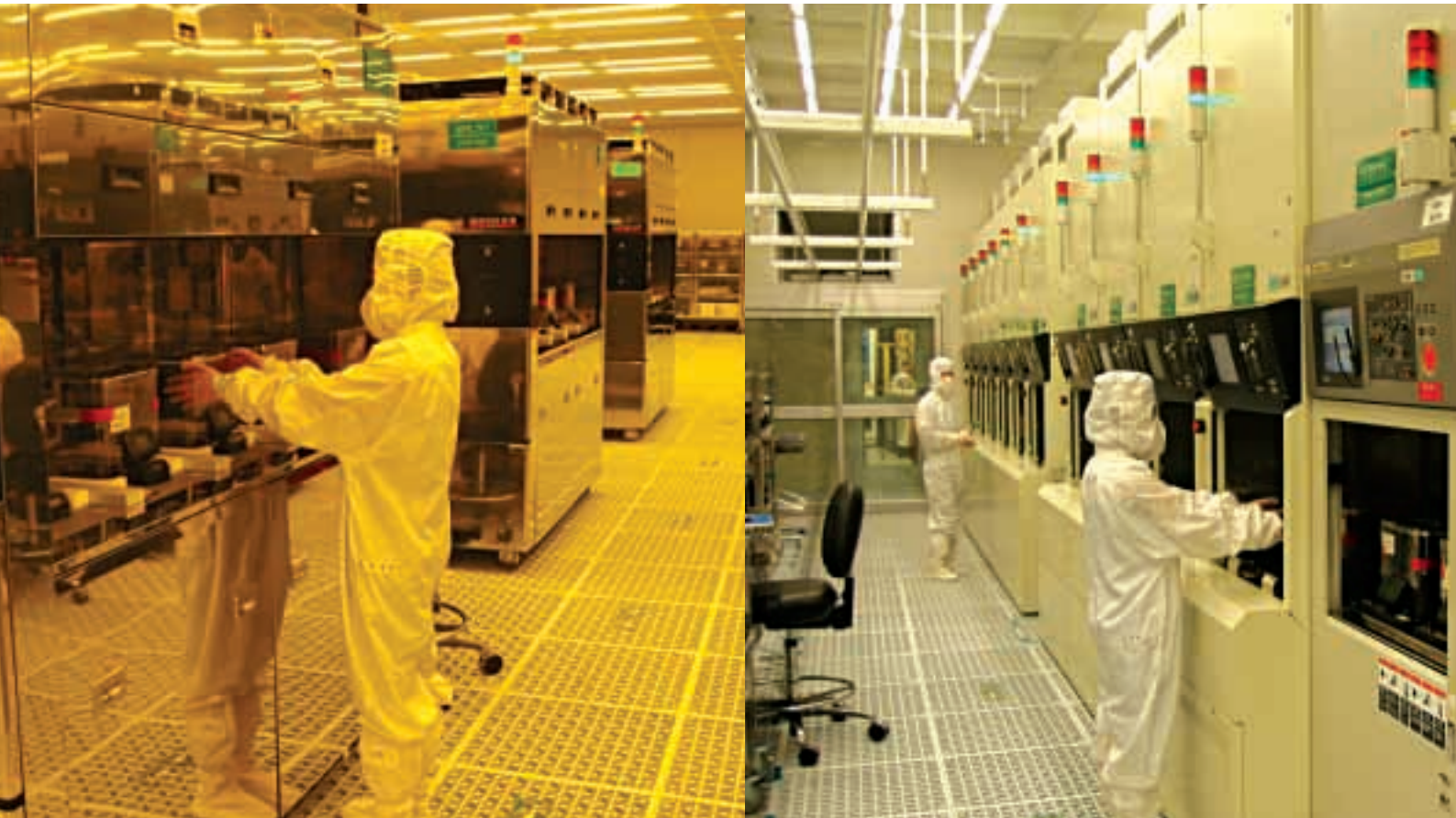
These semiconductors are used in various computing, communications, consumer and industrial applications, such as PCs, mobile telephones, and digital cameras

## Concern for the environment

SMIC is a pioneer for implementing class-leading measures for protecting the environment. These include advanced water recycling facilities at its fabs in Shanghai and Beijing, as well as air cooling systems in Beijing

SMIC has started a scrap wafer recycling facility in Shanghai to produce solar panel modules. The solar power industry encompasses what SMIC stands for: concern for the environment, tremendous market opportunity, and taking advantage of its market position in China





## Strong R&D team

Key to SMIC's rapid technology development and excellent fab management is a strong research and development team made up of experienced engineers from North America, Europe and Asia. The pool of talents includes over 2,500 semiconductor industry experts and technical staff

## Treasure & nurture our talents

SMIC values its talents tremendously. A mentorship program is in place to foster sharing of knowledge amongst employees. More than 500 classes are conducted annually on a diverse range of subjects including technology, business operations, management and personal development. SMIC also has joint education programs with Fudan, Jiaotong and Tongji Universities

SMIC offers quality housing for its employees in Shanghai and Beijing. The accommodation also benefits from close proximity to SMIC schools as well as other amenities



## Corporate Information

Registered name	Semiconductor Manufacturing International Corporation (the “Company” or “SMIC”)
Chinese name (for identification purposes only)	中芯國際集成電路製造有限公司
Registered office	PO Box 309 GT Ugland House George Town Cayman Islands
Head office and place of business in PRC	18 Zhangjiang Road PuDong New Area Shanghai 201203 PRC
Place of business in Hong Kong registered under Part XI of the Companies Ordinance	Suite 1505 15th Floor 9 Queen’s Road Central Hong Kong
Website address	<a href="http://www.smics.com">http://www.smics.com</a>
Company secretary	Anne Wai Yui Chen
Authorized representatives	Richard Ru Gin Chang Anne Wai Yui Chen
Places of listing	Stock Exchange of Hong Kong (“HKSE”) New York Stock Exchange (“NYSE”)
Stock code	0981 (HKSE) SMI (NYSE)

## FINANCIAL CALENDAR

Announcement of 2005 results	March 30, 2006
Book Closure Period	May 19, 2006 to May 30, 2006
Annual General Meeting	May 30, 2006
Financial year end	December 31

“ SMIC had been recognized by leading technology market research companies as the number 3 foundry in the world and achieved the highest growth rate of 19% amongst the top foundries in 2005. ”

Dear Shareholders,

According to the most recent research figures released earlier this year by several market research companies, China has already surpassed the United States to become the world's largest market for integrated circuits. SMIC had been recognized by leading technology market research companies as the number 3 foundry in the world in 2005. Its advanced 12" fab in Beijing is the first of its kind in China, and began commercial production in 2005. SMIC achieved the highest growth rate of approximately 20% amongst the top foundries last year and produced half of Chinese foundries' semiconductor output in 2005.

SMIC has manufactured for its Chinese customers numerous new and exciting products, some of which have received awards or been recognized by industry experts. During the year we produced the first advanced baseband chip based on China's own TD-SCDMA 3G Standard. A world class satellite broadcast receiver chip that SMIC manufactures for another Chinese customer has received a Technology Innovation Award from China's Ministry of Information Industry. Recently SMIC had also been certified as Sony's Green Partners in recognition of our strong commitment to environmental protection.

As a publicly listed company on the New York Stock Exchange, the Company is subject to the requirements of the Sarbanes-Oxley Act of 2002 ("SOX"). The Company has established committees and dedicated teams to improve the internal controls of the Company. The fulfillment of the requirements of SOX remains a priority for the Company, as the Company seeks to maintain a responsible corporate citizen, a high level of transparency and international standards of corporate governance.

The continuous integration of technology into our lives is accepted as a part of everyday life. SMIC is working on preparing for a world that is permeated with technology. SMIC has now established itself among the top tier of semiconductor foundries in the world, and is bringing the most advanced technology to foster excellence in the semiconductor industry. I look forward to sharing these very exciting developments with you as SMIC continues to expand its technology expertise to serve its customers and deliver superior returns to its shareholders.

Sincerely,  
**Yang Yuan Wang**  
*Chairman of the Board*

Shanghai, the PRC  
April 27, 2006

## Chief Executive Officer's Statement

*“ Our team in Beijing was able to ramp the yield of our customer's leading edge DDR2 DRAM product to industry leading levels, only nine months after our first 12-inch wafer fab began commercial production in March 2005. ”*

Dear Shareholders,

I am pleased to report SMIC has been able to continue to grow its revenues strongly despite a difficult environment for the semiconductor industry in early 2005. Revenue for the year increased to \$1,171 million as we continued to add capacity as demanded by our customers. Because we are a new foundry with only four years of commercial operations, and continue to expand our capacity to meet the increasing capacity demands of our customers, our depreciation expense as a percentage of revenues remains the highest in the foundry industry. Despite these high depreciation expenses, we believe that we will become profitable by improving our product mix, thereby increasing our average selling price. It is particularly significant that our team in Beijing was able to ramp the yield of our customer's leading edge DDR2 DRAM product to industry leading levels, only nine months after our first 12-inch wafer fab began commercial production in March 2005.

As part of our multi-prong approach to improve our product mix, our first logic product manufactured at the advanced 90 nanometer technology node is being qualified by our customer. We anticipate that we will begin producing this product commercially in Beijing in the second quarter of 2006. This advanced logic product will actually be the first 90 nanometer product out of our wafer fab in Beijing, and will be followed by DDR2 DRAM products for our foundry DRAM customers a short while later. This marks a very important milestone for the semiconductor industry in China and is a testament to the skills and knowledge of our world-class R&D and operations team in SMIC.

The last piece of the 90 nanometer puzzle is the cutting edge NAND flash product that we are developing in conjunction with Saifun Technologies Limited. I am very excited to see SMIC's product lines expanding into areas with such high growth potential. We will be utilizing a 90 nanometer production process, which is fully compatible with our logic wafer production lines. They will form an ideal advanced technology filler in our wafer fabs. We are looking to wrap up our design of our first NAND flash chip with a capacity of 2 gigabit by the middle of the year, and look to begin limited production on our 8-inch production lines at the end of the year. The design is very advanced and the size of these chips is extremely small and competitive with the ones being produced by the industry leaders, making them ideal for use in removable storage in wireless handsets, which we believe is a market with one of the highest growth potential in the next few years.

*“ Our first logic product manufactured at the advanced 90 nanometer technology node marks a very important milestone for the semiconductor industry in China and is a testament to the skills and knowledge of our world-class R&D and operations team in SMIC. ”*



## Chief Executive Officer's Statement

During the second half of 2005 we have seen the semiconductor industry recover very strongly, and consequently we made the decision to ramp up our fabs in 2006 to take advantage of this cycle. In order to serve our customers better for general logic products at mainstream and advanced nodes, we will continue to ramp out the front end fabs in Shanghai to their maximum designed capacity, and also continue to build out our copper interconnect capacity on 8-inch wafer, according to customer demand. We are seeing very substantial demand for our advanced copper interconnect services on 8-inch wafers. We expect this trend to continue for the rest of 2006 and aim to derive 35% of our logic products revenue from 0.13 micron and below in the fourth quarter of 2006. Shanghai continues to form the cornerstone of our main foundry operations and I thank our colleagues for keeping our megafab a world-class fab.

As I mentioned previously our Beijing operations have been successfully producing DDR2 DRAM at 0.11 micron technology node for almost one year, and by the middle of this year all our DRAM products produced on 12-inch wafers will have been transferred to a smaller and more advanced 90 nanometer node. We are planning for our Beijing fab and a new facility in Shanghai to spearhead SMIC's future expansion into 12-inch wafer manufacturing. We have witnessed the tremendous progress of IC design houses in China with their technical design capability improving by leaps and bounds, and we are anticipating even greater cooperation with the rising stars in China in 2006.

Cumulatively we are anticipating a very exciting year for SMIC. We have spent a lot of effort in making sure SMIC is well positioned to take advantage of the many opportunities that lie ahead. Our capital expenditure target for 2006 of US\$1.1 billion is based on anticipated customer demand for our services this year and beyond. We have taken on management contracts to operate wafer fabs in Chengdu and Wuhan, and are building a shell to house our first 12-inch in Shanghai, in order to take advantage of anticipated demand from our customers from China and the rest of the world. Our testing and assembly facility in Chengdu has commenced production in March this year, which enables SMIC to offer a complete turnkey service for customers' products in China. Our

joint venture with Toppan Printing Co. Ltd. in the manufacture of on-chip color filters and micro lenses for CMOS image sensors has also entered commercial production to take advantage of the fact that China has already become the largest market for mobile handsets in 2005. Our foray into solar power is also going extremely well. We have constructed a facility for this project and are in discussions regarding a separate facility to manufacture the raw materials to support the solar cell venture. Together with the growth in the traditional foundry business I hope it would enable SMIC to overcome its depreciation expenses, which as a percentage of revenues remains the highest in the foundry industry.

I am proud that SMIC has been able to attract so many dedicated professionals both from abroad and within China. Last year we promoted two of our very experienced employees to the positions of Vice President of Logic Technology Development to lead our 65 nanometer and below R&D efforts, and Senior Vice President of Fab Operations in Shanghai which has been turned into a "mega-fab" consisting of all of our fabs at that location. The dedication of the management and staff of SMIC is an important ingredient necessary to meet the challenges and opportunities ahead here in China. We would like to take this opportunity to record our cordial thanks to them.

*“ I am proud that SMIC has been able to attract so many dedicated professionals both from abroad and within China. We would like to take this opportunity to record our cordial thanks to them. ”*

May God bless you and SMIC,  
**Richard R. Chang**  
Chief Executive Officer

Shanghai, the PRC  
April 27, 2006

## Business Review

In 2005, SMIC continued to grow its business despite a slowdown in the semiconductor industry in the early part of the year, thereby affirming SMIC's business strategy.

### OVERVIEW OF BUSINESS DEVELOPMENTS

Our operations continue to remain strong. At the end of 2005, we had increased our monthly capacity to 152,219 8-inch equivalents per month. During 2005, our wafers shipped and sales increased from 943,463 wafers and US\$974.7 million in 2004 to 1,347,302 8-inch wafers and US\$1.1 billion in 2005, representing a 42.8% and 20.2% increase, respectively. According to a leading IC industry market research company, we held 6% of the foundry market in 2005, which represents a growth rate of approximately 20%, the highest growth rate among the foundries.

We generated US\$648.1 million in cash from operations in 2005 which represents a 24.9% increase from 2004. However, our depreciation expenses remain among the highest in the foundry industry. Furthermore, because we are a new foundry with only four years of commercial operations and continue to expand our capacity to meet the increasing capacity demands of our customers, our depreciation expense as a percentage of revenues remains the highest in the foundry industry.

Despite these high depreciation expenses, we believe that we will become profitable by improving our product mix, thereby increasing our average selling price. In 2005, 40.6% of our overall sales were from products that utilized advanced technology of 0.13 micron and below. Revenues generated from 0.13 micron and below technology nodes as a percentage of our logic revenues increased from 14.0% in 2004 to 23.4% in 2005. We expect that this upward trend will continue for the rest of 2006 and expect this to reach approximately 35% in the fourth quarter of 2006 as some of our fabless and IDM customers are migrating a significant portion of their products to the 0.13 micron and below technology nodes.

In 2005, we have also entered into agreements with Saifun Semiconductor to license Saifun's NROM technology to manufacture NAND flash products. We will use our 90nm logic process with this technology. We expect to commence production of our first product using this licensed technology which will be a 2-gigabit NAND flash product by the end of this year.

We entered into an agreement in 2005 with one of the top fabless companies in the world to co-develop our 65nm process. These efforts have begun already and we aim to deliver engineering samples by the end of 2006.

### CUSTOMERS AND MARKETS

We target a diversified and global customer base, consisting of leading IDMs, fabless semiconductor companies, and systems and other companies and seek to maintain our leadership position in China.

At the end of 2005, we had commenced commercial production for 5 of the top 10 fabless and IDMs in the world. Overall in 2005, we engaged 93 new customers, bringing the total number of our customers to 254. For 2005, our revenue by region was led by North America at 40.8%, then Europe at 27.0%, then Asia Pacific (excluding Japan) at 26.8%, and Japan at 5.3%. These customers participate in the consumer, communications or computer market segments. We intend to maintain a diversified customer mix in terms of end-market applications, processes, and geographical focus in order to manage our exposure to each market segment.

We seek to maintain our leadership position in the semiconductor industry in China by exploiting our first mover advantage to capture the growing China IC industry. According to a leading technology market research, China's IC consumption has registered a compound annual growth rate of 33% since 2000, and reached US\$40.8 billion in IC consumption in 2005, becoming the world's largest regional IC market for the first time. A leading technology market research expects that by 2010, China's IC market is projected to more than triple and estimated to reach US\$124 billion in terms of overall consumption. The main types of products driving this demand relate to communication ICs (i.e., 3G) and smart phones, digital television, MP3, wireless LAN, CPU and DSP.

At the same time, the gap between the domestic demand for integrated circuits in China and the domestic supply continues to increase. According to market researches, China's domestic manufacturers currently meets less than 5% of its IC demand, representing a gap between domestic supply and demand, of almost US\$38 billion. This gap will increase to almost US\$112 billion by 2010.

We believe that by establishing our company as a key foundry partner to local semiconductor companies at an early stage of their development, we will be well positioned to take advantage of the potential semiconductor growth in China. In 2005, our Mainland Chinese customers represented an area of growth as we engaged 55 new customers. In December 2005, more than 8% of our revenues were generated from Mainland Chinese companies. Among the new products we manufactured for these companies include the first 3G baseband chips on 0.13 micron process for the TD-SCDMA, WCDMA and CDMA2000 standards, a digital satellite receiver chip for set-top boxes and a HDTV video processor. We also commenced manufacturing for Hangzhou Guoxin Science & Technology Co., Ltd, a satellite broadcast receiver chip which received the 2005 Technology Innovation award from China's Ministry of Information Industry. We expect that the percentage of revenues from our Mainland Chinese customers will increase in 2006 as more of these customers commence commercial production. We are also working closely with our customers to migrate their products to more advanced technology nodes in order for the customers to reap benefits of economies of scale at these technology nodes.

We generate our sales primarily from fabricating semiconductors. We also derive a relatively small portion of our sales from the mask-making and wafer probing services that we perform for third parties separately from our foundry services.

## CAPACITY EXPANSION PLANS

We intend to maintain our strategy of expanding capacity and improving our process technology to meet both the capacity requirements and the technological needs of our customers. In 2005, our capital expenditures were approximately US\$903.4 million and we recorded depreciation and amortization costs of US\$745.9 million. We currently expect that our capital expenditures in 2006 will be approximately \$1.1 billion.

We plan to use this capital expenditure mainly to ramp up our fabs in Beijing, Shanghai, and Tianjin. We are scheduling that by the end of 2006, our monthly capacity will be over 185,000 8-inch wafer equivalents. In addition, we have taken on management contracts to operate wafer fabs in Chengdu and Wuhan, and are building a shell to house our first 12-inch facility in Shanghai in order to take advantage of anticipated demand from our customers from China and the rest of the world.

## RESEARCH AND DEVELOPMENT

The semiconductor industry is characterized by rapid changes in technology, frequently resulting in obsolescence of process technologies and products. As a result, our research and development efforts are essential to our overall success. We spent approximately \$78.9 million in 2005 on research and development expenses, which represented 6.7% of our sales. We employ over 600 research and development personnel, combining experienced semiconductor engineers with advanced degrees from leading universities around the world with top graduates from the leading universities in China. We believe this combination has enabled us to quickly bring our technology in line with the semiconductor industry roadmap and ensures that we will have skilled personnel to lead our technology advancement in the future. We are also developing our 65 nanometer technology with one of the top fabless companies in the world. We hope to produce engineering samples by the end of 2006.

# Business Review

## JOINT VENTURES

We have established numerous joint ventures in order to expand our service offerings to our customers. In July 2004, we entered into an agreement with Toppan Printing Co., Ltd., to establish Toppan SMIC Electronics (Shanghai) Co., Ltd., a joint venture in Shanghai for the manufacture of on-chip color filters and micro-lenses for CMOS image sensors. That joint venture began pilot production in December 2005 and is currently under qualification.

Our assembly and testing facility in Chengdu, China with United Test and Assembly Center Ltd. began commercial production in the first quarter of 2006. The facility can offer in-house turn-key manufacturing services in China.

We have also announced plans for a wafer reclamation project in Shanghai to produce solar power modules. We believe that this project will be profitable but that the scale is not sufficient. Therefore, we are considering, with partners, the establishment of a facility to manufacture polysilicon to meet the needs of our solar power project as well as the needs of other solar power companies.

## MATERIAL LITIGATION

On January 30, 2005 we resolved pending patent and trade secret litigation with Taiwan Semiconductor Manufacturing Company Limited ("TSMC"). Under the terms of the settlement, the two parties will cross license to each other's patent portfolio through December 2010 and we will pay TSMC US\$175 million, payable in installments over six years (US\$30 million in each of the first five years and US\$25 million in the sixth year). The agreement also provides for the dismissal of all pending legal actions without prejudice between the two companies in the U.S. Federal District Court, the California State Superior Court, the U.S. International Trade Commission, and the Taiwan District Court. In the settlement agreement, TSMC covenants not to sue SMIC for itemized acts of trade secret misappropriation as alleged in the complaints,

although the settlement does not grant a license to use any of TSMC's trade secrets. The patent cross license and settlement agreement are terminable upon a breach by SMIC, which may result in the reinstatement of the legal proceedings and acceleration of the outstanding payments under the settlement agreement.

## OUTLOOK FOR 2006

Our main focus in 2006 will be to achieve and maintain long-term profitability. We believe that we can achieve this goal primarily by improving our product mix, thereby increasing average selling price per wafer. We will be able to improve our product mix by:

- Migrating our customers' products down to 90 nanometer production process;
- Producing a larger proportion of our customer's logic products at 0.13 micron and below;
- Expanding our advanced wafer capacity according to customer demand; and
- Increasing the percentage of our revenues from logic products and reducing the percentage of revenue from DRAM products.

We will also continue to expand technology offerings to attract even more global customers. During the first half of 2006, we currently expect to see 90 nanometer logic and DRAM products in commercial production at our 12-inch fab in Beijing. Meanwhile, we will also be supporting our customers as they migrate to more advanced technologies, with a particular emphasis on our domestic customers as they migrate from 0.35 micron down to 0.18 micron and below process technology.

We will also continue to consider other strategic alliances and partnerships that will enable us to leverage our unique position in China to maximize shareholder return.

# Management's Discussion and Analysis of Financial Condition and Results of Operation

## CONSOLIDATED FINANCIAL DATA

The summary consolidated financial data presented below as of and for the years ended December 31, 2003, 2004 and 2005 are derived from, and should be read in conjunction with, and are qualified in their entirety by reference to, the audited consolidated financial statements, including the related notes, included elsewhere in this Annual Report. The selected consolidated financial data as of December 31, 2001 and 2002, is derived from audited consolidated financial statements not included in this Annual Report. The summary consolidated financial data presented below has been prepared in accordance with United States generally accepted accounting principles (the "U.S. GAAP").

*Note:* The Company has retroactively reclassified certain expenses to disclose financial performance in a manner consistent with the practices of other high-technology companies (the "Reclassification"). All figures presented herein have given effect, where applicable, to the Reclassification. Amortization of acquired intangibles assets expense, largely related to the patent cross-license agreement relating to the settlement of the litigation with TSMC and other license agreements, previously classified in cost of sales and research and development, have been reclassified into a single line item entitled amortization of acquired intangible assets under operating expenses. The impact of the Reclassification for the year ended December 31, 2004 and 2003 resulted in a decrease of cost of sales of US\$5.2 million and US\$3.5 million, a decrease in research and development of US\$9.2 million and US\$nil, and an increase in amortization of intangible assets expense of US\$14.4 million and US\$3.5 million, respectively.

	For the year ended December 31,				
	2001	2002	2003	2004	2005
	(in US\$ thousands, except for per share and per ADS data)				
<b>Income Statement Data:</b>					
Sales	\$-	\$50,315	\$365,824	\$974,664	\$1,171,319
Cost of sales <sup>(1)</sup>	-	105,238	359,779	716,225	1,081,588
Gross profit (loss)	-	(54,923)	6,045	258,439	89,731
Operating expenses:					
Research and development	9,572	38,254	34,913	74,113	78,865
General and administrative	17,316	18,351	29,705	54,038	35,701
Selling and marketing	771	4,776	10,711	10,384	17,713
Litigation settlement	-	-	-	23,153	-
Amortization of acquired intangible assets	-	-	3,462	14,368	41,251
Total operating expenses	27,659	61,381	78,791	176,056	173,530
Income (loss) from operations	(27,659)	(116,304)	(72,746)	82,383	(83,799)

# Management's Discussion and Analysis of Financial Condition and Results of Operation

	For the year ended December 31,				
	2001	2002	2003	2004	2005
	(in US\$ thousands, except for per share and per ADS data)				
Other income (expenses):					
Interest income	\$18,681	\$10,980	\$5,616	\$10,587	\$11,356
Interest expense	–	(176)	(1,425)	(13,698)	(38,785)
Foreign currency exchange gain (loss)	197	247	1,523	8,218	(3,355)
Other, net	187	2,650	888	2,441	4,462
Subsidy income	5,942	–	–	–	–
Total other income, net	25,007	13,701	6,602	7,548	(26,322)
(Loss) Income before income tax	(2,652)	(102,603)	(66,144)	89,931	(110,121)
Income tax – current	–	–	–	186	285
Minority interest	–	–	–	–	251
Loss from equity investment	–	–	–	–	(1,379)
Net income (loss)	(2,652)	(102,603)	(66,144)	89,745	(111,534)
Deemed dividend on preference shares <sup>(2)</sup>	–	–	37,117	18,840	–
Income (loss) attributable to holders of ordinary shares	\$(2,652)	\$(102,603)	\$(103,261)	\$70,905	\$(111,534)
Income (loss) per share, basic	\$(0.03)	\$(1.27)	\$(1.14)	\$0.01	\$(0.01)
Income (loss) per share, diluted	\$(0.03)	\$(1.27)	\$(1.14)	\$0.00	\$(0.01)
Shares used in calculating basic income (loss) per share <sup>(3)(4)</sup>	80,000,000	80,535,800	90,983,200	14,199,163,517	18,184,429,255
Shares used in calculating diluted income (loss) per share <sup>(3)(4)</sup>	80,000,000	80,535,800	90,983,200	17,934,393,066	18,184,429,255

(1) Including amortization of deferred stock compensation for employees directly involved in manufacturing activities.

(2) Deemed dividend represents the difference between the sale and conversion prices of warrants to purchase convertible preference shares we issued and their respective fair market values.

(3) Anti-dilutive preference shares, options and warrants were excluded from the weighted average ordinary shares outstanding for the diluted per share calculation. For 2001, 2002 and 2003, basic income (loss) per share did not differ from diluted loss per share.

(4) All share information have been adjusted retroactively to reflect the 10-for-1 share split effected upon completion of the global offering of its ordinary shares in March 2004 (the "Global Offering").

# Management's Discussion and Analysis of Financial Condition and Results of Operation

	As of December 31,				
	2001	2002	2003	2004	2005
	(in US\$ thousands)				
<b>Balance Sheet Data:</b>					
Cash and cash equivalents	\$178,920	\$91,864	\$445,276	\$607,173	\$585,797
Short-term investments	–	27,709	27,165	20,364	13,796
Accounts receivable, net of allowances	–	20,110	90,539	169,188	241,334
Inventories	4,749	39,826	69,924	144,018	191,238
Total current assets	235,196	185,067	680,882	955,418	1,047,465
Land use rights, net	48,913	49,354	41,935	39,198	34,768
Plant and equipment, net	478,950	1,290,910	1,523,564	3,311,925	3,285,631
Total assets	763,059	1,540,078	2,290,506	4,384,276	4,583,416
Total current liabilities	249,071	263,655	325,430	730,330	896,038
Total long-term liabilities	–	405,432	479,961	544,462	622,497
Total liabilities	249,071	669,087	805,391	1,274,792	1,518,535
Stockholders' equity	\$513,988	\$870,991	\$1,485,115	\$3,109,484	\$3,026,099

	For the year ended December 31,				
	2001	2002	2003	2004	2005
	(in US\$ thousands, except percentages and operating data)				
<b>Cash Flow Data:</b>					
Net income (loss)	\$(2,652)	\$(102,603)	\$(66,145)	\$89,745	\$(111,534)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:					
Depreciation and amortization	1,445	84,537	233,905	456,961	745,926
Net cash provided by (used in) operating activities	3,360	(48,802)	114,270	518,662	648,105
Purchases of plant and equipment	(459,779)	(761,704)	(453,097)	(1,838,773)	(872,519)
Net cash used in investing activities	(501,779)	(751,144)	(454,498)	(1,826,787)	(859,652)
Net cash provided by financing activities	583,152	712,925	693,497	1,469,764	190,364
Net increase (decrease) in cash and cash equivalents	\$84,630	\$(87,056)	\$353,412	\$161,896	\$(21,376)
<b>Other Financial Data:</b>					
Gross margin	–	–109.2%	1.7%	26.5%	7.7%
Operating margin	–	–231.2%	–19.9%	8.5%	–7.2%
Net margin	–	–203.9%	–18.1%	9.2%	–9.5%
<b>Operating Data:</b>					
Wafers shipped (in units):					
Logic <sup>(1)</sup>	–	26,419	188,316	597,533	662,895
Total <sup>(2)</sup>	–	82,486	476,451	943,463	1,347,302
Average selling price (in US\$):					
Logic <sup>(1)</sup>	–	\$794	\$896	\$1,066	\$962
Total <sup>(2)</sup>	–	\$558	\$733	\$979	\$834

(1) Excluding copper interconnects and DRAM wafers.

(2) Including logic, DRAM, copper interconnects and all other wafers.

# Management's Discussion and Analysis of Financial Condition and Results of Operation

## YEAR ENDED DECEMBER 31, 2005 COMPARED TO YEAR ENDED DECEMBER 31, 2004

**Sales.** Sales increased by 20.2% from US\$974.7 million for 2004 to US\$1,171.3 million for 2005, primarily as a result of the increase in the Company's manufacturing capacity and ability to use such capacity to increase sales. The number of wafers the Company shipped increased by 42.8%, from 943,463 8-inch wafer equivalents to 1,347,302 8-inch wafer equivalents, between these two periods. The average selling price of the wafers the Company shipped decreased by 14.8% from US\$979 per wafer to US\$834 per wafer, while the average selling price of the logic wafers the Company shipped decreased by 9.8% from US\$1,066 per wafer to US\$962 per wafer. The percentage of wafer revenues that used 0.13 micron and below process technology increased from 11.7% to 40.6% between these two periods.

**Cost of sales and gross profit (loss).** After giving effect to the Reclassification, cost of sales increased by 51.0% from US\$716.2 million for 2004 to US\$1,081.6 million for 2005. This increase was primarily due to the significant increase in sales volume, depreciation expenses as the Company installed new equipment to increase its capacity, and manufacturing labor expenses due to the increase in headcount. Other factors included an increase in the amount of direct and indirect materials purchased corresponding to the increase in wafers shipped.

The Company had a gross profit of US\$89.7 million for 2005 compared to a gross profit of US\$258.4 million in 2004. Gross margins were 7.7% in 2005 compared to 26.5% in 2004. The decrease in gross margins was primarily due to a decrease in the average selling price per wafer and a higher average cost per wafer resulting from an increase in depreciation expenses.

**Operating expenses and loss from operations.** After giving effect to the Reclassification, operating expenses decreased by 1.5% from US\$176.1 million for 2004 to US\$173.5 million for 2005 primarily due to the decrease in general and administrative expenses and amortization of deferred stock compensation.

As a part of the settlement with TSMC, as described in "Note 11. – Acquired intangible assets, net" and "Note 25. – Litigation", the Company allocated US\$20.3 million of the total settlement amount to amortization of acquired intangible assets in 2005.

After giving effect to the Reclassification, research and development expenses increased by 6.5% from US\$74.1 million for 2004 to US\$78.9 million for 2005. This increase in research and development expenses resulted primarily from non-recurring startup engineering costs associated with the ramp-up of Fab 4, 90 nanometer and 65 nanometer research and development activities and the increase in depreciation and amortization expenses.

General and administrative expenses decreased by 33.9% to US\$35.7 million for 2005 from US\$54.0 million for 2004, primarily due to a decrease in personnel and legal fees.

Selling and marketing expenses increased by from US\$10.4 million for 2004 to US\$17.7 million for 2005, primarily due to an increase in engineering material costs associated with sales activities and personnel related expenses.

As a result, the Company's loss from operations was US\$83.8 million in 2005 compared to income from operations of US\$82.4 million in 2004. Operating margin was negative 7.2% and 8.5%, respectively, for these two years.

**Other income (expenses).** Other income (expenses) decreased from US\$7.5 million in 2004 to a negative US\$26.3 million in 2005. This decrease was primarily attributable to the increase in interest expense from US\$13.7 million in 2004 to US\$38.8 million in 2005. This interest expense was primarily due to the increases in borrowing and the costs of borrowing. The foreign currency exchange gains decreased from US\$8.2 million in 2004 to a loss of US\$3.3 million in 2005.

**Net income (loss).** Due to the factors described above, the Company had a net loss of US\$111.5 million in 2005 compared to a net income of US\$89.7 million for 2004.



# Management's Discussion and Analysis of Financial Condition and Results of Operation

**Bad debt provision.** The Company determines its bad debt provision based on the Company's historical experience and the relative aging of receivables. The Company's bad debt provision excludes receivables from a selected number of customers due to a high level of collection confidence. The Company provides bad debt provision based on the age category of the remaining receivables. A fixed percentage of the total amount receivable is applicable to receivables in each past due age category, ranging from 1% for the shortest past due age category to 100% for the longest past due age category. Any receivables deemed non-collectible will be written off against the relevant amount of provision. The Company's bad debt provision made (reversed) in 2003, 2004, and 2005 amounted to US\$(0.1 million), US\$1.0 million, and US\$(0.01) million, respectively. The Company reviews, analyzes and adjusts bad debt provisions on a monthly basis.

**Deemed dividends on preference shares.** The Company did not record any deemed dividends on preference shares for 2005 compared to deemed dividends on preference shares of US\$18.8 million for 2004, representing the difference between the sale and conversion price of warrants to purchase Series D convertible preference shares issued in the first quarter of 2004 and their respective fair market values. All of these warrants expired unexercised upon the completion of the Company's global offering of its ordinary shares in March 2004 (the "Global Offering").

## DEBT ARRANGEMENTS

Set forth in the table below are the aggregate amounts, as of December 31, 2005, of the Company's future cash payment obligations under the Company's existing contractual arrangements on a consolidated basis:

Contractual obligations	Total	Payments due by period			
		Less than 1 year	1-2 years	3-5 years	After 5 years
(consolidated) (in US\$ thousands)					
Short-term borrowings	\$265,481	\$265,481	\$-	\$-	\$-
Long-term debt					
Secured long-term loans	740,637	246,081	345,439	149,117	-
Operating lease obligations <sup>(1)</sup>	9,814	6,898	119	179	2,618
Purchase obligations <sup>(2)</sup>	418,000	418,000	-	-	-
Investment commitments <sup>(3)</sup>	42,000	-	42,000	-	-
Other long-term obligations <sup>(4)</sup>	145,000	30,000	30,000	85,000	-
Total contractual obligations	\$1,620,932	\$966,460	\$417,558	\$234,296	\$2,618

(1) Represents our obligations to make lease payments to use the land on which our fabs are located in Shanghai and other office equipment we have leased.

(2) Represents commitments for construction or purchase of semiconductor equipment, and other property or services.

(3) Represents commitments to invest in certain joint venture projects.

(4) Includes the settlement with TSMC for an aggregate of \$175 million payable in installments over six years.

## Management's Discussion and Analysis of Financial Condition and Results of Operation

As of December 31, 2005, the Company's outstanding long-term liabilities primarily consisted of US\$740.6 million in secured bank loans, which are repayable in installments commencing in March 2005, with the last payment in March 2010.

**Long-term debt.** In December 2001, the Semiconductor Manufacturing International (Shanghai) Corporation ("SMIC Shanghai") entered into a long-term debt agreement for US\$432.0 million with a syndicate of four Chinese banks. The withdrawal period of the facility was 18 months starting from the loan agreement date. As of December 31, 2004, SMIC Shanghai had fully drawn down on this loan facility. In 2005, the interest rate on the loan ranges from 4.34% to 6.16%. The interest payment is due on a semi-annual basis. The principal amount is repayable starting in March 2005 in five semi-annual installments of US\$86.4 million. The interest expense incurred in 2005, 2004 and 2003 was US\$16.5 million, US\$14.0 million and US\$12.3 million, respectively, of which US\$3.6 million, US\$6.4 million and US\$11.9 million was capitalized as additions to assets under construction in 2005, 2004 and 2003, respectively.

As part of the same long-term loan arrangements, SMIC Shanghai had a RMB denominated line of credit of RMB396,960,000 (approximately US\$48 million) in 2001, with the same financial institutions. As of December 31, 2004, SMIC Shanghai had fully drawn on this line of credit. The interest rate for the loan is calculated based on the basic rate of a five-year term loan published by the People's Bank of China. The principal amount is repayable starting in March 2005 in five semi-annual installments of US\$9.6 million. The interest rate on the loan ranged from 5.02% to 5.27% in 2005. The interest expense incurred in 2005, 2004 and 2003 was US\$1.6 million, US\$2.5 million and US\$2.4 million, respectively, of which US\$0.4 million, US\$1.1 million and US\$2.3 million was capitalized as additions to assets under construction in 2005, 2004 and 2003, respectively. As of December 31, 2005, this facility was fully repaid.

In January 2004, SMIC Shanghai entered into the second phase long-term facility arrangement for US\$256.5 million with four Chinese banks. As of December 31, 2004, SMIC Shanghai had fully drawn down on this loan facility. In 2004, the interest rate on the loan ranged from 4.34% to 6.16%. The interest payment is due on a semi-annual basis. The principal amount is repayable starting in March 2006 in seven semi-annual installments of US\$36.6 million. The interest expense incurred in 2005 was US\$12.5 million and US\$3.9 million, of which US\$2.7 million and US\$nil were capitalized as additions to assets under construction in 2005 and 2004, respectively.

In connection with the second phase long-term facility arrangement, SMIC Shanghai has a RMB denominated line of credit of RMB235,678,000 (US\$28,476,030). As of December 31, 2005, SMIC Shanghai has no borrowings on this line of credit. In 2005, SMIC Shanghai fully utilized and then repaid in full prior to December 31, 2005. The interest expenses incurred in 2005 was US\$25,625.

These long-term loan agreements contained certain financial covenants which were superseded by the financial covenants set forth in SMIC Shanghai's long-term agreements from January 2004 as described below.

The financial covenants contained in the two long-term loan agreements entered into in January 2004 supersede the financial covenants contained in the long-term loan agreement entered into in December 2001. Any of the following would constitute an event of default for SMIC Shanghai beginning in March 2005, when the first payment of the loan from December 2001 is repayable:

- $(\text{Total liability} - \text{borrowings from shareholders, including principal and interest}) / \text{Total assets} > 65\%$ ;
- $(\text{Current assets} - \text{inventory}) / \text{Current liabilities} < 100\%$ ;
- $\text{Total liability} / \text{EBITDA} > 2.98$ ; and

# Management's Discussion and Analysis of Financial Condition and Results of Operation

- (Funds available for loan repayment in current year + Funds available for loan repayment at the beginning of the current year)/Repayment amount during the current year < 2.5.

Any of the following would constitute an event of default for SMIC Shanghai during the term of either of the two long-term loan agreements:

- Incurrence of any losses in 2005 as calculated on an annual basis;
- Incurrence of losses in 2006 in excess of US\$21.9 million;
- Incurrence of cumulative losses in 2007 in excess of US\$62.6 million;
- Incurrence of any losses in 2008; or
- Incurrence of research and development costs in any given year in excess of 15% of revenue for that year.

SMIC Shanghai has met these covenants as of December 31, 2005.

The total outstanding balance of these long-term facilities is collateralized by certain plant and equipment at the original cost of US\$2,446,731,548 as of December 31, 2005. These five-year bank loans are collateralized by the Shanghai fabs and equipment.

In May 2005, Semiconductor Manufacturing International (Beijing) Corporation ("SMIC Beijing") entered into a five year loan facility in the aggregate principal amount of US\$600.0 million, with a syndicate of financial institutions based in the PRC. This five-year bank loan will be used to expand the capacity of SMIC Beijing's fabs and is collateralized by the site's plant and equipment. The drawdown period of this facility was twelve months from the sign off date of the agreement. As of December 31, 2005, SMIC Beijing had drawn-down US\$225.0 million on this loan facility. The interest rate ranged on this loan facility from 5.25% to 6.26%. The principal amount is repayable starting in December 2007 in six semi-annual installments. The interest expense incurred in 2005 was US\$4.0 million, of which US\$879,906 was capitalized as additions to assets under construction in 2005.

Any of the following would constitute an event of default for SMIC Beijing during the term of the facility:

- [Net profit + depreciation + amortization + financial expenses – (increase of accounts receivable and advanced payments + increase of inventory – increase in accounts payable and advanced receipts)]/ financial expenses < 1; and
- (Total liability – borrowings from shareholders, including principal and interest)/Total assets > 60% (when SMIC Beijing's capacity is less than 20,000 12-inch wafers per month); and (Total liability – borrowings from shareholders, including principal and interest)/Total assets > 50% (when SMIC Beijing's capacity exceeds 20,000 12-inch wafers per month).

As of December 31, 2005, SMIC Beijing had a capacity of 12,164 12-inch wafers per month. SMIC Beijing has met these covenants as of December 31, 2005.

On December 15, 2005, the Company entered into a long-term loan facility agreement in the aggregate principal amount of EUR 85 million (equivalent to approximately US\$105 million) with a syndicate of banks and ABN Amro Bank N.V. Commerz Bank (Nederland) N.V. as the leading bank. The drawdown period of the facility ends on the earlier of (i) twenty months after the execution of the agreement or (ii) the date which the loans have been fully drawn down. Each draw down made under the facility shall be repaid in full by the Company in ten equal semi-annual installments. As of December 31, 2005, the Company had no borrowings on this facility.

**Short-term borrowings.** As of December 31, 2005, the Company had fifteen short-term credit agreements that provided total credit facilities up to approximately US\$431.0 million on a revolving credit basis. As of December 31, 2005, the Company had drawn down approximately US\$265.5 million under these credit agreements and approximately US\$165.4 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 loans ranged from 2.99% to 5.73% in 2005.

# Management's Discussion and Analysis of Financial Condition and Results of Operation

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 are 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.

The Company has accepted promissory notes from employees exercising options to purchase either ordinary shares or Series A convertible preference shares under the Company's 2001 employee stock option plans (the "Stock Option Plans"). At December 31, 2005, 2004 and 2003, the Company had notes receivable from employees related to the early exercise of employee stock options in the aggregate amount of US\$nil, US\$391,375, and US\$36,026,073, respectively. In 2005, the Company collected \$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.

## CAPITALIZED INTEREST

Interest cost 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\$7.6 million, US\$7.5 million, and US\$7.1 million net of government subsidies of US\$4.0 million, US\$nil, and US\$7.2 million in 2005, 2004 and 2003, 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. In 2005, 2004 and 2003, the

Company recorded amortization expenses relating to the capitalized interest of US\$3.3 million, US\$1.7 million, and US\$0.3 million, respectively.

## COMMITMENTS

As of December 31, 2005, the Company had commitments of US\$7.0 million to purchase land use rights for the living quarters at SMIC Beijing, US\$40.0 million for facilities construction obligations for the facility in Chengdu and the Beijing, Tianjin, and Shanghai fabs, and US\$371.0 million to purchase machinery and equipment for the testing facility in Chengdu, and the Beijing, Tianjin and Shanghai fabs. As of December 31, 2005, the Company had total commitments of US\$42.0 million to invest in certain joint venture projects. The Company expects to complete the cash injection of these projects in the next two years.

## DEBT TO EQUITY RATIO

As of December 31, 2005, the Company's debt to equity ratio was 33.2% calculated based on the sum of the short-term borrowings, current portion of long-term debt and long-term debt divided by total shareholders' equity.

## FOREIGN EXCHANGE RATE FLUCTUATION RISK

The Company's revenue, expense, and capital expenditures are primarily transacted in U.S. dollars. However, since the Company has operations consisting of manufacturing, sales and purchasing activities outside of the U.S., the Company enters into transactions in other currencies. The Company is primarily exposed to changes in exchange rate for the Euro, Japanese Yen, and Rmb.

To minimize these risks, the Company purchases foreign-currency forward exchange contracts with contract terms normally lasting less than six months to protect against the adverse effect that exchange rate fluctuations may have on foreign-currency denominated activities. These forward exchange contracts are principally denominated in Rmb, Japanese Yen or Euros and do not qualify for hedge accounting in accordance with SFAS No. 133.

# Management's Discussion and Analysis of Financial Condition and Results of Operation

## OUTSTANDING FOREIGN EXCHANGE CONTRACTS

As of December 31, 2005, the Company had outstanding foreign currency forward exchange contracts with notional amounts of US\$245.6 million. Notional amounts are stated in the U.S. dollar equivalents at spot exchange rates as of the respective dates. As of December 31, 2005, the fair value of foreign currency forward exchange contracts was approximately a loss of US\$2.6 million, which is recorded in accrued expenses and other current liabilities.

The Company had US\$61 million of foreign currency exchange contracts outstanding as of December 31, 2004, all of which matured in 2005.

The Company does not enter into foreign currency exchange contracts for speculative purposes.

	As of December 31, 2005	
	Notional amount	Fair value
	Expected maturity date (in US\$ thousands)	
<b>Forward Exchange Agreement</b>		
(Receive JPY/Pay US\$)		
Contract Amount	188,659,310	(2,556,943.30)
(Receive Euro/Pay US\$)		
Contract Amount	56,881,250	(141,781.76)
(Receive US\$/Pay Rmb)		
Contract Amount	81,952	91,010.62
<b>Total Contract Amount</b>	<b>245,622,512</b>	<b>(2,607,714.44)</b>

## INTEREST RATE RISK

The Company's exposure to interest rate risks relates primarily to the Company's long-term debt obligations, which the Company generally assumes to fund capital expenditures and working capital requirements. The table below presents annual principal amounts due and related weighted average implied forward interest rates by year of maturity for the Company's debt

obligations outstanding as of December 31, 2005. The Company's long-term debt obligations are all subject to variable interest rates. The interest rates on the Company's U.S. dollar-denominated loans are linked to the LIBOR rate. As a result, the interest rates on the Company's loans are subject to fluctuations in the underlying interest rates to which they are linked. The Company has entered into interest rate hedging contracts commencing from March 2005.

	As of December 31,			
	2006	2007	2008	2009
	(Forecast)			
	(in US\$ thousands, except percentages)			
<b>US\$ denominated</b>				
Average balance	246,080,580	197,173,071	148,265,571	111,625,243
Average interest rate	6.35%	6.34%	6.31%	6.36%
<b>Weighted average forward interest rate</b>	<b>6.35%</b>	<b>6.34%</b>	<b>6.31%</b>	<b>6.36%</b>

## Directors and Senior Management

Members of the Board who served during the year of 2005 were Yang Yuan Wang (Chairman of the Board (as of July 28, 2005) and Independent Non-executive Director); Richard Ru Gin Chang (Chairman of the Board (from March 18, 2004 to July 28, 2005) and Executive Director, President and Chief Executive Officer of the Company), Lai Xing Cai (Non-executive Director), Ta-Lin Hsu (Independent Non-executive Director), Yen-Peng Jou (Independent Non-executive Director), Tsuyoshi Kawanishi (Independent Non-executive Director), Henry Shaw (Independent Non-executive Director), and Lip-Bu Tan (Independent Non-executive Director). As of July 27, 2004, Lai Xing Cai appointed Fang Yao as his alternate Director. On February 6, 2006, Lai Xing Cai resigned from the Board, at which time Fang Yao also ceased being an alternate Director to Lai Xing Cai. On the same date, Fang Yao was appointed as a Non-executive Director of the Company.

Brief biographical details for Board members are set out on pages 28 through 29.

Shareholders are invited to re-elect and elect a Class I Director, the Class II Directors and a Class III Director at the 2006 annual general meeting of the Company's shareholders (the "AGM") to fill the vacancies available due to the retirements of the Directors mentioned below.

Three Directors, Ta-Lin Hsu, Yen-Pong Jou and Lip-Bu Tan, whose initial appointments as Directors took effect on September 25, 2001 (in respect of Ta-Lin Hsu and Yen-Pong Jou) and November 3, 2001 (in respect of Lip-Bu Tan) and who were re-appointed as Directors and designated as Class II Directors on March 18, 2004, will retire from office at the AGM pursuant to Article 90 of the Company's Articles of Association (the "Articles"). Ta-Lin Hsu and Lip-Bu Tan will each offer himself for re-election as

a Class II Director. Jiang Shang Zhou will offer himself for election as a Class II Director. If elected, each of Mr. Hsu, Mr. Tan and Mr. Jiang would hold office until the 2009 annual general meeting of the Company (the "2009 AGM").

One Director, Fang Yao, whose appointment as a Director took effect on 6th February, 2006 and who was designated as a Class III Director, will retire from office at the AGM pursuant to Article 126 of the Articles, and will offer himself for re-election as a Class III Director. If elected, Fang Yao would hold office until the annual general meeting of the Company's shareholders in 2007 (the "2007 AGM").

Following the resignation of Sean Hunkler (appointed as Non-executive Director on April 25, 2004 and ceased to be a Non-executive Director upon his resignation on December 2, 2004), the Board in accordance with the Articles, approved on December 21, 2004, the reduction in the numbers of Directors from nine (9) to eight (8). Pursuant to the resolution passed at a Board meeting held on March 29, 2006, the Board increased the numbers of Directors from eight (8) to nine (9), such increase to take effect on the date of the AGM. The additional member would serve as a Class I Director. Albert Yu will offer himself for election as a Class I Director.

Details of the proposed candidates for re-election and election are set out in the circular to the shareholders sent together with this annual report.

### ALTERNATE DIRECTORS

Upon the resignation of Lai Xing Cai as a Director on February 6, 2006, Fang Yao ceased being an alternate Director to Lai Xing Cai. On the same date, Fang Yao was appointed as a Director.

# Directors and Senior Management

## BOARD OF DIRECTORS

Members of the Board are re-elected or elected by the Company's shareholders. As of December 31, 2005, the Board consisted of eight (8) Directors. At the meeting of the Board on March 29, 2006, the Board increased its size from eight (8) to nine (9) Directors, such increase to take effect on the date of the AGM.

The following table sets forth the names of Directors and the Company's executive officers, including its founder, as of the date of this annual report. The Company's executive officers are appointed by, and serve at the discretion of, the Board.

Name	Age	Position
Yang Yuan Wang	71	Chairman and Independent Non-executive Director
Richard Ru Gin Chang	58	Founder, President, Chief Executive Officer and Executive Director
Ta-Lin Hsu	62	Independent Non-executive Director
Yen-Pong Jou*	45	Independent Non-executive Director
Tsuyoshi Kawanishi	76	Independent Non-executive Director
Henry Shaw	52	Independent Non-executive Director
Lip-Bu Tan	46	Independent Non-executive Director
Fang Yao	36	Non-executive Director
Morning Wu	49	Acting Chief Financial Officer, Chief Accounting Officer and Qualified Accountant
Marco Mora	47	Chief Operating Officer
Toshiaki Ikoma	64	Chief Technology Officer
Akio Kawabata	60	Vice President, Marketing
Jason Ting Chih Hsien	48	Vice President, Human Resources and General Affairs and Joint Compliance Officer
Anne Wai Yui Chen	43	Company Secretary, Hong Kong Representative and Joint Compliance Officer

\* *Retiring from office and will not offer himself for re-election at the date of the AGM.*

## Directors and Senior Management

### CHAIRMAN OF THE BOARD AND INDEPENDENT NON-EXECUTIVE DIRECTOR

Yang Yuan Wang is currently the Chairman and has been a Director since 2001. Professor Wang has more than 40 years of experience related to the semiconductor industry. He is the chairman of SMIC Shanghai, SMIC Beijing and SMIC Tianjin and is also the chief scientist of the Microelectronics Research Institute at Beijing University. He is a fellow of the Chinese Academy of Sciences, The Institute of Electrical and Electronics Engineers (USA), and The Institute of Electrical Engineers (UK).

### FOUNDER, PRESIDENT, CHIEF EXECUTIVE OFFICER AND EXECUTIVE DIRECTOR

Richard Ru Gin Chang founded the Company in April 2000 and is currently President, Chief Executive Officer and Executive Director. Dr. Chang is also a director of SMIC Shanghai, SMIC Beijing, SMIC Tianjing, Semiconductor Manufacturing International (AT) Corporation, Semiconductor Manufacturing International (Solar Cell) Corporation and Magnificent Tower Limited. Dr. Chang has over 27 years of semiconductor experience in foundry operations, wafer fabrication and research and development. From 1998 to 1999, Dr. Chang was President of Worldwide Semiconductor Manufacturing Corp., or WSMC, after joining the company in 1997. Prior to joining WSMC, Dr. Chang worked for 20 years at Texas Instruments Incorporated, where he helped build and manage the technology development and operations of ten semiconductor fabs and integrated circuit operations in the United States, Japan, Singapore, Italy and Taiwan. Dr. Chang received a PhD in Electrical Engineering from Southern Methodist University and a master's degree in Engineering Science from the State University

of New York. In December 2003, Dr. Chang was selected by the China Center of Information Development as one of the ten "China IT Economic People of 2003" for his role in influencing and contributing to the development of China's information technology industry. In February 2004, Dr. Chang received The Magnolia Silver Award, which is generally recognized as the highest award an individual may receive from the Shanghai Municipal Foreign Affairs Office. The award recognizes Dr. Chang's contributions to Shanghai's economy, social development and interchange and cooperation with foreign companies. In April 2005, Dr. Chang received The International Scientific and Technological Cooperation Award of The People's Republic of China. In November 2005, Dr. Chang received the Award of 2005 China IT Person of the Year and in February 2006, he received the 2004-2005 China Semiconductor Industry Leadership Award.

### NON-EXECUTIVE DIRECTOR

Fang Yao was an alternate Director to Lai Xing Cai, a Director, from July 2004 until February 6, 2006, at which time Mr. Cai resigned as a Director and Mr. Yao ceased to be an alternate Director. On the same date, Mr. Yao was appointed as a Director. Mr. Yao is an executive director of Shanghai Industrial Holdings Limited ("SIHL"). Mr. Yao also serves as a director and general manager of Shanghai Industrial United Holdings Co., Ltd., chairman of Guangdong Techpool Biochem-Pharma Co., Ltd. and Shanghai Sunway Biotech Co., Ltd., vice chairman of Bright Dairy and Food Co., Ltd. and Shenzhen Kangtai Biological Products Co., Ltd. and a director of Microport Medical (Shanghai) Co., Ltd., XiaMen Traditional Chinese Medicine Co., Ltd. and Shanghai Industrial Development Co., Ltd. He graduated from Chinese University of Hong Kong with a master's degree in Business Administration and has over 10 years' experience in money and capital markets.



### INDEPENDENT NON-EXECUTIVE DIRECTORS

Ta-Lin Hsu has been a Director since 2001 and is a director of SMIC Beijing. Dr. Hsu is the founder and chairman of H&Q Asia Pacific. Prior to founding H&Q Asia Pacific in 1986, Dr. Hsu was a general partner at Hambrecht & Quist and held the position of senior manager in the Corporate Research Division of IBM. Dr. Hsu has served on the boards of a number of public and private companies, and he currently serves on the board of trustees of the Asia Foundation and as a member of the Council of Foreign Relations. Dr. Hsu received his PhD in Electrical Engineering from the University of California at Berkeley and his undergraduate degree in Physics from National Taiwan University. Dr. Hsu is a member of the Advisory Board of the Haas School of Business at the University of California at Berkeley.

Yen-Pong Jou has been a Director since 2001 and will retire from office on the date of the AGM. Mr. Jou is the senior partner of Jou & Associates. Between 1985 and November 2003, Mr. Jou was general counsel of a public company. Mr. Jou received a law degree from the FuJen Catholic University School of Law in Taiwan.

Tsuyoshi Kawanishi has been a Director since 2001 and is also the chairman of SMIC Japan Corporation. Mr. Kawanishi has more than 50 years of experience in the electronics industry with Toshiba Corporation, where he served as, among other positions, senior executive vice

president and senior advisor. Mr. Kawanishi currently serves on the board of directors of Asyst Technologies, Inc., FTD Technology Pte. Ltd. and T.C.S. Japan, and acts as an advisor to Accenture Ltd., Kinetic Holdings Corporation and a number of private companies. Mr. Kawanishi is also the chairman of the Society of Semiconductor Industry Seniors in Japan and the Chairman of the SIP Consortium of Japan.

Henry Shaw has been a Director since 2001. Mr. Shaw is currently the senior partner of AsiaVest Partners TCW/YFY Ltd. Prior to joining AsiaVest Partners, Mr. Shaw was a vice president at Transpac Capital Pte. Ltd. and founded and served as chief financial officer of Mosel Vitelic Inc. Mr. Shaw serves on the board of directors of InterVideo, Inc. Mr. Shaw received a master's degree in Business Administration from National Cheng-Chi University in Taiwan.

Lip-Bu Tan has been a Director since 2002 and is a director of SMIC Tianjin. Mr. Tan is the founder and chairman of Walden International, a venture capital firm. Mr. Tan currently serves on the board of directors of Cadence Design Systems, Inc., Centillum Communications, Inc., Creative Technology Ltd., Flextronics International Ltd., Integrated Silicon Solution, Inc., Leadis Technology, Inc. and SINA Corporation, as well as a number of private companies. Mr. Tan received a master's degree in Nuclear Engineering from the Massachusetts Institute of Technology and a master's degree in Business Administration from the University of San Francisco.

# Directors and Senior Management

## SENIOR MANAGEMENT

Morning Wu joined the Company as Associate Vice President of Finance and Accounting in January 2003 and was appointed as Acting Chief Financial Officer, Chief Accounting Officer and Qualified Accountant of the Company as of March 28, 2005. Ms. Wu has over 25 years of experience in the investment and finance field. Prior to joining the Company, Ms. Wu held management positions with First Taiwan Securities Inc. and Grand Cathay Securities Co. Ltd. Her responsibilities at these companies included strategic planning, mergers & acquisitions and designing and monitoring risk management systems. She holds a licence for Accounting and Auditor with the Senior Civil Service Examination of Taiwan. Ms. Wu obtained a bachelor's degree in Accounting from the National Chengchi University, Taiwan and received a Business Administration master's degree and an Accounting master's degree from the National Taiwan University.

Marco Mora joined the Company in 2000 as Vice President of Operations and was named the Chief Operating Officer in November 2003. Mr. Mora has more than 20 years of experience in the semiconductor industry. Prior to joining the Company, Mr. Mora held management positions with STMicroelectronics N.V., Texas Instruments Italia S.p.A, Micron Technology Italia S.p.A and WSMC. Mr. Mora received a master's degree in Physics from the University of Milan.

Toshiaki Ikoma joined the Company as Chief Technology Officer in January 2004. Dr. Ikoma has extensive semiconductor experience in both academia and industry. Dr. Ikoma was the president of Texas Instruments Japan, Inc. for five years and, prior to that position, served as a professor of Electronics at the Institute of Industrial Science at the University of Tokyo from 1968 to 1994. Prior to joining the Company, he was a professor of Technology Management at the Graduate School of International Corporate

Strategy of Hitotsubashi University, Tokyo, beginning in 2002. Dr. Ikoma received a PhD in Electronics from the University of Tokyo.

Akio Kawabata joined the Company in 2002 and is currently the Vice President of Marketing. Mr. Kawabata has over 32 years of experience in the semiconductor industry. Prior to joining the Company, Mr. Kawabata held various management positions with Toshiba Corporation, including general manager of Toshiba's International Division, president of Toshiba Electronics Europe GmbH and managing director of Toshiba Asia Pacific. Mr. Kawabata received a master's degree in Electrical Engineering from Stanford University.

Jason Ting Chih Hsien joined the Company in January 2002 and became Vice President for Human Resources and General Affairs in January 2004. Dr. Ting also serves as one of the Joint Compliance Officers. He previously served as senior director of sales and marketing. Prior to joining the Company, Dr. Ting served as a Director of Walsin Lihwa Corporation in Taiwan. Dr. Ting received a PhD in Material Science from the University of Illinois.

## COMPANY SECRETARY

Anne Wai Yui Chen joined the Company in 2001 and is the Company's Hong Kong Representative, Company Secretary and one of the Joint Compliance Officers. Ms. Chen is admitted as a solicitor in Hong Kong, England and Wales and Australia and was admitted as an advocate and solicitor in Singapore. She had served as a deputy adjudicator of the Small Claims Tribunal in Hong Kong in 1999 and had served as the president from 2000 to 2002 and is currently a council member of the Hong Kong Federation of Women Lawyers. Prior to joining the Company in 2001, she had been a practicing solicitor in Hong Kong since 1987.

## SUBSIDIARIES

Except as otherwise listed below, the Company owns 100% of the issued and outstanding share capital of its subsidiaries. As of December 31, 2005, these subsidiaries are as follows:

1. 中芯國際集成電路(上海)有限公司  
**Semiconductor Manufacturing International (Shanghai) Corporation\***  
("SMIC Shanghai")  
Principal country of operation: Shanghai, PRC  
Place of incorporation: Shanghai, PRC  
Legal entity: Wholly foreign-owned enterprise  
Total investment: US\$4,000,000,000  
Registered capital: US\$1,340,000,000  
Equity holder: the Company (100%)
2. **Semiconductor Manufacturing International (Beijing) Corporation**  
("SMIC Beijing")  
Principal country of operation: Beijing, PRC  
Place of incorporation: Beijing, PRC  
Legal entity: Wholly foreign-owned enterprise  
Total investment: US\$1,250,000,000  
Registered capital: US\$650,000,000  
Equity holder: the Company (100%)
3. 中芯國際集成電路(天津)有限公司  
**Semiconductor Manufacturing International (Tianjin) Corporation\***  
("SMIC Tianjin")  
Principal country of operation: Tianjin, PRC  
Place of incorporation: Tianjin, PRC  
Legal entity: Wholly foreign-owned enterprise  
Total investment: US\$1,100,000,000  
Registered capital: US\$690,000,000  
Equity holder: the Company (100%)
4. **Semiconductor Manufacturing International (Chengdu) Corporation**  
("SMIC Chengdu")  
Principal country of operation: Sichuan, PRC  
Place of incorporation: Sichuan, PRC  
Legal entity: Wholly foreign-owned enterprise  
Total investment: US\$175,000,000  
Registered capital: US\$60,000,000  
Equity holder: the Company (56.7%, indirectly through Semiconductor Manufacturing International (AT) Corporation)
5. エス・エム・アイ・シ・ジャパン 株式会社  
SMIC Japan Corporation\*  
Principal country of operation: Japan  
Place of incorporation: Japan  
Authorised capital: JPY10,000,000  
divided into 200 shares of a par value of JPY50,000  
Equity holder: the Company (100%)
6. **SMIC, Americas**  
Principal country of operation: USA  
Place of incorporation: California, US  
Registered capital: No registered capital, authorized to issue 50,000,000 shares of common stock  
Equity holder: the Company (100%)
7. **Better Way Enterprises Limited**  
Principal country of operation: Samoa  
Place of incorporation: Samoa  
Authorised capital: US\$1,000,000  
divided into 1,000,000 shares of a par value of US\$1.00  
Equity holder: the Company (100%)
8. **SMIC Europe S.R.L.**  
Principal country of operation: Agrate Brianza (Milan), Italy  
Place of incorporation: Agrate Brianza (Milan), Italy  
Registered capital: Euros10,000  
Equity holder: the Company (100%)

\* For identification purposes only

## Report of the Directors

- 9. Garrison Consultants Limited**  
Principal country of operation: Samoa  
Place of incorporation: Samoa  
Authorised capital: US\$1,000,000 divided into 1,000,000 shares of a par value of US\$1.00  
Equity holder: the Company (100%, indirectly through Better Way Enterprises Limited)
- 10. Semiconductor Manufacturing International (AT) Corporation**  
Principal country of operation: Cayman Islands  
Place of incorporation: Cayman Islands  
Authorised capital: US\$1,900,000 divided into 100,000,000 ordinary shares of US\$0.01 each and 90,000,000 Series A preference shares of US\$0.01 each  
Equity holder: the Company (56.7%)
- 11. Semiconductor Manufacturing International (Solar Cell) Corporation**  
Principal country of operation: Cayman Islands  
Place of incorporation: Cayman Islands  
Authorised capital: US\$11,000  
Equity holder: the Company (100.0%)
- 12. 中芯能源科技(上海)有限公司  
SMIC Energy Technology (Shanghai) Corporation\***  
Principal country of operation: Shanghai, PRC  
Place of incorporation: Shanghai, PRC  
Legal entity: Wholly foreign-owned enterprise  
Total investment: US\$14,090,000  
Registered capital: US\$6,000,000  
Equity holder: the Company (100%, indirectly through Semiconductor Manufacturing International (Solar Cell) Corporation)
- 13. SMIC Commercial (Shanghai) Company**  
(formerly known as “SMIC Consulting Corporation”)  
Principal country of operation: Shanghai, PRC  
Place of incorporation: Shanghai, PRC  
Legal entity: Wholly foreign-owned enterprise  
Total investment: US\$1,100,000  
Registered capital: US\$800,000  
Equity holder: the Company (100%)
- 14. 中芯國際開發管理(成都)有限公司  
SMIC (Chengdu) Development Corporation\***  
Principal country of operation: Chengdu, PRC  
Place of incorporation: Chengdu, PRC  
Legal entity: Wholly foreign owned enterprise  
Total Investment: US\$12,500,000  
Registered capital: US\$5,000,000  
Equity holder: the Company (100%)

### SHARE CAPITAL

During the year ended December 31, 2005, the Company issued 48,025,920 ordinary shares to certain of the Company’s eligible participants including employees, directors, officers and service providers of the Company (“eligible participants”) pursuant to the Company’s 2004 stock option plan (the “Stock Option Plan”) and 27,591,342 ordinary shares to certain eligible participants pursuant to the 2004 equity incentive plan of the Company (the “EIP”).

During the year ended December 31, 2005, the Company repurchased 6,895,534 ordinary shares from eligible participants pursuant to the terms of the Company’s 2001 Preference Shares Stock Plan and 2001 Regulation S Preference Shares Stock Plan (collectively the “2001 Preference Shares Plans”).

	Number of Ordinary Shares Outstanding
Outstanding Share Capital as at December 31, 2005	18,301,680,867

\* For identification purposes only

Under the terms of the Company's 2004 Equity Incentive Plan, the Compensation Committee of the Company may grant restricted share units ("Restricted Share Units") to eligible participants. Each Restricted Share Unit represents the right to receive one ordinary share. Restricted Share Units granted to new employees generally vest at a rate of 10% upon the second anniversary of the vesting commencement date, an additional 20% on the third anniversary of the vesting commencement date and an additional 70% upon the fourth anniversary of the vesting commencement date. Restricted Share Units granted to existing employees generally vest at a rate of 25% upon the first, second, third and fourth anniversaries of the vesting commencement date. Upon vesting of the Restricted Share Units and subject to the terms of the Insider Trading Policy and the payment by the participants of applicable taxes, the

Company will issue the relevant participants the number of ordinary shares underlying the awards of Restricted Share Units.

For the twelve months ended December 31, 2004, the Compensation Committee granted a total of 118,190,824 RSUs pursuant to which the Company issued an aggregate of 18,536,451 ordinary shares to its eligible participants on or around July 1, 2005. For the twelve months ended December 31, 2005, the Compensation Committee granted a total of 122,418,740 Restricted Share Units, and on February 20, 2006, the Compensation Committee granted a total of 3,110,000 Restricted Share Units. The remaining vesting dates of these Restricted Share Units (after deducting the number of Restricted Share Units granted but cancelled due to the departure of eligible participants prior to vesting) approximately are as follows:

Vesting dates	Approximate no. of RSUs (the actual number of shares eventually to be issued may change due to departure of eligible participants prior to vesting)
<b>2006</b>	
1-Jan	280,000
1-Jul	1,006,524
1-Aug	500,000
1-Sep	15,364,685
13-Sep	250,000
16-Oct	12,500
<b>2007</b>	
1-Jan	10,622,500
25-Apr	20,000
29-Apr	50,000
1-Jul	1,006,524
1-Aug	520,000
1-Sep	15,364,685
13-Sep	250,000
16-Oct	12,500
<b>2008</b>	
1-Jan	10,710,000
25-Apr	40,000
29-Apr	100,000
1-Jul	1,006,524
1-Aug	540,000
1-Sep	15,364,685
13-Sep	250,000
16-Oct	12,500

## Report of the Directors

Vesting dates	Approximate no. of RSUs (the actual number of shares eventually to be issued may change due to departure of eligible participants prior to vesting)
<b>2009</b>	
1-Jan	10,710,000
25-Apr	140,000
29-Apr	350,000
1-Jul	506,524
1-Aug	640,000
1-Sep	15,364,685
13-Sep	250,000
16-Oct	12,500
<b>2010</b>	
1-Jan	10,430,000
<b>2011</b>	
1-Jan	87,500

### REPURCHASE, SALE OR REDEMPTION OF SECURITIES

Other than repurchases by the Company of ordinary shares from employees pursuant to the terms of the 2001 Stock Option Plans, as disclosed in the paragraph (Share Capital)

above, the Company has not repurchased, sold or redeemed any additional ordinary shares in 2005.

The number of shares that the Company repurchased on a monthly basis in 2005, pursuant to the terms of the Stock Options Plans, is set forth below.

Month	Number of Ordinary Shares Repurchased	Highest Repurchase Price Per Share (in HK\$)	Lowest Repurchase Price Per Share (in HK\$)	Aggregate Price Paid (in HK\$)
January	780,000	\$0.8657	\$0.0857	\$293,046.00
February	858,000	\$0.8657	\$0.039	\$283,315.10
March	0	-	-	-
April	1,923,100	\$0.1169	\$0.039	\$104,040.89
May	0	-	-	-
June	1,466,400	\$0.8657	\$0.039	\$202,820.57
July	0	-	-	-
August	1,053,334	\$0.039	\$0.039	\$41,080.03
September	0	-	-	-
October	609,700	\$0.8657	\$0.039	\$107,593.43
November	0	-	-	-
December	205,000	\$0.8657	\$0.039	\$32,865.50

### PUBLIC FLOAT

As at the date of this annual report, the public (as defined in the Rules Governing the Listing of Securities on the HKSE ("Listing Rules")) holds more than 25% of the Company's total issued share capital.

### DEBT TO EQUITY RATIO

As of December 31, 2005, the Company's debt to equity ratio was 33.2% calculated based on the sum of the short-term borrowings, current portion of long-term debt and long-term debt divided by total shareholders' equity.

## DIVIDENDS AND DIVIDEND POLICY

At the end of 2005, the Company's accumulated deficit increased to US\$247.9 million from an accumulated deficit of US\$136.4 million at the end of 2004. The Company has not declared or paid any cash dividends on the ordinary shares. We intend to retain any earnings for use in the Company's business and do not currently intend to pay cash dividends on the ordinary shares. Dividends, if any, on the outstanding shares will be declared by and subject to the discretion of the Board and must be approved at the annual general meeting of shareholders. The timing, amount and form of future dividends, if any, will also depend, among other things, on:

- the Company's results of operations and cash flow;
- the Company's future prospects;
- the Company's capital requirements and surplus;
- the Company's financial condition;
- general business conditions;
- contractual restrictions on the payment of dividends by the Company to its shareholders or by the Company's subsidiaries to the Company; and
- other factors deemed relevant by the Board.

The Company's ability to pay cash dividends will also depend upon the amount of distributions, if any, received by the Company from its wholly-owned Chinese operating subsidiaries. Under the applicable requirements of Chinese Company Law, the Company's subsidiaries in China may only distribute dividends after they have made allowances for:

- recovery of losses, if any;
- allocation to the statutory common reserve funds;
- allocation to staff and workers' bonus and welfare funds; and
- allocation to a discretionary common

reserve fund if approved by the Company's shareholders.

More specifically, these operating subsidiaries may only pay dividends after 10% of their net profit has been set aside as statutory common reserves and a discretionary percentage of their net profit has been set aside for the staff and workers' bonus and welfare funds. These operating subsidiaries are not required to set aside any of their net profit as statutory common reserves if such reserves are at least 50% of their respective registered capital. Furthermore, if they record no net income for a year, they generally may not distribute dividends for that year.

## CONTRACTS OF SIGNIFICANCE

There were no contracts of significance during the year in which any of the Directors were materially interested.

## MAJOR SUPPLIERS AND CUSTOMERS

In 2005, the Company's largest and five largest raw materials suppliers accounted for approximately 10.6% and 40.7%, respectively, of the Company's overall raw materials purchases. Having made reasonable enquiries, the Company is not aware of any Director or shareholder (which to the knowledge of the Directors owns more than 5% of the Company's issued share capital) or their respective associates which had interests in any of the Company's five largest suppliers in 2005. Almost all of the Company's materials are imported free of value-added tax and import duties due to concessions granted to the semiconductor industry in China.

For 2005, the Company's largest and five largest customers accounted for approximately 25.8% and 64.0%, respectively, of the Company's total overall sales. The Company's Chief Executive Officer, Richard Ru Gin Chang, and his wife together hold shareholding interests of less than 0.1% in one of the Company's five largest customers in 2005, Texas Instruments Incorporated. Having made reasonable enquiries, the Company is not aware of any other Director or shareholder (which to the knowledge of the Directors owns more than 5% of the Company's issued share capital) or their respective associates which had interests in any of the Company's five largest customers in 2005.

# Report of the Directors

## PRE-EMPTIVE RIGHTS

The Company confirms that no pre-emptive rights exist in the law of the Cayman Islands.

## DIRECTORS' INTERESTS

As at December 31, 2005, the interests or short positions of the Directors in the ordinary shares, underlying shares and debentures of the Company (within the meaning of Part XV of the Securities and Futures Ordinance (Cap. 571 of

the laws of Hong Kong) ("SFO")), which were notified to the Company and the SEHK pursuant to Divisions 7 and 8 of Part XV of the SFO (including interests or short positions which they are taken or deemed to have under such provisions of the SFO), and as recorded in the register required to be kept under section 352 of the SFO or as otherwise notified to the Company and the SEHK pursuant to the Model Code for Securities Transactions by Directors of Listed Issuers were as follows:

Board Member	Nature of Interest	Number of Shares	Percentage of Aggregate Interests to Total Issued Share Capital
Richard R. Chang	Personal Interest <sup>(1)</sup>	33,579,550	
	Personal Interest <sup>(2)</sup>	17,100,000	
	Corporate Interest <sup>(3)</sup>	20,000,000	
	Interest of Spouse	9,790,000	
	Interest of Child under 18	11,200,000	
Total		91,669,550	*
Ta-Lin Hsu	Corporate Interest <sup>(4)</sup>	15,300,010	
	Personal Interest <sup>(5)</sup>	500,000	
Total		15,800,010	*
Yen-Pong Jou	Personal Interest <sup>(5)</sup>	500,000	*
Tsuyoshi Kawanishi	Personal Interest <sup>(5)</sup>	500,000	
	Personal Interest <sup>(6)</sup>	1,500,000	
Total		2,000,000	*
Henry Shaw	Personal Interest <sup>(5)</sup>	500,000	*
Lip-Bu Tan	Personal Interest <sup>(5)</sup>	500,000	*
Yang Yuan Wang	Personal Interest <sup>(5)</sup>	500,000	*

### Notes:

\* Indicates less than 1%.

1. Pursuant to a Charitable Pledge Agreement dated December 1, 2003, Richard Ru Gin Chang and his spouse, Scarlett K. Chang (collectively, the "Donors") have pledged to transfer 10,000,000 of such ordinary shares as a charitable gift to The Richard and Scarlett Chang Family Foundation, a Delaware nonprofit nonstock corporation organized exclusively for religious, charitable, scientific, literary and education purposes within the meaning of Section 501(c)(3) of the US Internal Revenue Code of 1986, as amended, such transfer to be made in full at or prior to the death of the surviving Donor. In addition, 2,639,550 of such ordinary shares are jointly held by Richard Ru Gin Chang and his spouse, Scarlett K. Chang.

2. The Compensation Committee has granted Dr. Chang options to purchase an aggregate of 15,100,000 ordinary shares if fully exercised, and an award of 2,000,000 Restricted Share Units (each representing the right to receive one ordinary share) (the "RSU"). As of December 31, 2005, none of these options have been exercised and 25% of the RSUs have vested.

3. These ordinary shares are held by Jade Capital Company, LLC, a Delaware limited liability company (the "LLC"), of which Richard Ru Gin Chang and his spouse, Scarlett K. Chang (collectively, the "Members"), are the sole members. It is the current intent of the Members that all or a portion of the net income of the LLC be used for philanthropic purposes, including but not limited to contributions to charitable organizations that are tax-exempt under Section 501(c)(3) of the US Internal Revenue Code of 1986, as amended.



4. Ta-Lin Hsu has a controlling interest in AP3 Co-Investment Partners, LDC, which holds 15,300,010 ordinary shares.
5. Each Independent Non-executive Director and Non-executive Director was granted an option to purchase 500,000 ordinary shares, if fully exercised at a price per 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, 2005, these options have not been exercised. Lai Xing Cai has declined such option.
6. Tsuyoshi Kawanishi has been granted options to purchase an aggregate of 1,500,000 ordinary shares, if fully exercised. As of December 31, 2005, these options have not been exercised.

## DIRECTORS' SERVICE CONTRACTS

No Director proposed for re-election or election at the forthcoming AGM has or proposes to have

a service contract which is not determinable by the Company or any of its subsidiaries within one year without payment of compensation, other than statutory compensation.

## SUBSTANTIAL SHAREHOLDERS

### Substantial shareholders' interest

Set out below are the names of the parties (not being a Director or chief executive of the Company) which were interested in 5 percent or more of the nominal value of the share capital of the Company and the respective relevant numbers of shares in which they were interested as at December 31, 2005 as recorded in the register kept by the Company under section 336 of the SFO.

Name of Shareholder	Number of Shares Held	Percentage Held
Shanghai Industrial Investment (Holdings) Company Limited ("SIIC")	1,814,991,340 (long position) <sup>(1)</sup>	9.92% (long position)
	26,426,137 (long position) <sup>(2)</sup>	0.14% (long position)
	11,690,563 (long position) <sup>(3)</sup>	0.06% (long position)
	6,851,119 (short position) <sup>(3)</sup>	0.03% (short position)
	4,794,491 (short position) <sup>(4)</sup>	0.03% (short position)
Total:	1,853,108,040 (long position)	10.12% (long position)
	11,645,610 (short position)	0.06% (short position)
Credit Suisse Group <sup>(5)</sup>	2,760,000 (long position) <sup>(6)</sup>	0.02% (long position)
	381,346,030 (long position) <sup>(7)</sup>	2.08% (long position)
	1,383,837,000 (long position) <sup>(8)</sup>	7.56% (long position)
	25,705,000 (long position) <sup>(9)</sup>	0.14% (long position)
	234,000 (long position) <sup>(10)</sup>	0.00% (long position)
	418,500 (long position) <sup>(11)</sup>	0.00% (long position)
	2,695,000 (short position) <sup>(6)</sup>	0.01% (short position)
	161,430,000 (short position) <sup>(7)</sup>	0.88% (short position)
	2,001,626,000 (short position) <sup>(8)</sup>	10.94% (short position)
	24,000,000 (short position) <sup>(9)</sup>	0.13% (short position)
	Total:	1,794,300,530 (long position)
2,189,751,000 (short position)		11.96% (short position)

# Report of the Directors

## Notes:

- (1) All such shares are held by S. I. Technology Production Holdings Limited ("SITPHL") which is wholly-owned by Shanghai Industrial Holdings Limited ("SIHL"). SIHL is an indirect non-wholly owned subsidiary of SIIC which are holding SIHL's shares through its wholly-owned subsidiaries namely, SIIC Capital (B.V.I.) Limited, Shanghai Investment Holdings Limited and SIIC CM Development Limited, which together are entitled to exercise or control the exercise of more than one-third of the voting power at the general meetings of SIHL. By virtue of the SFO, SIIC and its subsidiaries namely, Shanghai Investment Holdings Limited and Shanghai Industrial Investment Treasury Company Limited are deemed to be interested in the 1,814,991,340 Shares held by SITPHL. The Company's Directors, Lai Xing Cai (resigned from the Board on February 6, 2006) who is the chairman of SIHL and Fang Yao, who is the executive director of SIHL. It is the Company's understanding that voting and investment control over the ordinary shares beneficially owned by SIHL are maintained by the board of directors of SIHL.
- (2) 9,816,457 of such ordinary shares are held by SIIC CM Development Funds Limited which is owned as to 50% by each of SIIC CM Development Limited and Eternal Success Holdings Limited which are in turn wholly-owned by SIIC. 16,609,680 of such ordinary shares are held by SIIC Treasury (B.V.I.) Limited which is a wholly-owned subsidiary of SIIC.
- (3) All such ordinary shares are held by SIHL Treasury Limited which is a wholly-owned subsidiary of SIHL.
- (4) All such ordinary shares are held by SIIC Treasury (B.V.I.) Limited which is wholly-owned by SIIC.
- (5) The information contained herein is based on the Forms 2 filed by Credit Suisse with the Company on January 11, 2006 to report on changes in positions reported as at December 7, 2005.
- (6) Such ordinary shares are held by Credit Suisse Securities (USA) LLC (formerly known as Credit Suisse First Boston LLC) which is a wholly-owned subsidiary of Credit Suisse (USA), Inc. (formerly known as Credit Suisse First Boston (USA), Inc.), which is in turn a wholly-owned subsidiary of Credit Suisse Holdings (USA) Inc. (formerly known as Credit Suisse First Boston Inc). Credit Suisse Holdings (USA) Inc. is 57% owned by Credit Suisse and 43% owned by Credit Suisse Group. Credit Suisse is also a wholly-owned subsidiary of Credit Suisse Group.
- (7) Such ordinary shares are held by Credit Suisse International (formerly known as Credit Suisse First Boston International) which is 24%, 56% and 20% owned by Credit Suisse (International) Holding AG (formerly known as Credit Suisse First Boston (International) Holding AG), Credit Suisse and Credit Suisse Group, respectively. Credit Suisse (International) Holding AG is wholly-owned by Credit Suisse, which is in turn wholly-owned by Credit Suisse Group.
- (8) Such ordinary shares are held by Credit Suisse (Hong Kong) Limited (formerly known as Credit Suisse First Boston (Hong Kong) Limited) which is 29.8% owned by Credit Suisse First Boston International (Guernsey) Limited and 70.2% owned by Credit Suisse (International) Holding AG. Credit Suisse First Boston International (Guernsey) Limited is wholly-owned by Credit Suisse (International) Holding AG. Credit Suisse (International) Holding AG is wholly-owned by Credit Suisse, which is in turn wholly-owned by Credit Suisse Group.
- (9) Such ordinary shares are held by Credit Suisse Securities (Europe) Limited (formerly known as Credit Suisse First Boston (Europe) Limited) which is wholly-owned by Credit Suisse Investment Holdings (UK) (formerly known as Credit Suisse First Boston (UK) Investment Holdings), which is 98.07% owned by Credit Suisse Investments (UK) (formerly known as Credit Suisse First Boston (UK) Investments) and 1.93% owned by Credit Suisse First Boston Management AG. Both Credit Suisse Investments (UK) and Credit Suisse First Boston Management AG are wholly-owned by Credit Suisse (International) Holding AG. Credit Suisse (International) Holding AG is wholly-owned by Credit Suisse, which is in turn wholly-owned by Credit Suisse Group.
- (10) Such ordinary shares are held by Credit Suisse which is wholly-owned by Credit Suisse Group.
- (11) Such ordinary shares are held by Credit Suisse, New York Branch, a branch of Credit Suisse, which is in turn wholly-owned by Credit Suisse Group.

## EMOLUMENTS TO THE DIRECTORS

The chart below sets forth the emoluments to each of our Directors, including Richard Ru Gin Chang, our President, Chief Executive Officer and Executive Director, in 2005, 2004 and 2003.

	Richard Ru Gin Chang (in US\$)	Tsuyoshi Kawanishi (in US\$)	Wang Yang Yuan (in US\$)	Ta-Lin Hsu (in US\$)	Lip-Bu Tan (in US\$)	Henry Shaw (in US\$)	Yen-Pong Jou (in US\$)	Lai Xing Cai (in US\$)	Total (in US\$)
<b>2005</b>									
Salaries and other benefits	\$190,724	\$-	\$-	\$-	\$-	\$-	\$-	\$-	\$190,724
Stock Option Benefits*	97,664	49,026	8,608	8,608	8,608	8,608	-	-	189,730
<b>Total</b>	<b>\$288,388</b>	<b>\$49,026</b>	<b>\$8,608</b>	<b>\$8,608</b>	<b>\$8,608</b>	<b>\$8,608</b>	<b>\$8,608</b>	<b>\$-</b>	<b>\$380,454</b>
<b>2004</b>									
Salaries and other benefits	\$190,343	\$-	\$-	\$-	\$-	\$-	\$-	\$-	\$190,343
Stock Option Benefits*	-	221,464	-	-	-	-	-	-	221,464
<b>Total</b>	<b>\$190,343</b>	<b>\$221,464</b>	<b>\$-</b>	<b>\$-</b>	<b>\$-</b>	<b>\$-</b>	<b>\$-</b>	<b>\$-</b>	<b>\$411,807</b>
<b>2003</b>									
Salaries and other benefits	\$191,621	\$-	\$-	\$-	\$-	\$-	\$-	\$-	\$191,621
Stock Option Benefits*	-	5,000	-	-	-	-	-	-	5,000
<b>Total</b>	<b>\$191,621</b>	<b>\$5,000</b>	<b>\$-</b>	<b>\$-</b>	<b>\$-</b>	<b>\$-</b>	<b>\$-</b>	<b>\$-</b>	<b>\$196,621</b>

\* For a description of any options granted and exercised in 2005, please see the summary of grants of options as set forth under "Outstanding Share Options" in this annual report.

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 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, 2005, these options have not been exercised. Lai Xing Cai has declined such option.

## FIVE HIGHEST PAID INDIVIDUALS

The five individuals whose emoluments were the highest in the Company for the years ended December 31, 2005 and 2004, included Richard Ru Gin Chang, the Company's President, Chief Executive Officer and 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:

	2005 (in US\$)	2004 (in US\$)
Salaries, Housing Allowances, Other Allowances, and Benefits in Kind	\$513,570	\$430,144
Discretionary Bonuses	\$92,455	\$105,665
Stock option benefits*	\$325,889	\$620,060
Amounts paid to induce member to join Board	-	-

\* For a description of any options exercised in 2005, please see the summary of grants of options as set forth under "Outstanding Share Options" in this annual report.

## Report of the Directors

The five individuals whose emoluments were the highest in the Company for 2005 and 2004 may not be the same.

Emoluments (in HK\$)	Number of Individuals	
	2005	2004
\$1,000,000 – \$1,500,000	–	3
\$1,500,001 – \$2,000,000	3	–
\$2,000,000 – \$2,500,000	1	–
\$4,500,001 – \$5,000,000	–	1

### 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 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 8% of their basic salary. The contribution of such an arrangement is approximately US\$4.1 million, US\$2.5 million, US\$1.5 million and US\$1.0 million for the years ended December 31, 2005, 2004, 2003 and 2002, 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 at the Company’s request at another corporation 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 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 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 re-comply with the Listing Rules, in particular, it will make a further announcement and seek independent shareholders’ approval of the new maximum aggregate annual value of the New Indemnification Agreements.

## Report of the Directors

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, 2005, no payment was made to any Director under the Original Indemnification Agreements or 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 have provided a letter confirming that:

- (a) in relation to the Original Indemnification Agreements:
  - (i) the continuing connected transactions have received the approval of the Board;

- (ii) the Company has received a confirmation from its legal advisers as to Cayman Islands law, Maples and Calder, that the Original Indemnification Agreements were entered into and the Company's obligations thereunder were assumed by it, in accordance with the Articles and applicable Cayman Islands law; 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 of the Original Indemnification Agreements for the period from January 1, 2005 to May 5, 2005.

- (b) 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 Identification Agreements for the period from May 6, 2005 to December 31, 2005.

## EMPLOYEES

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

Function	As of December 31,			
	2002	2003	2004	2005
Managers	224	338	570	679
Professionals <sup>(1)</sup>	817	961	3,109	3,648
Technicians	1,837	2,746	3,389	4,127
Clerical staff	315	398	572	642
Total <sup>(2)</sup>	3,193	4,443	7,640	9,096

Notes:

- (1) Professionals include engineers, lawyers, accountants and other personnel with specialized qualifications, excluding managers.
- (2) Includes 99, 38, 14 and 283 temporary and part-time employees in 2002, 2003, 2004 and 2005, respectively.

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

Location of Facility	As of December 31,			
	2002	2003	2004	2005
Shanghai	3,146	4,033	5,481	6,232
Beijing	40	341	1,026	1,534
Tianjin	–	49	1,107	1,034
Chengdu	–	–	–	261
United States	5	13	16	18
Europe	–	4	5	7
Japan	2	3	3	6
Hong Kong	–	–	2	4
Total	3,193	4,443	7,640	9,096

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, 2005, 1,084 and 144 of the Company's employees held master's degrees and doctorate degrees, respectively. As of the same date, 2,796 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 2005.

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.

## Report of the Directors

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 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 Stock Option 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 and may only be granted to employees of the Company and its subsidiaries. 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 Stock Option Plan*

The Compensation Committee shall be responsible for the administration of the Stock Option Plan. 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 Stock Option Plan. 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.

## Report of the Directors

(f) *Limit of the Stock Option Plan*

The number of ordinary shares that may be issued under the Stock Option Plan and the Employee Stock Purchase Plan shall not exceed ten per cent. 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 9.2% of the total issued shares of the Company as at March 31, 2006).

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 per cent. 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 per cent. (1%) (or 0.1 per cent. 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 Stock Option Plan, 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 contendere 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.

## Report of the Directors

(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 Stock Option Plan) 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 Stock 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 Stock Option 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 Stock Option Plan*

The Stock Option Plan shall remain in force for a period of ten years commencing on the date of its approval by the Company's shareholders.

(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. 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 Stock Option 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. 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

## Report of the Directors

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. Internal 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 ESPP 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 per cent. 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 shall not exceed ten per cent. 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 9.2% of the total issued shares of the Company as at March 31, 2006).

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 per cent. 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 per cent. 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 per cent. of the then issued and outstanding ordinary shares unless otherwise allowed under the Listing Rules.

## Report of the Directors

(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 ESPP 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 subparagraph (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 Company's shareholders unless terminated in accordance with subparagraph (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 ADS.

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. 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 ESPP.

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. 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 purchase rights over its ADSs to its employees under the ESPP at an exercise price which is at a discount (up to 15 per cent. discount) to market price.

### **Valuation of Options Granted**

Details of the valuation of the options granted during the year ended December 31, 2005, including the accounting policy adopted for the share options are set out in notes 3(v), 3(x) and 20 of the financial statements. Investors should be aware that such valuations were prepared subject to a number of assumptions and are limited by the limitations of the pricing model."

### Outstanding Share Options

Details of the 2001 Stock Option Plans and the Stock Option Plan are as follows:

#### 2001 Stock Option Plan

Name/Eligible Participants	Date Granted	Period during which Rights Exercisable	No. of Options Granted	Exercise Price Per Share (USD)	Options Outstanding as of 1/1/05	Options Lapsed During Period	Options Due to Repurchase of Ordinary Shares During Period*	Options Exercised During Period	Options Cancelled During Period	Options Outstanding as of 12/31/05	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	7/1/2002 – 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	600,000	-	-	600,000	-	-	\$0.21	\$0.03
Senior Management	10/4/2002	4/10/2002 – 4/09/2012	1,350,000	\$0.02	1,350,000	-	-	-	-	1,350,000	\$-	\$0.05
Senior Management	24/4/2003	4/24/2003 – 4/23/2013	1,500,000	\$0.05	1,500,000	-	-	-	-	1,500,000	\$-	\$0.14
Senior Management	15/1/2004	1/15/2004 – 1/14/2014	10,700,000	\$1.00	10,450,000	6,000,000	-	2,000,000	-	2,450,000	\$0.21	\$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	8,096,000	145,500	2,457,334	866,500	-	7,064,000	\$0.20	\$0.03
Employees	1/4/2001	4/1/2001 – 3/31/2011	2,900,000	\$0.01	-	18,000	270,000	-	-	-	\$-	\$0.03
Employees	2/4/2001	4/02/2001 – 4/01/2011	2,216,000	\$0.01	416,000	-	-	68,000	-	330,000	\$0.20	\$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	-	-	90,000	-	-	-	\$-	\$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	-	-	135,000	-	-	-	\$-	\$0.03
Employees	14/5/2001	5/14/2001 – 5/13/2011	1,597,000	\$0.01	47,000	-	180,000	22,000	-	25,000	\$0.22	\$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	35,000	-	-	35,000	-	-	\$0.21	\$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	-	90,000	-	-	69,000	\$-	\$0.03
Employees	10/7/2001	7/10/2001 – 7/09/2011	20,000	\$0.01	20,000	-	-	20,000	-	-	\$0.20	\$0.03
Employees	15/7/2001	7/15/2001 – 7/14/2011	1,045,000	\$0.01	788,000	-	-	218,000	-	570,000	\$0.20	\$0.03
Employees	16/7/2001	7/16/2001 – 7/15/2011	2,220,000	\$0.01	128,000	-	-	-	-	128,000	\$-	\$0.03
Employees	20/7/2001	7/20/2001 – 7/19/2011	20,000	\$0.01	14,000	-	-	-	-	14,000	\$-	\$0.03
Employees	2/7/2001	7/2/2001 – 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	189,000	14,000	-	81,000	-	94,000	\$0.22	\$0.03
Employees	7/8/2001	8/07/2001 – 8/06/2011	20,000	\$0.01	20,000	-	-	-	-	20,000	\$-	\$0.03

Name/Eligible Participants	Date Granted	Period during which Rights Exercisable	No. of Options Granted	Exercise Price Per Share (USD)	Options Outstanding as of 1/1/05	Options Lapsed During Period	Options Due to Repurchase of Ordinary Shares During Period*	Options Exercised During Period	Options Cancelled During Period	Options Outstanding as of 12/31/05	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	51,448,300	459,000	1,511,000	13,434,100	-	37,555,200	\$0.21	\$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	36,934,500	420,000	-	4,076,000	-	32,438,500	\$0.21	\$0.03
Employees	24/1/2002	1/24/2002 – 1/23/2012	7,684,500	\$0.02	4,996,340	750,700	55,300	582,000	-	3,663,640	\$0.21	\$0.03
Employees	10/4/2002	4/10/2002 – 4/09/2012	1,315,000	\$0.01	65,000	-	-	-	-	65,000	\$-	\$0.05
Employees	10/4/2002	4/10/2002 – 4/09/2012	47,349,000	\$0.02	32,588,500	682,000	225,000	2,345,700	-	29,560,800	\$0.20	\$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	\$-	\$0.06
Employees	28/6/2002	6/28/2002 – 6/27/2012	39,740,000	\$0.02	29,312,000	1,054,000	-	1,853,800	-	26,404,200	\$0.20	\$0.06
Employees	28/6/2002	6/28/2002 – 6/27/2012	18,944,000	\$0.05	13,471,000	604,000	-	369,000	-	12,498,000	\$0.20	\$0.06
Employees	11/7/2002	7/11/2002 – 7/10/2012	250,000	\$0.01	250,000	-	-	250,000	-	-	\$0.20	\$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	830,000	750,000	-	-	-	80,000	\$-	\$0.07
Employees	26/9/2002	9/26/2005 – 9/25/2012	5,770,000	\$0.02	3,642,000	-	-	56,000	-	3,586,000	\$-	\$0.08
Employees	26/9/2002	9/26/2005 – 9/25/2012	65,948,300	\$0.05	47,276,150	3,412,675	48,150	2,455,125	-	41,408,350	\$0.20	\$0.08
Employees	9/1/2003	1/09/2003 – 1/08/2013	53,831,000	\$0.05	39,225,800	1,917,000	144,000	950,100	-	36,358,700	\$0.21	\$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	17,013,820	1,734,511	-	380,171	-	14,899,138	\$0.20	\$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	38,921,500	2,747,700	-	1,730,450	-	34,443,350	\$0.21	\$0.14
Employees	15/7/2003	7/15/2003 – 7/14/2013	59,699,900	\$0.05	39,929,900	3,008,410	-	858,490	-	36,063,000	\$0.20	\$0.17
Employees	10/10/2003	10/10/2003 – 10/09/2013	49,535,400	\$0.10	37,988,600	6,548,140	-	567,000	-	30,874,460	\$0.20	\$0.29
Employees	5/1/2004	1/05/2004 – 1/04/2014	130,901,110	\$0.10	110,218,140	10,942,215	-	3,663,559	-	95,612,366	\$0.20	\$0.33
Employees	15/1/2004	1/15/2004 – 1/14/2014	20,885,000	\$0.10	10,735,000	525,000	-	656,000	-	9,554,000	\$0.21	\$0.33
Employees	15/1/2004	1/15/2004 – 1/14/2014	300,000	\$0.25	300,000	300,000	-	-	-	-	\$-	\$0.33
Employees	16/2/2004	2/16/2004 – 2/15/2014	14,948,600	\$0.10	7,581,900	1,048,050	-	809,750	-	5,724,100	\$0.20	\$0.33
Employees	16/2/2004	2/16/2004 – 2/15/2014	76,954,880	\$0.25	67,210,690	6,536,455	-	-	-	60,674,235	\$-	\$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 Participants	Date Granted	Period during which Rights Exercisable	No. of Options Granted	Exercise Price Per Share (USD)	Options Outstanding as of 1/1/05	Options Lapsed During Period	Options Repurchase of Ordinary Shares During Period*	Options Exercised During Period	Options Cancelled During Period	Options Outstanding as of 12/31/05	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	32,280,300	42,000	125,000	6,372,500	-	25,865,800	\$0.21	\$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	680,000	62,500	-	-	-	617,500	\$-	\$0.11
Employees	24/1/2002	1/24/2002 – 1/23/2012	58,357,500	\$0.11	9,201,340	415,800	135,000	282,350	-	8,523,190	\$0.20	\$0.12
Employees	10/4/2002	4/10/2002 – 4/09/2012	51,384,000	\$0.11	7,108,000	431,000	-	382,200	-	6,294,800	\$0.20	\$0.13
Employees	28/6/2002	6/28/2002 – 6/27/2012	63,332,000	\$0.11	16,926,000	602,000	-	600,500	-	15,723,500	\$0.17	\$0.14
Employees	11/7/2002	7/11/2002 – 7/10/2012	4,530,000	\$0.11	2,615,000	750,000	-	1,060,000	-	805,000	\$0.21	\$0.14
Employees	26/9/2002	9/26/2002 – 9/25/2012	73,804,800	\$0.11	20,363,320	1,651,455	189,750	716,775	-	17,995,090	\$0.18	\$0.15
Employees	9/1/2003	1/09/2003 – 1/08/2013	12,686,000	\$0.11	2,157,000	-	-	-	-	2,157,000	\$-	\$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 of the 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 of the 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

Name/Eligible Participants	Date Granted	Period during which Rights Exercisable	No. of Options Granted	Exercise Price Per Share (USD)	Options Outstanding as 1/1/05	Additional Options Lapsed During Period	Options Repurchased of Ordinary Shares During Period*	Options Exercised During Period	Options Cancelled During Period	Options Outstanding as of 12/31/05	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	10/11/2004	11/10/2004 – 11/09/2009	500,000	\$0.22	500,000	-	-	-	-	500,000	\$-	\$0.22
Richard Chang	7/4/2004	4/07/2004 – 4/06/2014	100,000	\$0.31	100,000	-	-	-	-	100,000	\$-	\$0.31
Richard Chang	11/5/2005	5/11/2005 – 5/10/2015	15,000,000	\$0.20	-	15,000,000	-	-	-	15,000,000	\$-	\$0.22
Ta-Lin Hsu	10/11/2004	11/10/2004 – 11/09/2009	500,000	\$0.22	500,000	-	-	-	-	500,000	\$-	\$0.22
Yen-Pon Jou	10/11/2004	11/10/2004 – 11/09/2009	500,000	\$0.22	500,000	-	-	-	-	500,000	\$-	\$0.22
Henry Shaw	10/11/2004	11/10/2004 – 11/09/2009	500,000	\$0.22	500,000	-	-	-	-	500,000	\$-	\$0.22
Lip-Bu Tan	10/11/2004	11/10/2004 – 11/09/2009	500,000	\$0.22	500,000	-	-	-	-	500,000	\$-	\$0.22
Wang Yang Yuan	10/11/2004	11/10/2004 – 11/09/2009	500,000	\$0.22	500,000	-	-	-	-	500,000	\$-	\$0.22
Senior Management	18/3/2004	3/18/2004 – 3/17/2014	150,000	\$0.35	190,000	40,000	-	-	-	150,000	\$-	\$0.35
Senior Management	11/5/2005	5/11/2005 – 5/10/2015	1,100,000	\$0.20	-	1,100,000	-	-	-	1,100,000	\$-	\$0.20
Senior Management	11/11/2005	11/11/2005 – 11/10/2015	11,640,000	\$0.15	-	11,640,000	-	-	-	11,640,000	\$-	\$0.15
Others	18/3/2004	3/18/2004 – 3/17/2014	20,000	\$0.35	20,000	-	-	-	-	20,000	\$-	\$0.35
Others	2/7/2004	7/27/2004 – 7/26/2014	200,000	\$0.20	200,000	-	-	-	-	200,000	\$-	\$0.20
Others	11/5/2005	5/11/2005 – 5/10/2015	100,000	\$0.20	-	100,000	-	-	-	100,000	\$-	\$0.20
Others	11/11/2005	11/11/2005 – 11/10/2015	3,580,000	\$0.15	-	3,580,000	-	-	-	3,580,000	\$-	\$0.15
Employees	18/3/2004	3/18/2004 – 3/17/2014	49,949,700	\$0.35	45,077,750	4,922,350	-	-	-	40,155,400	\$-	\$0.35
Employees	25/4/2004	4/25/2004 – 4/24/2014	22,591,800	\$0.28	20,836,800	1,696,450	-	-	-	19,140,350	\$-	\$0.28
Employees	2/7/2004	7/27/2004 – 7/26/2014	35,983,000	\$0.20	33,192,000	4,061,000	-	-	-	29,131,000	\$-	\$0.20
Employees	10/11/2004	11/10/2004 – 11/09/2014	52,036,140	\$0.22	51,772,730	10,218,920	-	-	-	41,553,810	\$-	\$0.22
Employees	11/5/2005	5/11/2005 – 5/10/2015	94,381,300	\$0.20	-	94,381,300	-	-	-	80,257,423	\$-	\$0.20
Employees	11/8/2005	8/11/2005 – 8/10/2015	32,279,500	\$0.22	-	32,279,500	-	-	-	31,107,500	\$-	\$0.22
Employees	11/11/2005	11/11/2005 – 11/10/2015	149,642,000	\$0.15	-	149,642,000	-	-	-	147,345,000	\$-	\$0.15

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

Name/Eligible Participants	Date Granted	Period during which Rights Exercisable	No. of RSUs Awarded	Exercise Price Per Share (USD)	RSUs Outstanding as of 1/1/05	Additional RSUs Granted During Period	RSUs Lapsed During Period	RSUs Lapsed Due to Repurchase of Ordinary Shares During Period*	Shares Issued During Period	RSUs Cancelled During Period	RSUs Outstanding as of 12/31/05	Weighted Average Closing Price of Shares immediately before Dates on which Restricted Shares Units were Vested (USD)	Weighted Average Closing Price of Shares immediately before Dates on which Restricted Shares Units were Granted (USD)
Senior Management	27/7/2004	7/27/2005 – 7/26/2015	1,130,000	\$0.00	1,130,000	-	100,000	-	257,500	-	772,500	\$0.21	\$0.20
Senior Management	11/8/2005	8/11/2005 – 8/10/2015	916,830	\$0.00	-	916,830	-	-	-	-	916,830	\$-	\$0.22
Senior Management	11/11/2005	11/11/2005 – 11/10/2015	2,910,000	\$0.00	-	2,910,000	-	-	-	-	2,910,000	\$-	\$0.15
Others	11/8/2005	8/11/2005 – 8/10/2015	156,888	\$0.00	-	156,888	-	-	-	-	156,888	\$-	\$0.22
Others	11/11/2005	11/11/2005 – 11/10/2015	2,100,000	\$0.00	-	2,100,000	-	-	-	-	2,100,000	\$-	\$0.15
Employees	1/7/2004	7/01/2005 – 6/30/2015	96,856,590	\$0.00	93,649,680	-	7,661,770	-	22,641,784	-	63,346,126	\$0.21	\$0.22
Employees	27/7/2004	7/27/2005 – 7/26/2015	19,447,520	\$0.00	16,417,520	-	2,432,500	-	3,891,980	-	10,093,140	\$0.21	\$0.20
Employees	10/11/2004	11/10/2005 – 11/09/2015	756,714	\$0.00	756,714	-	150,536	-	50,178	-	556,000	\$0.23	\$0.22
Employees	11/5/2005	5/11/2006 – 5/10/2016	4,630,000	\$0.00	-	4,630,000	-	-	250,000	-	2,060,000	\$0.13	\$0.20
Employees	11/8/2005	8/11/2005 – 8/10/2015	69,430,022	\$0.00	-	69,430,022	3,642,315	-	-	-	65,787,707	\$-	\$0.22
Employees	11/11/2005	11/11/2005 – 11/10/2015	40,275,000	\$0.00	-	40,275,000	735,000	-	-	-	39,540,000	\$-	\$0.15
Richard Chang	11/5/2005	5/11/2006 – 5/10/2016	2,000,000	\$0.00	-	2,000,000	-	-	500,000	-	1,500,000	\$0.21	\$0.20

Awards of 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 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.

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, is expected to comply or advise as to reasons for deviations (the “Code Provisions”) and recommended best practices with 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](http://www.smics.com) under “Corporate Governance”, incorporates all of the Code Provisions of the CG Code and many of the Recommended Practices. On July 28, 2005, Mr. Yang Yuan Wang was elected by the Board as the Independent Non-executive Chairman of the Board in compliance with Code Provision A.2.1 of the CG Code, which requires the roles of chairman and the chief executive officer to be segregated and performed by different individuals. In addition, the Company has adopted or put in place various policies, procedures, and practices in compliance with the provision of the CG Policy. Subject to the above, 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, 2005 to December 31, 2005, 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, 2005. 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, 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 eight Directors as at the date of the annual report. Directors may be elected 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. The Class II Directors will be elected at the AGM for a term of three years. The Class III Directors were elected for a term of three years following the completion of the Global Offering and thereafter will serve a term of three years.

# Corporate Governance Report

The following table sets forth the names, classes and categories of the Directors, as at the date of this annual report:

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
Ta-Lin Hsu	Independent Non-executive Director	Class II
Yen-Pong Jou	Independent Non-executive Director	Class II
Lip-Bu Tan	Independent Non-executive Director	Class II
Tsuyoshi Kawanishi	Independent Non-executive Director	Class III
Fang Yao	Non-executive Director	Class III

Brief biographical details for Board members are set out on pages 28 through 29. During the year ended December 31, 2005, 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, Ta-Lin Hsu, Yen-Pong Jou and Lip-Bu Tan, whose appointments as Directors took effect from September 25, 2001, September 25, 2001 and November 3, 2001, respectively, and who were designated as Class II Directors upon the completion of the Global Offering, will retire from office on the date of the AGM pursuant to Article 90 of the Articles. Mr. Hsu and Mr. Tan will each offer himself for re-election at the AGM. Jiang Shang Zhou will offer himself for election as a Class II Director. If elected, each of Mr. Hsu, Mr. Tan and Mr. Jiang would hold office until the 2009 AGM.

In addition, Fang Yao, whose appointment as a Director took effect on February 6, 2006 and who was designated as a Class III Director, will retire from office at the AGM pursuant to Article 126 of the Articles, and will offer himself for re-election as a Class III Director. If elected, Fang Yao would hold office until the 2007 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 roles of the Chairman of the Board and Chief Executive Officer were segregated and exercised by two individuals as of July 28, 2005.

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 regular 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 despatched 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 a 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, 2005, the Board held a total of thirteen (13) meetings. Details of Directors' attendance at the Board meetings are set forth below:

	Number of Meetings Attended	Attendance Rate
Wang Yang Yuan	12/13 <sup>1</sup>	92.3%
Richard Ru Gin Chang	13/13	100%
Lai Xing Cai	12/13 <sup>2</sup>	92.3%
Ta-Lin Hsu	13/13 <sup>3</sup>	100%
Yen-Pong Jou	12/13 <sup>4</sup>	92.3%
Tsuyoshi Kawanishi	12/13 <sup>5</sup>	92.3%
Henry Shaw	12/13 <sup>6</sup>	92.3%
Lip-Bu Tan	13/13 <sup>7</sup>	100%
Average Attendance Rate		95.19%

- 1 4 of these meetings were attended by proxy
- 2 Represented by Fang Yao, his alternate Director
- 3 3 of these meetings were attended by proxy
- 4 12 of these meetings were attended by proxy
- 5 5 of these meetings were attended by proxy
- 6 2 of these meetings were attended by proxy
- 7 1 of these meetings was attended by proxy

**Procedure regarding the Appointment of Directors.** At its meeting on September 22, 2005, the Board approved the standard procedures regarding the appointment of Directors. This policy 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 or not 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.

## BOARD COMMITTEES

The Board has established the following 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, 2005, 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.

# Corporate Governance Report

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 2005, 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 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 2005 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 annual salary of US\$148,438, granted him 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, 2005, none of these options have been exercised and 25% of such RSUs have vested.

Other than as set forth above, the Board did not grant, in 2005, options to any Non-executive Director and Independent Non-executive Director as compensation for their service on the Board. On November 10, 2004, the Board granted to each Non-executive Director and Independent Non-executive Director, an option to purchase 500,000 ordinary shares at a price per ordinary share of US\$0.22. These options vested on March 19, 2005. These options will expire on November 9, 2009. Lai Xing Cai has declined such option.

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 2005;
- (ii) the profit-sharing and bonus policies;
- (iii) the long term compensation strategy, including 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 regular 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 relevant rules and regulations. The relevant papers for the Compensation Committee meeting were despatched 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, 2005, 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	5/5	100%
Lip-Bu Tan	5/5	100%
Average Attendance Rate	5/5	100%

**Audit Committee.** As of December 31, 2005, 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;

# Corporate Governance Report

- 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 2005, the Audit Committee reviewed:

- the financial reports for the year ended December 31, 2004 and the six month period ended June 30, 2005;
- 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 financial reports;
- the Company's budget for 2005;
- 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 and financial reporting integrity 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 those of the Compliance Office (as defined and discussed below), which monitors the Company's 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;
- the Company's outside auditors' engagement letters; and
- the internal audit charter, the risk management policy, the anti-fraud policy and the policy regarding the engagement of the Company's outside auditors to supply non-audit services.

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 regular 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 Audit Committee in complying with relevant rules and regulations. The relevant papers for the Audit Committee meetings were despatched to Audit Committee members 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.

# Corporate Governance Report

During the year ended December 31, 2005, the Audit Committee held a total of six (6) meetings. Details of Directors' attendance at the Audit Committee are set forth below:

	Number of Meetings Attended	Attendance Rate
Henry Shaw	6/6	100%
Lip-Bu Tan	6/6	100%
Yang Yuan Wang	6/6*	100%
Average Attendance Rate	6/6	100%

\* 2 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, 2005.

	2005 (in US\$)
Audit Fees	\$812,000
Audit-Related Fees	\$150,000
Tax Fees	\$118,000
All Other Fees	\$ 41,131
Total	\$1,121,131

## 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 file an assessment of its effectiveness with the United States Securities and Exchange Commission. Beginning in fiscal year 2006, the Company's external auditors are required to attest to such valuation.

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.

# Corporate Governance Report

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, the Risk Management Committee, Disclosure Committee and Compliance Office 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 analyses, 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 other 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, on all alleged fraud cases relating to financial reporting. 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, 2005 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 Office and another one for 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 reports 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 two executive officers 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 put 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 2005 AGM, the then-Chairman of the Board, 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 2005 AGM, which was held on May 6, 2005 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 2005 AGM, the Company's shareholders:

- re-elected Richard Ru Gin Chang and Henry Shaw as Directors for terms of three years;
- approved an amendment to the Articles to comply with amendments to Appendix 3 to the Listing Rules which came into effect on March 31, 2004;
- approved the New Indemnification Agreement to be executed by and between the Company and each of its Directors as further described on page 41;
- 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 2005 AGM; and
- 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 2005 AGM.

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, Chief Executive Officer and Executive Director 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 2005 AGM and the above referenced conference calls, the Company's shareholders were invited to a gathering 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, 2005 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 pages 37 and 38.

The market capitalization of the Company as of December 31, 2005 was US\$2,463,687,809 (issued share capital of 18,301,680,867 ordinary shares at the closing market price of HK\$1.05 per ordinary share). The public float as of such date was approximately 89%.

The AGM is scheduled to be held at the Company's headquarters at 18 Zhangjiang Road, PuDong New Area, Shanghai, China 201203 on May 30, 2006 at 4:00 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 NYSE 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 certain 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 NYSE listing standards.

## Social Responsibility

### 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 for its employees near our manufacturing sites and has significantly helped the local communities to grow and prosper with us.

In January of 2005, 2,675 employees of SMIC raised a total of nearly US\$45,000 that was donated to the Red Cross of China for use in disaster relief efforts for the South Asia Tsunami of 2004.

### 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 has been a long-standing supporter of the Enyou Foundation and our senior management has been actively involved in the foundation. SMIC's President, Chief Executive Officer and Executive Director, Richard Ru Gin 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. In

2006, SMIC was certified as one of Sony's Green Partners on recognition of SMIC's strong commitment to environmental protection.

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. In 2005, we broke ground on Fab 10, which will be 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.

## Social Responsibility

**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.

## **Deloitte.** 德勤

### **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, 2005, 2004 and 2003 and the related consolidated statements of operations, stockholders' equity and comprehensive income (loss), and cash flows for the years ended December 31, 2005, 2004 and 2003. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2005, 2004 and 2003 and the result of its operations and its cash flows for the years ended December 31, 2005, 2004 and 2003 in conformity with accounting principles generally accepted in the United States of America.

**Deloitte Touche Tohmatsu**  
*Certified Public Accountants*

Hong Kong  
March 29, 2006

# Consolidated Balance Sheets

(In U.S. dollars)

	Notes	2005	December 31, 2004	2003
<b>ASSETS</b>				
Current assets:				
Cash and cash equivalents		\$ 585,796,887	\$ 607,172,570	\$ 445,276,334
Short-term investments	6	13,795,859	20,364,184	27,164,603
Accounts receivable, net of allowances of \$1,091,340 in 2005, \$1,105,165 in 2004 and \$114,473 in 2003	5	241,333,914	169,188,287	90,538,517
Inventories	7	191,237,636	144,017,852	69,923,879
Prepaid expense and other current assets		15,300,591	12,842,994	15,387,319
Assets held for sale	8	-	1,831,972	32,591,363
Total current assets		1,047,464,887	955,417,859	680,882,015
Land use rights, net	9	34,767,518	39,197,774	41,935,460
Plant and equipment, net	10	3,285,631,131	3,311,924,599	1,523,564,055
Acquired intangible assets, net	11	195,178,898	77,735,299	41,120,465
Investments held to maturity	6	-	-	3,004,724
Equity investment	12	17,820,890	-	-
Prepaid service contract		2,552,407	-	-
<b>TOTAL ASSETS</b>		<b>\$ 4,583,415,731</b>	<b>\$ 4,384,275,531</b>	<b>\$ 2,290,506,719</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>				
Current liabilities:				
Accounts payable	13	\$ 262,318,432	\$ 364,333,613	\$ 211,762,334
Accrued expenses and other current liabilities		92,916,030	82,857,551	33,298,915
Short-term borrowings	16	265,481,082	91,000,000	-
Current portion of promissory note	15	29,242,001	-	15,000,000
Current portion of long-term debt	16	246,080,580	191,986,372	-
Note payable to stockholder	14	-	-	27,018,043
Deposit received from stockholders	14	-	-	38,351,407
Income tax payable		-	152,000	-
Total current liabilities		896,038,125	730,329,536	325,430,699
Long-term liabilities:				
Promissory note	15	103,254,436	-	-
Long-term debt	16	494,556,385	544,462,074	479,960,575
Long-term payables relating to license agreements	17	24,686,398	-	-
Total long-term liabilities		622,497,219	544,462,074	479,960,575
Total liabilities		1,518,535,344	1,274,791,610	805,391,274

# Consolidated Balance Sheets

(In U.S. dollars)

	Notes	December 31,		
		2005	2004	2003
Commitments	22			
Minority interest		38,781,863	-	-
Stockholders' equity:				
Series A convertible preference shares, \$0.0004 par value, nil, 1,000,000,000 and 1,000,000,000 shares authorized in 2005, 2004 and 2003, shares issued and outstanding nil in 2005 and 2004, 954,977,374 in 2003, respectively	19	-	-	381,990
Series A-1 non-convertible preference shares, \$0.00001 par value, nil, nil and 1,000,000,000 shares authorized in 2005, 2004 and 2003, shares issued and outstanding nil in 2005 and 2004, 219,499,674 in 2003, respectively	19	-	-	2,195
Series A-2 convertible preference shares, \$0.0004 par value, nil, nil and 42,373,000 authorized in 2005, 2004 and 2003 shares issued and outstanding and nil in 2005 and 2004, 42,373,000 in 2003, respectively	19	-	-	16,949
Series B convertible preference shares, \$0.0004 par value, nil, nil and 50,000,000 authorized in 2005, 2004 and 2003, shares issued and outstanding nil in 2005 and 2004, 2,350,000 in 2003, respectively	19	-	-	940
Series C convertible preference shares, \$0.0004 par value, nil, nil and 215,285,714 authorized in 2005, 2004 and 2003, shares issued and outstanding nil in 2005 and 2004, 181,718,858 in 2003, respectively	19	-	-	72,688
Series D convertible preference shares, \$0.0004 par value, nil, nil and 122,142,857 authorized in 2005, 2004 and 2003, shares issued and outstanding nil in 2005 and 2004, 7,142,857 in 2003, respectively	19	-	-	2,857
Ordinary shares, \$0.0004 par value, 50,000,000,000, 50,000,000,000 and 22,454,944,800 authorized in 2005, 2004 and 2003, shares issued and outstanding 18,301,680,867 in 2005, 18,232,179,139 in 2004 and 242,595,000 in 2003, respectively	19	7,320,673	7,292,872	97,038
Warrants	20	32,387	32,387	37,839,931
Additional paid-in capital		3,291,407,448	3,289,724,885	1,835,820,085
Subscription receivable from stockholders		-	-	(105,420,031)
Notes receivable from stockholders	20	-	(391,375)	(36,026,073)
Accumulated other comprehensive income		138,978	387,776	199,827
Deferred stock compensation		(24,881,919)	(51,177,675)	(40,582,596)
Accumulated deficit		(247,919,043)	(136,384,949)	(207,290,355)
Total stockholders' equity		3,026,098,524	3,109,483,921	1,485,115,445
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY		\$ 4,583,415,731	\$ 4,384,275,531	\$ 2,290,506,719
Net current assets (liabilities)		\$ 151,426,762	\$ 225,088,323	\$ 355,451,316
Total assets less current liabilities		\$ 3,687,377,606	\$ 3,653,945,995	\$ 1,965,076,020

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

# Consolidated Statements of Operations

(In U.S. dollars)

	Notes	Year ended December 31,		
		2005	2004	2003
Sales	23	\$ 1,171,318,735	\$ 974,664,696	\$ 365,823,504
Cost of sales	2	1,081,587,786	716,225,372	359,778,796
Gross profit		89,730,949	258,439,324	6,044,708
Operating expenses:				
Research and development	2	78,865,305	74,113,116	34,912,898
General and administrative	2	35,700,768	54,038,382	29,704,976
Selling and marketing	2	17,713,228	10,383,794	10,711,098
Litigation settlement	25	–	23,153,105	–
Amortization of intangible assets	2	41,251,077	14,368,025	3,461,977
Total operating expenses		173,530,378	176,056,422	78,790,949
Income (loss) from operations	28	(83,799,429)	82,382,902	(72,746,241)
Other income (expense):				
Interest income		11,355,972	10,587,244	5,615,631
Interest expense		(38,784,323)	(13,697,894)	(1,424,740)
Foreign currency exchange gain (loss)		(3,355,279)	8,217,567	1,522,661
Others, net		4,461,925	2,441,057	888,189
Total other income, net		(26,321,705)	7,547,974	6,601,741
(Loss) income before income tax		(110,121,134)	89,930,876	(66,144,500)
Income tax – current	18	284,867	186,044	–
Net (loss) income after taxes and before minority interest and loss from equity investment		(110,406,001)	89,744,832	(66,144,500)
Minority interest		251,017	–	–
Loss from equity investment	12	(1,379,110)	–	–
Net (loss) income		(111,534,094)	89,744,832	(66,144,500)
Deemed dividends on preference shares	30	–	18,839,426	37,116,629
(Loss) income attributable to holders of ordinary shares		\$ (111,534,094)	\$ 70,905,406	\$ (103,261,129)



# Consolidated Statements of Operations

(In U.S. dollars)

	Notes	Year ended December 31,		
		2005	2004	2003
(Loss) income per share, basic	21	\$ (0.01)	\$ 0.01	\$ (1.14)
(Loss) income per share, diluted	21	\$ (0.01)	\$ 0.00	\$ (1.14)
Shares used in calculating basic (loss) income per share	21	18,184,429,255	14,199,163,517	90,983,200
Shares used in calculating diluted (loss) income per share	21	18,184,429,255	17,934,393,066	90,983,200
* Share-based compensation related to each accounts balance is as follows:				
Cost of sales		\$ 11,931,713	\$ 11,595,131	\$ 5,539,275
Research and development		4,899,376	5,138,402	2,842,775
General and administrative		6,469,366	8,023,343	1,793,185
Selling and marketing		2,435,394	2,254,202	1,264,279
Total		\$ 25,735,849	\$ 27,011,078	\$ 11,439,514

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

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

(In U.S. dollars)

	Preference shares										Additional paid-in capital	Subscription receivable from stockholders	Notes receivable from stockholders	Accumulated other comprehensive income (loss)	Deferred stock compensation, net	Total stockholders' equity (loss)	Total Comprehensive income (loss)						
	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	Ordinary shares	Warrants	Share Amount	Share Amount													
Balance at December 31, 2002	853,330,736	381,459	214,493,674	2,195	42,373,000	16,949	2,350,000	940	-	-	241,435,200	96,370	-	1,330,760,359	(107,430,000)	68,944,638	30,004	(20,842,113)	(104,028,226)	870,591,536	\$(16,253,058)		
Issuance of warrants to a service provider	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	129,942		
Issuance of Series C convertible preference shares and warrants (net of share issuance costs of \$300,000)	-	-	-	-	-	-	-	-	-	60,000,000	-	-	-	35,645,570	594,624,430	(105,000,000)	-	-	-	-	584,200,000		
Issuance of Series C convertible preference shares to employees	-	-	-	-	-	-	-	-	-	1,718,558	688	-	-	8,722,556	-	-	-	-	-	-	8,723,273		
Issuance of Series D convertible preference shares and Series D warrants for license agreements	-	-	-	-	-	-	-	-	-	-	1,142,857	2,687	-	2,064,419	22,932,724	-	-	-	-	-	25,000,000		
Exercise of employee stock options	2,467,930	-	-	-	-	-	-	-	-	12,000,000	4,800	-	-	4,233,250	-	-	-	-	-	-	3,033,732		
Repurchase of restricted ordinary shares	(1,241,312)	(496)	-	-	-	-	-	-	-	(10,641,000)	(4,532)	-	-	(1,502,689)	-	-	-	-	-	-	(1,507,717)		
Collection of subscription receivables from stockholders	-	-	-	-	-	-	-	-	-	-	-	-	-	107,036,889	-	-	-	-	-	-	107,036,889		
Deemed dividend on preference shares	-	-	-	-	-	-	-	-	-	-	-	-	-	31,178,997	-	-	-	-	-	-	31,178,997		
Net loss	-	-	-	-	-	-	-	-	-	-	-	-	-	37,116,629	-	-	-	-	-	-	(37,116,629)		
Foreign currency translation adjustments	-	-	-	-	-	-	-	-	-	-	-	-	-	143,570	-	-	-	-	-	-	143,570		
Unrealized gain on short-term investments	-	-	-	-	-	-	-	-	-	-	-	-	-	26,253	-	-	-	-	-	-	26,253		
Balance at December 31, 2003	854,077,374	381,950	214,493,674	2,195	42,373,000	16,949	2,350,000	940	18,178,558	72,888	7,142,857	2,687	242,355,000	97,038	37,838,931	1,633,200,065	(105,420,031)	68,026,073	193,827	(40,362,358)	1,865,115,145	\$(65,934,677)	
Issuance of Series D convertible preference shares and Series D warrants to Motorola and INTEL	-	-	-	-	-	-	-	-	-	-	957,114,286	38,285	-	27,653,760	308,141,738	-	-	-	-	-	-	335,943,204	
Issuance of Series D preference shares in exchange for software licenses	-	-	-	-	-	-	-	-	-	-	914,285	365	-	5,659,691	-	-	-	-	-	-	-	5,660,236	
Issuance of Series B convertible preference shares in exchange for intangible assets	-	-	-	-	-	-	-	-	-	-	-	-	750,000	300	-	-	-	-	-	-	-	2,739,653	
Issuance of Series B convertible preference shares to a service provider	-	-	-	-	-	-	-	-	-	-	12,243	5	-	45,065	-	-	-	-	-	-	-	45,030	
Conversion of preference shares to ordinary shares upon initial public offering	(54,322,624)	(541,958)	-	-	(42,373,000)	(16,949)	(5,312,245)	(1,245)	(18,178,558)	(72,888)	(103,771,428)	(41,368)	(14,927,787,880)	5,971,115	(65,373,768)	58,917,072	-	-	-	-	-	-	
Issuance of ordinary shares upon initial public offering (net of issuance cost of US\$7,007,700)	-	-	-	-	-	-	-	-	-	-	-	-	3,000,000,000	1,242,121	-	1,015,847,000	-	-	-	-	-	1,016,629,151	
Redemption of Series A-1 preference shares	-	-	(214,493,674)	-	-	-	-	-	-	-	-	-	-	55	(91,555)	179,910	-	-	-	-	-	(79,598)	
Shares and warrants issued to a service provider	-	-	-	-	-	-	-	-	-	-	-	-	136,640	953	5,272,597	-	-	-	-	-	-	5,272,100	
Issuance of ordinary shares in exchange for equipment	-	-	-	-	-	-	-	-	-	-	-	-	23,597,830	8,883	1,990,004	-	-	-	-	-	-	1,991,111	
Exercise of stock options	-	-	-	-	-	-	-	-	-	-	-	-	20,786,039	8,307	(81,136)	-	-	-	-	-	-	(66,839)	
Repurchase of restricted ordinary shares	(54,150)	(22)	-	-	-	-	-	-	-	-	-	-	(13,397,300)	(5,347)	(60,811)	-	-	-	-	-	-	(60,833)	
Repurchase of restricted preference shares	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	105,400,031	
Collection of subscription receivable from stockholders	-	-	-	-	-	-	-	-	-	-	-	-	-	116,420,031	-	-	-	-	-	-	-	35,634,686	
Collection of note receivables from employees	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	27,011,078	
Deemed dividend on preference shares	-	-	-	-	-	-	-	-	-	-	-	-	-	37,066,197	-	-	-	-	-	-	-	(18,838,428)	
Net income	-	-	-	-	-	-	-	-	-	-	-	-	-	18,838,426	-	-	-	-	-	-	-	87,744,832	
Foreign currency translation adjustments	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	258,381	
Unrealized gain on investments	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	(68,442)	
Balance at December 31, 2004	-	-	-	-	-	-	-	-	-	-	-	-	\$-18,232,179,139	\$7,262,872	\$32,387	\$2,295,724,665	\$-	\$391,375	\$37,776	\$51,177,675	\$136,339,493	\$1,003,883,321	\$89,652,781
Net profit of a subsidiary attributable to minority interest upon injection	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	(32,880)
Exercise of stock options	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	2,402,100
Repurchase of restricted ordinary shares	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	(99,029)	
Collection of note receivables from employees	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	391,375	
Deemed stock compensation, net	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	25,735,849	
Net income	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	(111,534,094)
Foreign currency translation adjustments	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	(192,246)
Unrealized gain on investments	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	(58,552)
Balance at December 31, 2005	-	-	-	-	-	-	-	-	-	-	-	-	\$-18,301,688,867	\$7,262,873	\$32,387	\$2,291,407,446	\$-	\$18,978	\$24,881,916	\$47,919,043	\$33,026,086,574	\$11,752,262	

# Consolidated Statements of Cash Flows

(In U.S. dollars)

	Year ended December 31,		
	2005	2004	2003
Operating activities:			
Income (loss) attributable to holders of ordinary shares	\$ (111,534,094)	\$ 70,905,406	\$ (103,261,129)
Deemed dividends on preference shares	–	18,839,426	37,116,629
Net income (loss)	(111,534,094)	89,744,832	(66,144,500)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Minority interest	(251,017)	–	–
Gain on disposal of plant and equipment	(3,001,881)	(733,822)	(8,029)
Depreciation and amortization	745,926,095	456,960,522	233,904,866
Non-cash interest expense	5,395,177	–	795,279
Amortization of acquired intangible assets	41,251,077	14,368,025	3,461,977
Amortization of share-based compensation	25,735,849	27,011,078	11,439,514
Share of loss of affiliate company	1,379,110	–	–
Stock compensation from Series C convertible preference shares	–	–	2,707,201
Changes in operating assets and liabilities:			
Accounts receivable, net	(72,145,627)	(78,649,770)	(70,428,402)
Inventories	(47,219,784)	(74,093,973)	(30,097,945)
Prepaid expense and other current assets	(5,172,943)	2,551,664	(8,868,710)
Accounts payable	26,425,817	49,235,998	18,752,474
Income tax payable	(152,000)	152,000	–
Accrued expenses and other current liabilities	41,469,028	32,115,883	18,756,638
Net cash provided by operating activities	648,104,807	518,662,437	114,270,363
Investing activities:			
Purchase of plant and equipment	(872,519,397)	(1,838,773,389)	(453,097,184)
Proceeds from government grant to purchase plant and equipment	18,538,886	–	–
Proceeds from disposal of plant and equipment	11,750,109	1,343,003	54,613
Proceeds received from sale of assets held for sale	6,434,115	8,215,128	4,562,934
Purchase of acquired intangible assets	(11,167,883)	(7,307,996)	(3,585,000)
Purchase of short-term investments	(19,817,525)	(66,224,919)	(23,985,420)
Proceeds paid for long-term investment	(19,200,000)	–	–
Purchase of investments held to maturity	–	–	(3,004,724)
Sale (purchase) of investments held to maturity	–	3,004,297	–
Sale of short-term investments	26,329,298	72,957,324	24,556,329
Net cash used in investing activities	(859,652,397)	(1,826,786,552)	(454,498,452)

# Consolidated Statements of Cash Flows

(In U.S. dollars)

	Year ended December 31,		
	2005	2004	2003
Financing activities:			
Proceeds from short-term borrowings	394,158,994	91,000,000	30,000,000
Repayment of short-term borrowings	(219,677,912)	–	(33,624,597)
Repayment of note payable to stockholder for land use rights	–	(12,778,797)	(23,981,957)
Repayment of long-term debt	(249,244,093)	–	–
Proceeds from long-term debt	253,432,612	256,487,871	88,733,767
Repayment of redeemable convertible promissory note	(30,000,000)	(15,000,000)	–
Proceeds from issuance of Series C convertible preference shares	–	–	530,216,072
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	107,009,969
Proceeds from exercise of employee stock options	2,303,151	681,339	2,634,442
Collection of notes receivables from employees	391,376	35,245,774	–
Change in deposits received from stockholders	–	(38,151,407)	(7,491,144)
Proceeds from issuance of redeemable convertible preference shares to minority investor in a subsidiary (note 1)	39,000,025	–	–
Net cash provided by financing activities	190,364,153	1,469,763,962	693,496,552
Effect of exchange rate changes	(192,246)	256,389	143,570
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(21,375,683)	161,896,236	353,412,033
CASH AND CASH EQUIVALENTS, beginning of year	607,172,570	445,276,334	91,864,301
CASH AND CASH EQUIVALENTS, end of year	\$ 585,796,887	\$ 607,172,570	\$ 445,276,334
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:			
Income taxes paid	\$ 436,867	\$ 34,044	\$ 8,379
Interest paid	\$ 47,113,456	\$ 20,104,223	\$ 14,732,932

## Consolidated Statements of Cash Flows

(In U.S. dollars)

	Year ended December 31,		
	2005	2004	2003
<b>SUPPLEMENTAL DISCLOSURES OF NON-CASH INVESTING AND FINANCING ACTIVITIES</b>			
Series C convertible preference shares issued to investors for subscription receivable	\$ -	\$ -	\$ 105,000,000
Issuance of Series C convertible preference share warrants	\$ -	\$ -	\$ 35,645,570
Note payable waived by stockholder in exchange for land use rights	\$ -	\$ (14,239,246)	\$ -
Series D convertible preference shares issued to acquire assets and assume liabilities from Motorola and MCEL	\$ -	\$ 278,180,024	\$ 25,000,000
Issuance of Series D convertible preference share warrants	\$ -	\$ 27,663,780	\$ 2,064,419
Deemed dividends on Series C and Series D convertible preference shares	\$ -	\$ 18,839,426	\$ 37,116,629
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	\$ -
Deferred stock compensation	\$ (26,295,756)	\$ 10,595,079	\$ 19,739,483
Ordinary and preference shares issued in exchange for employee note receivable	\$ -	\$ (388,924)	\$ (968,535)
Issuance of promissory note for acquired intangible assets	\$ (132,496,437)		
Inception of long-term payable for acquired intangible assets	\$ (24,686,398)		

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

# Notes to the Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003

(In U.S. dollars)

## 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, 2005 include the following:

Name of company	Place and date of incorporation/ establishment	Attributable equity interest held	Principal activity
Garrison Consultants Limited ("Garrison")	Western Samoa April 3, 2000	100%	Provision of consultancy services
Betterway Enterprises Limited ("Betterway")	Western 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 June 30, 2005	100%	Investment holding
SMIC Energy Technology (Shanghai) Science Corporation ("Energy science")*	The PRC September 9, 2005	100%	Manufacturing and trading of solar cell related semiconductor products

\* Companies registered as wholly foreign-owned enterprises in the PRC.

# Notes to the Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003  
(In U.S. dollars)

## 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 \$39 million, representing 43.33% equity interest of AT.

## 2. RECLASSIFICATIONS OF CERTAIN ACCOUNTS

- (a) 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 prior years have been reclassified to conform 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 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 intercompany 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 allowance for receivables, inventory valuation, useful lives and commencement of productive use for plant and equipment and acquired intangible assets, accruals for sales adjustments and warranties, other liabilities and stock compensation expense.

# Notes to the Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003

(In U.S. dollars)

## 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 as available for sale and 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.

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, short-term investments and accounts receivable. 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 2005, 2004 and 2003, inventory was written down by \$13,808,697, \$10,506,374 and \$nil, respectively, to reflect the lower of cost or market.



# Notes to the Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003  
(In U.S. dollars)

## 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 placed in service.

### (k) Acquired intangible assets

Acquired intangible assets, which consist primarily of technology and licenses are carried at cost less accumulated amortization. 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, 2005. The Company had no goodwill as of December 31, 2005, 2004 and 2003.

### (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.

# Notes to the Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003

(In U.S. dollars)

## 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 \$7,617,123, \$7,531,038 and \$7,090,635, net of government subsidies of \$3,991,000, \$nil, and \$7,220,000 in 2005, 2004 and 2003, 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. In 2005, 2004 and 2003, the Company recorded amortization expenses relating to the capitalized interest of \$3,296,641, \$1,681,089 and \$307,954, respectively.

### (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 \$12,391,000, \$nil and \$7,220,000 in 2005, 2004 and 2003, respectively, which were calculated based on the interest expense on the Company's estimated borrowings. The Company recorded government subsidies as a reduction of capitalized interest for the year and any excess was recorded as advance receipts in the year when the cash is received from the government.

#### (2) *Value added tax refunds*

The Company received subsidies of \$3,747,951, \$1,949,265 and \$nil in 2005, 2004 and 2003, 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 costs of sales.

# Notes to the Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003  
(In U.S. dollars)

## 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### (o) Government subsidies (Continued)

#### (3) Government awards

The Company received government awards of \$2,650,709 in the form of reimbursement of certain expenses in 2005, accordingly these awards were recorded as reduction of expenses.

The Company received \$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. The Company received no government awards in 2003.

#### (4) Sales tax refunds

The Company received sales tax refunds of \$609,461, \$573,992 and \$nil in 2005, 2004 and 2003, respectively, which were recorded as an offset of the general and administrative expenses.

#### (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 has been granted with such subsidy of RMB160 million (equal to US\$19,777,951), of which RMB150 million (equal to US\$18,538,886) has been actually received as of December 31, 2005. Subsidies were used to offset the account of construction in progress as they were strictly related to the construction of 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.

# Notes to the Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003

(In U.S. dollars)

## 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 basis 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, and long-term debt. 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 and long-term debt approximates fair value due to variable interest rates that approximate market rates.

# Notes to the Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003  
(In U.S. dollars)

## 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### (v) Stock-based compensation

The Company grants stock options to its employees and certain non-employees. The Company accounts for employee stock-based compensation in accordance with Accounting Principles Board Opinion No. 25 ("APB 25"), "Accounting for Stock Issued to Employees," which requires the Company to record a compensation charge for the excess of the fair value of the stock at the grant date or any other measurement date over the amount an employee must pay to acquire the stock. The compensation expense is recognized over the applicable service period, which is usually the vesting period. The Company accounts for stock-based awards to non-employees in accordance with SFAS No. 123, "Accounting for Stock-Based Compensation," which requires the Company to record a charge for the services rendered by the non-employees using the Black-Scholes option pricing model. The Company's disclosures are in accordance with SFAS No. 148, "Accounting for Stock-Based Compensation-Transition and Disclosure."

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, the Company's pro forma (loss) income would have been as follows:

	Year ended December 31,		
	2005	2004	2003
(Loss) income attributable to holders of ordinary shares	\$ (111,534,094)	\$ 70,905,406	\$ (103,261,129)
Add: Stock compensation as reported	25,735,849	27,011,078	11,439,514
Less: Stock compensation determined using the fair value method	(32,997,627)	(37,486,703)	(17,253,078)
Pro forma (loss) income attributable to holders of ordinary shares	\$ (118,795,872)	\$ 60,429,781	\$ (109,074,693)
(Loss) income per share:			
Basic – pro forma	\$ (0.01)	\$ 0.00	\$ (1.20)
Diluted – pro forma	\$ (0.01)	\$ 0.00	\$ (1.20)
Basic – as reported	\$ (0.01)	\$ 0.01	\$ (1.14)
Diluted – as reported	\$ (0.01)	\$ 0.00	\$ (1.14)

The fair value of each option grant and share granted are estimated on the date of grant using the Black-Scholes option pricing model with the following assumptions used for grants during the applicable period.

	2005	2004	2003
Average risk-free rate of return	4.16%	2.64%	2.94%
Weighted average expected option life	1-4 years	0.5-4 years	4.0 years
Volatility rate	30.39%	52.45%	67.99%
Dividend yield (Preference share only)	–	–	8%

# Notes to the Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003

(In U.S. dollars)

## 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,		
	2005	2004	2003
Forward foreign exchange contracts	\$ 245,622,512	\$ 61,034,335	\$ 133,010,951
Interest rate swap contracts	340,000,000	-	-
	\$ 585,622,512	\$ 61,034,335	\$ 133,010,951

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 Renminbi, the Japanese Yen and the European Euro. The foreign-currency forward exchange contracts do not qualify for hedge accounting. In 2005, 2004 and 2003, 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	U.S. dollar equivalents
<b>As of December 31, 2005</b>		
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
<b>As of December 31, 2004</b>		
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
<b>As of December 31, 2003</b>		
Japanese Yen	6,250,900,000	\$ 58,445,915
European Euro	39,652,028	49,565,036
Renminbi	206,917,500	25,000,000
		\$ 133,010,951

# Notes to the Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003  
(In U.S. dollars)

## 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### (w) Derivative financial instruments (Continued)

In 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 2005, ineffective hedging gains or losses on the interest rate swap contracts were recognized in the statement of operations. As of December 31, 2005, the Company had outstanding interest rate swap contracts with notional amounts of \$340,000,000.

The fair values of each derivative instrument are as follows:

	December 31,		
	2005	2004	2003
Forward foreign exchange contracts	\$ (2,607,714)	\$ (283,344)	\$ 432,568
Interest rate swap contracts	(1,270,811)	—	—
	\$ (3,878,525)	\$ (283,344)	\$ 432,568

As of December 31, 2005, the fair value of foreign-currency forward exchange contracts, which approximates \$(2,607,714), was recorded in accrued expenses and other current liabilities with the change of fair value recorded as part of other income (expense), net in the statement of operations.

As of December 31, 2005, the fair value of the interest rate swap contracts, which approximates \$(1,270,811), was recorded in accrued expenses and other current liabilities. The interest expense incurred in 2005 was \$1,372,477, which includes both the change of fair value of the outstanding interest rate swap contracts as well as cost associated with settlement of certain interest rate swap contracts during the year.

### (x) Recently issued accounting standards

In November 2004, FASB issued SFAS No.151, "Inventory Costs – an amendment of ARB No.43, Chapters 4". This statement amends the guidance in Accounting Research Board ("ARB") No.43, Chapters 4, "Inventory Pricing" to clarify the accounting for abnormal amounts of idle facility expenses, freight, handling costs, and wasted material (spoilage). This Statement requires that those items be recognized as current period charges. In addition, this Statement requires that allocation of fixed production overheads to the cost of conversion be based on the normal capacity of the production facilities. This Statement is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The Company does not expect the adoption of this Statement will have a material effect on the Company's financial position, cash flows or results of operations.

# Notes to the Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003

(In U.S. dollars)

## 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### (x) Recently issued accounting standards (Continued)

The Company accounts for stock-based compensation awards issued to employees using the intrinsic value measurement provisions of APB 25. Accordingly, no compensation expense has been recorded for stock options granted with exercise prices greater than or equal to the fair value of the underlying common stock at the option grant date. On December 16, 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment ("SFAS 123R"). SFAS 123R eliminates the alternative of applying the intrinsic value measurement provisions of APB 25 to stock compensation awards issued to employees. Rather, SFAS 123R requires enterprises to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. That cost will be recognized over the period during which an employee is required to provide services in exchange for the award, known as the requisite service period (usually the vesting period).

The Company has quantified the effects of the adoption of SFAS 123R and expects that the new standard may result in significant stock-based compensation expense. The pro forma effects on net income and earnings per share if the Company had applied the fair value recognition provisions of original SFAS 123 on stock compensation awards (rather than applying the intrinsic value measurement provisions of APB 25) have been disclosed above. Although such pro forma effects of applying original SFAS 123 may be indicative of the effects of adopting SFAS 123R, the provisions of these two statements differ in some important respects. The actual effects of adopting SFAS 123R will be dependent on numerous factors including, but not limited to, the valuation model chosen by the Company to value stock-based awards; the assumed award forfeiture rate; the accounting policies adopted concerning the method of recognizing the fair value of awards over the requisite service period; and the transition method (as described below) chosen for adopting SFAS 123R.

SFAS 123R will be effective for the Company's fiscal quarter beginning December 15, 2005, and requires the use of the Modified Prospective Application Method. Under this method SFAS 123R is applied to new awards and to awards modified, repurchased, or cancelled after the effective date. Additionally, compensation cost for the portion of awards for which the requisite service has not been rendered (such as unvested options) that are outstanding as of the date of adoption shall be recognized as the remaining requisite services are rendered. The compensation cost relating to unvested awards at the date of adoption shall be based on the grant-date fair value of those awards as calculated for pro forma disclosures under the original SFAS 123. In addition, companies may use the Modified Retrospective Application Method. This method may be applied to all prior years for which the original SFAS 123 was effective or only to prior interim periods in the year of initial adoption. If the Modified Retrospective Application Method is applied, financial statements for prior periods shall be adjusted to give effect to the fair-value-based method of accounting for awards on a consistent basis with the pro forma disclosures required for those periods under the original SFAS 123.



# Notes to the Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003  
(In U.S. dollars)

## 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### (x) Recently issued accounting standards (Continued)

In May 2005, the Financial Accounting Standards Board issued Statement No. 154, "Accounting Changes and Error Corrections," ("FASB 154") which changes the requirements for the accounting for and reporting of a change in accounting principle. This statement replaces APB Opinion No. 20, Accounting Changes, and FASB Statement No. 3, Reporting Accounting Changes in Interim Financial Statements, and applies to all voluntary changes in accounting principle as well as changes required by an accounting pronouncement in the rare instance that a new pronouncement does not include specific transition provisions. APB Opinion No. 20 previously required that the cumulative effect of a voluntary change to a new accounting pronouncement be recognized in net income for the period of the change. FASB Statement No. 154 now requires retrospective application of a voluntary change in accounting principle to prior periods' financial statements unless it is impracticable to determine either the period-specific effects of the cumulative effect of the change. Additionally, this Statement redefines the term "restatement" as the revising of previously issued financial statements to reflect the correction of the error. Reporting the correction of an error in previously issued financial statements and a change in accounting estimate is carried forward from the guidance provided in APB Opinion 20. FASB Statement No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The adoption of FASB 154 is not expected to have a material impact on the Company's financial position, results of operations, or cash flows.

### (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.

# Notes to the Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003

(In U.S. dollars)

## 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 \$0.2087 per share and a warrant to purchase 8,285,714 Series D convertible preference shares for \$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 \$0.01 per share in exchange for \$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 \$0.2087 per share and a warrant to purchase 1,142,857 Series D convertible preference shares for \$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 \$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 \$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.

An aging analysis of trade debtors is as follows:

	2005	2004	2003
Current	\$ 192,303,054	\$ 148,502,815	\$ 74,273,846
Overdue:			
Within 30 days	38,017,540	15,901,323	16,114,311
Between 31 to 60 days	2,528,249	2,656,964	118,220
Over 60 days	8,485,071	2,127,185	32,140
	\$ 241,333,914	\$ 169,188,287	\$ 90,538,517

# Notes to the Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003  
(In U.S. dollars)

## 6. INVESTMENTS

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

	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

	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

	December 31, 2003			
	Cost	Gross unrealized gains	Gross unrealized losses	Fair value
Corporate bond	\$ 3,023,938	\$ 12,462	\$ -	\$ 3,036,400
Mutual fund	23,985,420	142,783	-	24,128,203
	\$ 27,009,358	\$ 155,245	\$ -	\$ 27,164,603

The cost and estimated fair value of the long-term debt securities held to maturity by contractual maturity were as follows:

### Maturity Date

	December 31, 2003	
	Cost	Estimated Fair Value
Due in 2-5 years	\$ 3,004,724	\$ 2,992,160

As of December 31, 2005 and 2004, the Company did not have any long-term debt securities.

# Notes to the Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003

(In U.S. dollars)

## 7. INVENTORIES

	2005	2004	2003
Raw materials	\$ 55,697,982	\$ 39,336,929	\$ 15,799,636
Work in progress	115,210,052	83,953,481	50,079,252
Finished goods	20,329,602	20,727,442	4,044,991
	\$ 191,237,636	\$ 144,017,852	\$ 69,923,879

## 8. ASSETS HELD FOR SALE

Assets held for sale represent residential real estate that the Company has constructed for its employees. During 2003, the Company decided to offer to sell this real estate to its employees over the next twelve months. Accordingly, the Company had classified the \$32,591,363 carrying value, representing historical cost less accumulated depreciation, as assets held for sale as of December 31, 2003.

As of December 31, 2004, the Company had sold residential real estate with a carrying value of \$12,089,113 to employees for \$12,778,062, which resulted in a gain on disposition of \$688,949. The Company has reclassified the majority of the unsold residential real estate units of \$18,670,278 to land use rights, plant and equipment and recorded a cumulative adjustment for depreciation expense of \$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 \$1,831,972, representing 44 sets of the residential real estate units.

As of December 31, 2005, the Company sold residential real estate units with a carrying value of \$1,679,818 for \$2,322,409, which resulted in a gain on disposal of \$642,591. Meanwhile, the Company has reclassified the remaining unsold real estate units of \$152,154 to land use rights, plant and equipment. Accordingly, the Company recorded a cumulative adjustment for depreciation expense of \$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.

## 9. LAND USE RIGHTS, NET

	2005	2004	2003
Land use rights (50-70 years)	\$ 38,504,311	\$ 42,412,453	\$ 44,136,870
Less: Accumulated amortization	(3,736,793)	(3,214,679)	(2,201,410)
	\$ 34,767,518	\$ 39,197,774	\$ 41,935,460

# Notes to the Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003  
(In U.S. dollars)

## 10. PLANT AND EQUIPMENT, NET

	2005	2004	2003
Buildings	\$ 212,205,753	\$ 203,375,644	\$ 91,436,319
Facility, machinery and equipment	382,928,570	339,852,626	112,611,314
Manufacturing machinery and equipment	3,810,671,778	2,838,231,084	1,331,916,555
Furniture and office equipment	75,696,024	51,932,370	27,840,169
Transportation equipment	1,581,493	1,324,144	769,227
	<b>4,483,083,618</b>	3,434,715,868	1,564,573,584
Less: Accumulated depreciation and amortization	(1,515,923,860)	(772,416,194)	(315,993,086)
Construction in progress	318,471,373	649,624,925	274,983,557
	<b>\$3,285,631,131</b>	\$3,311,924,599	\$1,523,564,055

## 11. ACQUIRED INTANGIBLE ASSETS, NET

	2005	2004	2003
Cost:			
Technology	\$ 5,782,943	\$ 5,782,943	\$ 5,817,442
Licenses	146,451,215	85,719,858	34,702,500
Patent licenses	102,025,819	4,062,500	4,062,500
	<b>\$ 254,259,977</b>	\$ 95,565,301	\$ 44,582,442
Accumulated Amortization:			
Technology	(3,689,655)	(2,451,817)	(1,218,750)
Licenses	(36,452,597)	(13,637,114)	(870,536)
Patent licenses	(18,938,827)	(1,741,071)	(1,372,691)
	<b>(59,081,079)</b>	(17,830,002)	(3,461,977)
Acquired intangible assets, net	<b>\$ 195,178,898</b>	\$ 77,735,299	\$ 41,120,465

### 2005

The Company entered into a settlement and license agreement with Taiwan Semiconductor Manufacturing Company ("TSMC") on January 31, 2005, which provides for the dismissal of all pending legal actions without prejudice between the two companies in the U.S. federal district court, the California State Superior Court, the US International Trade Commission, and the Taiwan District Court. As a part of the settlement, the Company agreed to pay TSMC an aggregate of \$175 million, in installments of a six-year promissory note (see Note 15). The Company engaged an external valuation company to perform a valuation study to determine the fair market value of the agreements relating to the intellectual property with respect to their pre-settlement and post-settlement values. Based on the valuation study, the Company recorded \$23.2 million of the settlement amount as an accrued litigation expense in 2004 and \$134.8 million intangible assets associated with the settlement in 2005.

The Company entered into various other license agreements with third parties whereby the Company purchased licenses for cash consideration of \$23,878,489.

# Notes to the Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003

(In U.S. dollars)

## 11. ACQUIRED INTANGIBLE ASSETS, NET (Continued)

### 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 \$0.01 per share in exchange for certain licenses from Motorola, which was valued at \$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 \$5,060,256.

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

### 2003

The Company issued a warrant to purchase 57,143 Series B convertible preference shares for an intellectual property development license which was valued at \$129,942 as of December 31, 2003. In conjunction with the intellectual property development license agreement, the Company would redeem the warrant in increments when the contractual party ("service provider") meets certain predetermined milestones stipulated in the agreement. In 2004, upon attaining certain milestones, the Company issued 12,343 shares of Series B convertible preference shares valued at \$45,090 and 136,640 ordinary shares valued at \$17,965, respectively, to the service provider. In 2005, no ordinary shares were issued by the Company in respect of the warrant. As of December 31, 2004 and 2005, the warrant to purchase 359,300 ordinary shares was valued at \$32,387 and \$32,387, respectively.

The Company issued 7,142,857 Series D convertible preference shares and a warrant to purchase 714,286 Series D convertible preference shares at \$0.01 per share in exchange for certain licenses from Motorola, which was valued at \$25,000,000 (see Note 4).

The Company entered into various other license agreements with third parties whereby the Company purchased licenses for \$4,705,000.

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 \$41,251,077, \$14,368,025 and \$3,461,977 in 2005, 2004 and 2003 respectively. The Company will record amortization expenses related to the acquired intangible assets of \$43,214,158, \$42,034,491, \$38,514,999, \$28,256,023, and \$22,559,626 for 2006, 2007, 2008, 2009 and 2010 respectively.

# Notes to the Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003  
(In U.S. dollars)

## 12. EQUITY INVESTMENT

	December 31, 2005	
	Carrying Amount	% of Ownership
Toppan SMIC Electronics (Shanghai) Co., Ltd.	\$ 17,820,890	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 \$19,200,000 into Toppan SMIC, representing its 30% ownership. As of December 31, 2005, the Company recorded its share of the net loss of the equity investment for the year 2005 balance to be carried forward which amounted to \$1,379,110.

## 13. ACCOUNTS PAYABLE

An aging analysis of the accounts payable is as follows:

	2005	2004	2003
Current	\$ 209,142,167	\$ 307,396,991	\$ 184,834,802
Overdue:			
Within 30 days	22,479,945	38,803,625	17,666,570
Between 31 to 60 days	4,593,542	4,351,844	3,397,082
Over 60 days	26,102,778	13,781,153	5,863,880
	\$ 262,318,432	\$ 364,333,613	\$ 211,762,334

## 14. DEPOSIT RECEIVED FROM STOCKHOLDERS AND NOTE PAYABLE TO STOCKHOLDER

During 2003, the Company received subscription deposits from existing and potential investors to secure the future purchase of the Company’s convertible preference shares. The Company converted the deposits as partial purchase consideration of convertible preference shares. The Company incurred interest expense of \$nil, \$nil and \$147,779 in 2005, 2004 and 2003, respectively.

During 2001, the Company purchased land use rights from a stockholder for \$50,000,000 in exchange for a note payable. The Company has repaid \$22,981,957 in 2003 and \$12,778,797 in 2004. The remaining balance of \$14,239,246 was waived by the stockholder and recognized as a reduction to the cost of the land use right in 2004.

# Notes to the Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003

(In U.S. dollars)

## 15. PROMISSORY NOTE

In 2005, the Company reached an settlement and license agreement with TSMC as detailed in Note 11 and Note 25. Under this agreement, the Company issued thirteen non-interest bearing promissory notes with an aggregate amount of \$175,000,000 as the settlement consideration. The Company has recorded a discount of \$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 \$30,000,000 in 2005 and the outstanding promissory notes are as follows:

Maturity	December 31, 2005	
	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
	<b>145,000,000</b>	<b>132,496,437</b>
Less: Current portion of promissory notes	<b>30,000,000</b>	<b>29,242,001</b>
Long-term portion of promissory notes	<b>\$115,000,000</b>	<b>\$103,254,436</b>

In 2005, the Company recorded interest expense of \$4,527,146 relating to the amortization of the discount.

In 2002, the Company entered into a technology transfer agreement with a third party whereby the Company acquired technology and patent licenses in exchange for \$15,000,000, 1,666,667 Series B convertible preference shares valued at \$2,750,000 and a \$15,000,000 non-interest bearing redeemable convertible promissory note which was callable by the earlier of August 23, 2004 or 6 months before IPO by the holder. The Company has recorded a discount for the imputed interest on the redeemable convertible promissory note which has been recorded as a direct reduction of the face amount of the note. The Company calculated the discount using an effective interest rate of 3.69%, resulting in a discount of \$971,370. In January 2004, the Company redeemed the convertible promissory note in cash. In 2004 and 2003, the Company recorded interest expense of \$nil and \$795,279 relating to the amortization of the discount, respectively.



# Notes to the Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003  
(In U.S. dollars)

## 16. INDEBTEDNESS

Short-term and long-term debt is as follows:

	2005	2004	2003
Short-term borrowings from commercial banks (a)	\$ 265,481,082	\$ 91,000,000	\$ –
Long-term debt by contracts (b):			
Shanghai phase I USD syndicate loan	\$ 259,200,000	\$ 432,000,000	\$ 432,000,000
Shanghai phase I RMB syndicate loan	–	47,966,446	47,960,575
Shanghai phase II USD syndicate loan	256,481,965	256,482,000	–
Beijing USD syndicate loan	224,955,000	–	–
	\$ 740,636,965	\$ 736,448,446	\$ 479,960,575
Long-term debt by repayment schedule:			
2005	\$ –	\$ 191,986,372	\$ 191,984,230
2006	246,080,580	265,267,355	191,984,230
2007	197,173,071	169,273,861	95,992,115
2008	148,265,571	73,280,572	–
2009	111,625,243	36,640,286	–
2010	37,492,500	–	–
	740,636,965	736,448,446	479,960,575
Less: current maturities of long-term debt	246,080,580	191,986,372	–
Non-current maturities of long-term debt	\$ 494,556,385	\$ 544,462,074	\$ 479,960,575

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

As of December 31, 2003, the Company had five short-term agreements that provided borrowings totalling up to \$210,615,750 on a revolving credit basis. As of December 31, 2003, the Company had no outstanding balance under these agreements. Borrowings under the credit agreements were unsecured. The interest expense incurred in 2003 was \$111,533, which was capitalized as additions to assets under construction. The average interest rate on the loan was 2.47% in 2003.

As of December 31, 2004, the Company had seven short-term credit agreements that provided total credit facilities up to \$253,000,000 on a revolving credit basis. As of December 31, 2004, the Company had drawn down \$91,000,000 under these credit agreements and \$162,000,000 is available for future borrowings. The outstanding borrowings under the credit agreements were unsecured. The interest expense incurred in 2004 was \$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 \$431 million on a revolving credit basis. As of December 31, 2005, the Company had drawn down approximately \$265 million under these credit agreements and approximately \$166 million is available for future borrowings. The outstanding borrowings under the credit agreements are unsecured. The interest expense incurred in 2005 was \$8,987,676. The interest rate on the loan ranged from 2.99% to 5.73% in 2005.

# Notes to the Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003

(In U.S. dollars)

## 16. INDEBTEDNESS (Continued)

### (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 \$432,000,000. The withdrawal period of the facility was 18 months starting from the loan agreement date. As of December 31, 2004 and 2003, SMIS had fully utilized the loan amount. In 2005, the interest rate on the loan ranged from 4.34% to 6.16%. 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 \$86,400,000. As of December 31, 2005, three installments of \$259,200,000 are remaining. The interest expense incurred in 2005, 2004 and 2003 was \$16,499,858, \$14,014,698 and \$12,326,043, respectively, of which \$3,631,872, \$6,396,254 and \$11,921,430 was capitalized as additions to assets under construction in 2005, 2004 and 2003, respectively.

#### *Shanghai Phase I RMB syndicate loan*

SMIS had a RMB denominated line of credit of RMB396,960,000 (approximately \$48 million) in 2001, with the same financial institutions. As of December 31, 2004 and 2003, 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 principal amount is repayable starting from March 2005 in five semi-annual installments of \$9,593,289. The annual interest rate on the loan ranged from 5.02% to 5.27% in 2005. The interest expense incurred in 2005, 2004 and 2003 was \$1,649,858, \$2,451,885 and \$2,354,741, respectively, of which \$362,172, \$1,134,784 and \$2,277,672 was capitalized as additions to assets under construction in 2005, 2004 and 2003, respectively. As of December 31, 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 \$256,481,965 with the same financial institutions. As of December 31, 2005 and 2004, SMIS had fully utilized the loan. In 2005, the interest rate on the loan ranged from 4.34% to 6.16%. 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 \$36,640,286. The interest expense incurred in 2005 and 2004 was \$12,470,302 and \$3,890,105, of which \$2,743,173 and \$nil was capitalized as additions to assets under construction in 2005 and 2004, respectively.

In connection with the second phase long-term facility arrangement, SMIS has a RMB denominated line of credit of RMB235,678,000 (\$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 \$25,625.

The total outstanding balance of SMIS's long-term debt is collateralized by certain plant and equipment at the original cost of \$2,446,731,548 as of December 31, 2005.

# Notes to the Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003  
(In U.S. dollars)

## 16. INDEBTEDNESS (Continued)

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

#### *Beijing USD syndicate loan*

In May 2005, SMIB entered into a five-year loan facility in the aggregate principal amount of \$600,000,000, with a syndicate of financial institutions based in the PRC. This five-year bank loan will be used to expand the capacity of SMIB's fabs and are collateralized by its plant and equipment. The withdrawal period of the facility was twelve months from date of signing the agreement. As of December 31, 2005, SMIB has drawn down \$224,955,000 on this loan facility. The interest rate range on the loan ranged from 5.25% to 6.26%. The principal amount is repayable starting from December 2007 in six equal semi-annual installments. The interest expense incurred in 2005 was \$3,991,080, of which \$879,906 was capitalized as additions to assets under construction in 2005.

The total outstanding balance of Beijing USD syndicate loan is collateralized by certain plant and equipment at the original cost of \$427,266,052 as of December 31, 2005.

#### *Other*

On December 15, 2005, the Company entered into a long-term loan facility agreement in the aggregate principal amount of EUR 85 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 will be 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 installments. As of December 31, 2005, the Company had no borrowings on this loan.

The long-term debt arrangements contain financial covenants as defined in the loan agreements. The Company met these covenants as of December 31, 2005.

# Notes to the Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003

(In U.S. dollars)

## 17. 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, 2005 are as follows:

Maturity	December 31, 2005	
	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
	<b>34,500,000</b>	<b>31,478,388</b>
Less: Current portion of long-term payables	7,000,000	6,791,990
Long-term portion of long-term payables	<b>\$ 27,500,000</b>	<b>\$ 24,686,398</b>

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

In 2005, the Company recorded interest expense of \$868,032 relating to the amortization of the discount.

## 18. 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 second year of receiving exemption from FEIT.

According to PRC tax regulations, the Company’s Chengdu subsidiary could be 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, 2005, Chengdu subsidiary is still in the process of applying for the tax holiday.

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 2005 and 2004, the Company’s US subsidiary had recorded current income tax expense of \$223,846 and \$186,044, respectively, resulting from certain non-deductible stock-based compensation being allocated to such entity. The Company had minimal taxable income in Japan and Europe.

# Notes to the Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003  
(In U.S. dollars)

## 18. INCOME TAXES (Continued)

The principal components of the temporary differences are as follows:

	2005	2004	2003
Temporary differences may generate deferred tax assets are as follows:			
Allowances and reserves	\$ 14,900,038	\$ 11,824,717	\$ 328,558
Warranty reserve	–	1,875,476	–
Start-up costs	24,756,498	32,490,503	6,878,762
Net operating loss carry forwards	113,086,517	32,216,296	84,473,312
Unrealized exchange loss	1,970,974	–	–
Other	12,323	56,622	–
	<b>\$ 154,726,350</b>	<b>\$ 78,463,614</b>	<b>\$ 91,680,632</b>
Temporary differences may generate deferred tax liabilities are as follows:			
Capitalized interest	\$ (16,622,988)	\$ (11,753,459)	\$ (5,890,472)
Unrealized exchange gain	(115,405)	–	(275,783)
Other	–	(146,767)	(53,430)
	<b>\$ (16,738,393)</b>	<b>\$ (11,900,226)</b>	<b>\$ (6,219,685)</b>

No deferred taxes have been recorded relating to these differences as they are expected to reverse during the tax exemption period. The tax losses carried forward as at December 31, 2005 amounted to \$113,086,517 which were solely generated in PRC and will expire in 2010.

## 19. 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 \$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 \$18,839,426.
- (2) 914,285 Series D convertible preference shares to acquire certain software licenses with a fair value of \$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 \$2,739,853. (see Note 11)
- (4) 12,343 Series B convertible preference shares to a service provider which was valued at \$45,090. (see Note 11)

# Notes to the Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003

(In U.S. dollars)

## 19. CAPITAL STOCK (Continued)

- (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 \$17,965. (see Note 11)
- (7) 23,957,830 ordinary shares to a supplier in exchange for certain equipment with a fair value of \$5,222,180.

In 2003, the Company issued:

- (1) 179,667,007 shares of Series C convertible preference shares and a warrant to purchase 17,966,662 Series C convertible preference shares to investors for \$628,034,568 (net of issuance costs of \$800,000), of which \$105,000,000 was outstanding as subscriptions receivable at December 31, 2003 representing 30,000,000 Series C convertible preference shares. In 2004, the Company received a cash payment of \$105,000,000 relating to the outstanding subscription receivable. The accounting treatment requires a beneficial conversion feature on the Series C convertible preference shares to be calculated. The proceeds received in the Series C offering were first allocated between the convertible instrument and the Series C 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 share at the commitment date resulting in the recognition of a deemed dividend of \$34,585,897.
- (2) 7,142,857 shares of Series D convertible preference shares and a warrant to purchase 714,286 Series D convertible preference shares for a license agreement with an estimated fair value of \$25,000,000. 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 were 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 \$1,942,163.
- (3) 332,993 shares of Series C convertible preference shares and a warrant to purchase 33,299 Series C convertible preference shares to investors for \$1,165,432. The accounting treatment requires a beneficial conversion feature on the Series C convertible preference shares to be calculated. The proceeds received in the Series C offering were first allocated between the convertible instrument and the Series C 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 share at the commitment date resulting in the recognition of a deemed dividend of \$588,569.
- (4) 1,718,858 shares of Series C convertible preference shares were issued to certain employees for \$6,016,072. These shares were issued at a price below their estimated fair-market value and, accordingly, the Company has recorded a compensation charge of \$2,707,201.

# Notes to the Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003  
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## 20. 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. As of December 31, 2005, options to purchase 423,580,483 ordinary shares were outstanding. As of December 31, 2005, options to purchase 892,919,517 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 (all the preference shares are converted to ordinary shares after IPO) are authorized under the 2001 Option Plan. 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 are amortized on a straight-line basis generally over 4 years. Following the IPO, the Company no longer issues stock options under the 2001 plan. As of December 31, 2005, options to purchase 622,382,919 ordinary shares were outstanding. As of December 31, 2005, options to purchase 327,216,616 ordinary shares were available for future grant.

In January 2004, the Company adopted the 2004 Employee 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 was 455,409,330 ordinary shares. As of December 31, 2005, 189,739,191 restricted share units were outstanding and 238,078,797 ordinary shares were available for future grant through the issuance of restricted shares, restricted share units and stock appreciation rights.

For stock options granted prior to the IPO, the Company has obtained a valuation analysis performed by an independent appraiser to reassess the determination of the market value of the Company's ordinary and preference shares. The valuation analysis utilizes generally accepted valuation methodologies such as the income and market approach and discounted cash flow approach to value the Company's business. As a result, stock compensation expense is recorded for the difference between the fair market value of the ordinary and preference shares and the exercise price of the employee stock options. Subsequent to the initial public offering, options were granted at the fair market value of the ordinary share at the date of grant. Accordingly, there are no compensation charges generated from these option grants under APB 25.

The Company recorded a stock compensation expense of \$25,735,849, \$27,011,078 and \$11,439,514 in 2005, 2004 and 2003, respectively.

# Notes to the Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003

(In U.S. dollars)

## 20. STOCK OPTIONS AND WARRANTS (Continued)

A summary of the stock option activity is as follows:

	Ordinary shares		Preference shares	
	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price
Options outstanding at January 1, 2003	290,298,400	\$0.02	12,861,090	\$1.12
Granted	244,001,200	\$0.06	1,289,350	\$1.11
Exercised	(12,000,500)	\$0.04	(2,467,900)	\$1.11
Cancelled	(41,518,620)	\$0.05	(1,379,200)	\$1.11
Options outstanding at December 31, 2003	480,780,480	\$0.04	10,303,340	\$1.12
Conversion from preference shares into ordinary shares upon initial public offering	103,033,400	\$0.11	(10,303,340)	\$1.11
Granted	437,160,230	\$0.19	–	–
Exercised	(19,366,689)	\$0.05	–	–
Cancelled	(122,921,041)	\$0.10	–	–
Options outstanding at December 31, 2004	878,686,380	\$0.10	–	–
Granted	307,722,800	\$0.17	–	–
Exercised	(48,342,070)	\$0.05	–	–
Cancelled	(92,103,708)	\$0.15	–	–
<b>Options outstanding at December 31, 2005</b>	<b>1,045,963,402</b>	<b>\$0.13</b>	<b>–</b>	<b>–</b>

The weighted average per-share fair value of options as of the grant date was as follows:

	2005	2004	2003
Ordinary shares	\$ 0.05	\$ 0.17	\$ 0.13
Preference shares	–	–	\$ 0.70



# Notes to the Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003  
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## 20. STOCK OPTIONS AND WARRANTS (Continued)

The following table summarizes information with respect to stock options outstanding at December 31, 2005:

	Options outstanding			Options exercisable	
	Number outstanding	Weighted average remaining contractual life	Weighted average exercise price	Number exercisable	Weighted average exercise price
Ordinary shares:					
\$0.01	81,864,700	5.84 years	\$0.01	74,862,200	\$0.01
\$0.02	65,314,640	6.38 years	\$0.02	20,354,325	\$0.02
\$0.05	180,150,538	7.10 years	\$0.05	32,514,136	\$0.05
\$0.10-0.15	388,046,306	8.42 years	\$0.12	91,289,866	\$0.11
\$0.20-0.28	289,544,318	8.87 years	\$0.22	17,819,777	\$0.24
\$0.31-0.35	41,042,900	8.18 years	\$0.35	41,042,900	\$0.35
	1,045,963,402			277,883,204	

### Options to non-employees

The Company granted 6,311,257, 23,960,000 and 200,000 options to purchase ordinary shares and nil, nil and 15,750 options to purchase preference shares to its external consultants in exchange for certain services in 2005, 2004 and 2003, respectively. The Company recorded a stock compensation expense of \$828,498, \$765,557 and \$26,296 in 2005, 2004 and 2003, respectively, estimated on the basis of the Black-Scholes option pricing model with the following assumptions:

	2005	2004	2003
Average risk free rate of return	4.36%	2.64%	2.94%
Weighted average contractual option life	5-10 years	0.5-4 years	4 years
Volatility rate	30.39%	52.45%	67.99%
Dividend yield (Preference shares only)	—	—	8%

### Restricted share units

Pursuant to the 2004 EIP, the Company granted 122,418,740 and 118,190,824 restricted share units in 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 \$23,348,378 and \$26,001,981 in 2005 and 2004, respectively, which is expensed over the vesting period. As a result, the Company has recorded a compensation expense of \$7,051,688 and \$3,080,312 in 2005 and 2004 respectively. In 2005 and 2004, 27,591,342 and nil of restricted share units were vested. As of December 31, 2005, restricted share units to purchase 189,739,191 ordinary shares were outstanding and unvested.

# Notes to the Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003

(In U.S. dollars)

## 20. STOCK OPTIONS AND WARRANTS (Continued)

### Warrants to investors

- (1) In January 2004, the Company granted Motorola a warrant to purchase 9,571,428 Series D convertible preference shares (see Notes 4&11). The warrant had an exercise price of \$0.01 per share and became exercisable after March 31, 2005, but only if a qualified public offering was not completed prior to such date. The fair value of the warrant was approximately \$27,663,780 at the grant date, estimated on the basis of the Black-Scholes option pricing model with the following assumptions:

	<b>2004</b>
Expected volatility	57%
Risk-free interest rate	2%
Expected dividend payment rate as a percentage of the stock price on the date of grant	Nil
Contractual life of the warrant	1.25 years

In March 2004, the Company completed its IPO with an offering price of \$0.35 per share. Accordingly, the warrant expired without being exercised.

- (2) Pursuant to the license agreements dated December 5, 2003 between the Company and Motorola (see Notes 4 & 11), the Company granted Motorola a warrant to purchase 714,286 Series D convertible preference shares. The warrants have an exercise price of \$0.01 per share and became exercisable after March 31, 2005, but only if a qualified public offering was not completed prior to such. The fair value of the warrant was approximately \$2,064,419 at the grant date, estimated on the basis of the Black-Scholes option pricing model with the following assumptions:

	<b>2003</b>
Expected volatility	57%
Risk-free interest rate	2%
Expected dividend payment rate as a percentage of the stock price on the date of grant	Nil
Contractual life of the warrant	1.25 years

In March 2004, the Company completed its initial public offering with an offering price of \$0.35 per share. Accordingly, the warrant expired without being exercised.

# Notes to the Consolidated Financial Statements

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## 20. STOCK OPTIONS AND WARRANTS (Continued)

### Warrants to investors (Continued)

- (3) On November 20, 2003, the Company granted to one of its stockholders a warrant to purchase 33,299 Series C convertible preference shares. The warrant has an exercise price of \$0.01 per share and became exercisable after March 31, 2005, but only if a qualified public offering was not completed prior to such date. The fair value of the warrant was approximately \$93,743 at the grant date, estimated on the basis of the Black-Scholes option pricing model with the following assumptions:

	2003
Expected volatility	57%
Risk-free interest rate	2%
Expected dividend payment rate as a percentage of the stock price on the date of grant	Nil
Contractual life of the warrant	1.25 years

In February 2004, holders of the warrants to purchase Series C convertible preference shares agreed to amend such warrants to provide that the warrants were terminated effective upon completion of the IPO.

- (4) Pursuant to the terms of the Series C convertible preference share agreement dated on September 8, 2003 between the Company and its stockholders, the Company had granted warrants to purchase 17,966,662 Series C convertible preference shares. The warrants had an exercise price of \$0.01 per share and became exercisable after March 31, 2005, but only if a qualified public offering was not completed prior to such date. The fair value of the warrants was approximately \$35,551,827 at the grant date, estimated on the basis of the Black-Scholes option pricing model with the following assumptions:

	2003
Expected volatility	70%
Risk-free interest rate	3%
Expected dividend payment rate as a percentage of the stock price on the date of grant	Nil
Contractual life of the warrant	1.50 years

In February 2004, holders of the Company's Series C convertible preference shares agreed to amend such warrants to provide that the warrants were terminated effective upon completion of the initial public offering in March 2004.

# Notes to the Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003

(In U.S. dollars)

## 20. STOCK OPTIONS AND WARRANTS (Continued)

### Other warrants

In 2003, the Company entered into an intellectual property development license agreement with a service provider. The service provider has granted the Company a 10 year license to use its related technology in connection with the design of certain products. In exchange for the license SMIC granted a warrant to purchase 57,143 Series B convertible preference shares at \$0.35 per share. The Company will issue the Series B convertible preference shares upon the achievement of certain test results, delivery of certain design and circuit schematics and certain other predetermined development milestones. In 2004, the Company issued 12,343 Series B convertible preference shares and 136,640 ordinary shares valued at \$45,090 and \$17,965, respectively, upon attaining certain milestones. As of December 31, 2005, the warrant to purchase 359,300 ordinary shares was outstanding. Accordingly, the fair market value of the warrant has been recorded at December 31, 2005 and will continue to be recorded until the service provider completes the remaining milestone, at which time each warrant relating to the completed milestone is adjusted for the last time to its then-current fair value.

The fair value of the warrant was approximately \$32,387, \$32,387 and \$129,942 at December 31, 2005, 2004 and 2003 estimated on the basis of the Black-Scholes option pricing model with the following assumptions:

	2005	2004	2003
Expected price volatility range	35%	52%	60%
Risk-free interest rate	4.4%	4.1%	4.5%
Expected dividend payment rate as a percentage of the stock price on the date of grant	Nil	Nil	Nil
Contractual life of the warrant	7.53 years	8.53 years	10 years

### Option to investors

Pursuant to the terms of the Series A convertible preference share agreement dated in September 2001 between the Company and certain of its shareholders, as amended (the "Purchase Agreement"), the Company granted to certain investors an option (the "Option") to purchase an aggregate of \$35,000,000 worth of Series A convertible preference shares on the same terms and conditions as those purchased by the other investors (as defined in the Purchase Agreement). The fair value of the Option was approximately \$5,757,881 at the grant date, estimated on the basis of the Black-Scholes option pricing model with the following assumptions.

	2003
Expected volatility	60%
Risk-free interest rate	3%
Expected dividend payment rate as a percentage of the stock price on the date of grant	Nil
Contractual life of stock option	0.75 year

In 2002, the investors exercised an option for cash consideration of \$25,000,000 for 22,500,222 of Series A convertible preference shares. The remaining outstanding options expired on June 30, 2002.

# Notes to the Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003  
(In U.S. dollars)

## 20. STOCK OPTIONS AND WARRANTS (Continued)

### Notes receivable from employees

At December 31, 2005, 2004 and 2003, the Company had notes receivable from employees related to the early exercise of employee stock options in the aggregate amount of \$nil, \$391,375 and \$36,026,073, respectively. In 2005, the Company collected \$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 2005, 2004 and 2003, the notes earned interest in the aggregate amount of \$40,238, \$641,173 and \$1,223,552, respectively. As of December 31, 2005, 2004 and 2003 the Company had the following shares subject to repurchase:

	2005	2004	2003
Ordinary shares	35,964,021	203,973,224	159,288,650
Preference shares	Nil	Nil	28,890,560

# Notes to the Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003

(In U.S. dollars)

## 21. 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:

	2005	2004	2003
(Loss) income attributable to holders of ordinary shares	\$ (111,534,094)	\$ 70,905,406	\$ (103,261,129)
Basic and diluted:			
Weighted average ordinary shares outstanding	18,264,791,383	14,441,917,246	241,594,670
Less: Weighted average ordinary shares outstanding subject to repurchase	(80,362,128)	(242,753,729)	(150,611,470)
Weighted average shares used in computing basic income per share	18,184,429,255	14,199,163,517	90,983,200
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	18,184,429,255	17,934,393,066	90,983,200
Basic (loss) income per share	\$ (0.01)	\$ 0.01	\$ (1.14)
Diluted (loss) income per share	\$ (0.01)	\$ 0.00	\$ (1.14)

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, 2005, the Company had 306,419,133 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 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.

# Notes to the Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003  
(In U.S. dollars)

## 21. RECONCILIATION OF BASIC AND DILUTED (LOSS) INCOME PER SHARE (Continued)

As of December 31, 2003, the Company had 14,210,425,630 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 2003, as their effect would have been antidilutive due to the net loss reported in that year.

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

	December 31		
	2005	2004	2003
Series A convertible preference shares	–	–	9,549,773,740
Series A-2 convertible preference shares	–	–	423,730,000
Series B convertible preference shares	–	–	25,636,360
Series C convertible preference shares	–	–	3,180,080,180
Series D preference shares	–	–	119,789,170
Warrants to purchase Series B convertible preference shares	–	–	623,380
Warrants to purchase Series C convertible preference shares	–	–	315,000,000
Warrants to purchase Series D convertible preference shares	–	–	11,978,920
Warrants to purchase ordinary shares	–	9,584,403	–
Outstanding options to purchase ordinary shares	<b>177,325,981</b>	66,185,550	480,780,480
Outstanding options to purchase Series A convertible preference shares	–	–	103,033,400
Outstanding unvested restricted share units to purchase ordinary shares	<b>129,093,152</b>	–	–
	<b>306,419,133</b>	75,769,953	14,210,425,630

## 22. COMMITMENTS

### (a) Purchase commitments

As of December 31, 2005 the Company had the following commitments to purchase land use rights, machinery and equipment and construction obligations. The machinery and equipment is scheduled to be delivered at the Company's facility by December 31, 2006.

Land use rights	\$7,000,000
Facility construction	40,000,000
Machinery and equipment	371,000,000
	<b>\$418,000,000</b>

# Notes to the Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003

(In U.S. dollars)

## 22. COMMITMENTS (Continued)

### (b) Investment commitments

As of December 31, 2005, the Company had total commitments of \$42,000,000 to invest in certain projects. The Company expects to complete the cash injection of these projects in the next two years.

### (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 2005, 2004 and 2003, the Company incurred royalty expense of \$8,710,935, \$6,258,709 and \$2,626,916, 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 2005, 2004 and 2003, the Company earned royalty income of \$705,217, \$336,216 and \$nil, 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's 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 2005, 2004 and 2003 was \$6,952,946, \$1,740,283 and \$2,059,986, respectively.

### (e) Operating lease as lessee

The Company leases land use rights under non-cancellable leases expiring at various times through 2053. Future minimum lease payments under these leases as of December 31, 2005 are as follows:

Year ending	
2006	\$ 6,897,813
2007	59,510
2008	59,510
2009	59,510
2010	59,510
Thereafter	2,677,937
	<hr/>
	\$ 9,813,790



# Notes to the Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003  
(In U.S. dollars)

## 23. 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.

	2005	2004	2003
Total sales:			
United States	\$ 478,162,160	\$ 391,433,443	\$ 134,080,431
Europe	316,576,024	125,596,424	40,251,482
Asia Pacific (Excluding Japan and Taiwan)	175,846,284	201,881,809	52,689,834
Taiwan	138,153,755	120,652,255	97,819,762
Japan	62,580,512	135,100,765	40,981,995
	<b>\$ 1,171,318,735</b>	<b>\$ 974,664,696</b>	<b>\$ 365,823,504</b>

Revenue is attributed to countries based on headquarter of operation.

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

## 24. 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,		
	2005	2004	2003	2005	2004	2003
A	26%	11%	8%	32%	15%	19%
B	15%	13%	11%	17%	8%	21%
C	9%	10%	12%	6%	6%	11%
D	8%	12%	12%	6%	7%	9%
E	7%	6%	5%	7%	15%	—
F	5%	13%	11%	3%	10%	17%
G	3%	5%	10%	1%	8%	2%
H	2%	4%	—	2%	12%	—

# Notes to the Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003

(In U.S. dollars)

## 25. LITIGATION

In December 2003, the Company became the subject of a lawsuit in the U.S. federal district court brought by TSMC relating to alleged infringement of five U.S. patents and misappropriation of alleged trade secrets relating to methods for conducting semiconductor fab operations and manufacturing integrated circuits. After the dismissal without prejudice of the trade secret misappropriation claims by the U.S. federal district court on April 21, 2004, TSMC refiled the same claims in the California State Superior Court and alleged infringement of an additional six patents in the U.S. federal district court lawsuit. In August 2004, TSMC filed a complaint with the U.S. International Trade Commission (“ITC”) alleging similar trade secret misappropriation claims and asserting three new patent infringement claims and simultaneously filed another patent infringement suit in the U.S. federal district court on the same three patents as alleged in the ITC complaint.

On January 31, 2005, the Company entered into a settlement agreement which provides for the dismissal of all pending legal actions without prejudice between the two companies in the U.S. federal district court, the California State Superior Court, the ITC, and the Taiwan District Court. Under the terms of the settlement agreement, TSMC covenants not to sue the Company for itemized acts of trade secret misappropriation as alleged in the complaints, although the settlement does not grant a license to use any of TSMC’s trade secrets. Furthermore, the parties also entered into a patent cross-license agreement under which each party agreed to license the other party’s patent portfolio through December 2010. As a part of the settlement, the Company also agreed to pay TSMC an aggregate of \$175 million, in installments of \$30 million for each of the first five years and \$25 million in the sixth year.

The Company engaged an external valuation company to determine the fair market value of the agreements relating to the intellectual property with respect to their pre-settlement and post-settlement values. Based on the valuation study, the Company recorded \$23.2 million of the settlement amount as an expense in 2004 and \$134.8 million of intangible assets associated with the licensed patents and trade secrets which were recorded in the first quarter of 2005 and amortized over the estimated remaining life of the technology.

## 26. 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 contribution of such an arrangement was approximately \$4,128,059, \$2,502,521 and \$1,464,332 for the years ended December 31, 2005, 2004 and 2003, respectively. The retirement benefits do not apply to expatriate employees.

# Notes to the Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003  
(In U.S. dollars)

## 27. 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 \$10,432,239 in 2005, \$12,655,906 in 2004. There were no appropriations to reserves in 2003.

## 28. COMPONENTS OF (LOSS) INCOME FROM OPERATIONS

	2005	2004	2003
(Loss) income from operations is arrived at after charging (crediting):			
Auditors' remuneration	\$ 1,121,131	\$ 695,990	\$ 134,781
Depreciation and amortization of property, plant and equipment	745,041,012	455,947,253	233,037,403
Amortization of land use rights	885,083	1,013,269	867,463
Amortization of intangible assets	41,251,077	14,368,025	3,461,977
Foreign currency exchange (gain) loss	(5,198,253)	1,446,113	3,418,619
Gain on disposal of plant and equipment	(3,001,881)	(733,822)	(8,029)
(Reversal of) bad debt expense	(13,825)	990,692	(122,378)
Inventory write-down	3,088,238	10,506,374	—
Staff costs inclusive of Directors' remuneration	\$ 102,163,244	\$ 88,417,658	\$ 61,416,841

# Notes to the Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003

(In U.S. dollars)

## 29. DIRECTORS' REMUNERATION AND FIVE HIGHEST PAID INDIVIDUALS

### Directors

Details of emoluments paid by the Company to the Directors of the Company in 2005, 2004 and 2003 are as follows:

	Richard Chang	Kawanishi Tsuyoshi	Wang Yang Yuan	Hsu Ta-Lin	Lip-Bu Tan	Henry Shaw	Jou Yen-Pong	Lai Xing Cai	Total
<b>2005</b>									
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
<b>Total emoluments</b>	<b>288,388</b>	<b>49,026</b>	<b>8,608</b>	<b>8,608</b>	<b>8,608</b>	<b>8,608</b>	<b>8,608</b>	<b>-</b>	<b>380,454</b>
<b>2004</b>									
Salaries and other benefits	190,343	-	-	-	-	-	-	-	190,343
Stock option benefits	-	221,464	-	-	-	-	-	-	221,464
<b>Total emoluments</b>	<b>190,343</b>	<b>221,464</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>411,807</b>
<b>2003</b>									
Salaries and other benefits	191,621	-	-	-	-	-	-	-	191,621
Stock option benefits	-	5,000	-	-	-	-	-	-	5,000
<b>Total emoluments</b>	<b>191,621</b>	<b>5,000</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>196,621</b>

The emoluments of the Directors were within the following bands:

	2005 Number of Directors	2004 Number of Directors	2003 Number of Directors
HK\$nil to HK\$1,000,000 (\$128,982)	7	6	11
HK\$1,000,001(\$128,982) to HK\$1,500,000 (\$193,473)	-	1	1
HK\$1,500,001(\$193,473) to HK\$2,000,000 (\$257,965)	-	1	-
HK\$2,000,001(\$257,965) to HK\$2,500,000 (\$322,456)	1	-	-

The Company granted 15,000,000, 5,100,000 and nil options to purchase ordinary shares of the Company to the Directors in 2005, 2004 and 2003, respectively. As of December 31, 2005, nil stock option was exercised and 500,000 stock options were cancelled.

Stock option benefits were generated from granting stock options to an Independent Non-executive Director of the Company. Other than this, none of the Non-executive Directors received fees or other remuneration in 2005, 2004 and 2003.

In 2005, 2004 and 2003, 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. One Director has declined an option to purchase 500,000 ordinary shares which the Board granted in November 2004.

# Notes to the Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003  
(In U.S. dollars)

## 29. DIRECTORS' REMUNERATION AND FIVE HIGHEST PAID INDIVIDUALS (Continued)

### Five highest paid employees' emoluments

Of the five individuals with the highest emoluments in the Group, one (2004: one; 2003: one) is Director of the Company whose emoluments is included in the disclosure above. The emoluments of the remaining four in 2005, 2004 and 2003 are as follows:

	2005	2004	2003
Salaries and other benefits	\$ 513,570	\$ 430,144	\$ 362,037
Bonus	92,455	105,665	141,294
Stock option benefits	325,880	620,060	120,314
Total emoluments	\$ 931,905	\$ 1,155,869	\$ 623,645

Their emoluments were within the following bands:

	2005 Number of individuals	2004 Number of individuals	2003 Number of individuals
HK\$nil to HK\$1,000,000 (\$128,982)	–	–	–
HK\$1,000,001 (\$128,982) to HK\$1,500,000 (\$193,473)	–	3	4
HK\$1,500,001 (\$193,473) to HK\$2,000,000 (\$257,965)	3	–	–
HK\$2,000,001 (\$257,965) to HK\$2,500,000 (\$322,456)	1	–	–
HK\$4,500,001 (\$580,420) to HK\$5,000,000 (\$644,912)	–	1	–

In 2005, 2004 and 2003, no emoluments were paid by the Company to any of the Directors or the five highest paid individuals as an inducement to join or upon joining the Company or as compensation for loss of office. One Director has declined an option to purchase 500,000 ordinary shares which the Board granted in November 2004.

## 30. 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 2005, 2004 and 2003.

# Notes to the Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003

(In U.S. dollars)

## 31. 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 has recently been issued to specify recognition, measurement and disclosure for equity compensation. IFRS 2 requires all share-based payment to be recognised 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 the Company can account for stock-based compensation issued to employees using one of the two following methods.

### (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 and the compensation charge recorded by the Company was \$25,735,849 for the year ended December 31, 2005 (2004: \$27,011,078; 2003: \$11,439,514). 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.

- (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.

# Notes to the Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003  
(In U.S. dollars)

## 31. 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 1 January 2005, an issuer of such instrument creates a financial liability (a contractual arrangement to deliver cash or other financial 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 is 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.

Accordingly, adjustments are made to reclassify assets held for sale to land use rights and plant and equipment, and to record relevant depreciation expenses in the Statement of Operations in 2003.

In 2004, IFRIC 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.

# Notes to the Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003

(In U.S. dollars)

## 31. 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.

	2005	2004	2003
Net (loss) income attributable to holders of ordinary shares as reported under US GAAP	\$ (111,534,094)	\$ 70,905,406	\$ (103,261,129)
IFRS adjustments:			
(i) Recognizing an expense for share-based payment	(7,261,778)	(5,813,564)	(10,475,625)
(iii) Depreciation of incremental costs allocated to plant and equipment	–	(124,944)	–
(iii) Amortization of discount on convertible promissory notes	–	–	102,749
(iv) Deemed dividend	–	18,839,426	37,116,625
(v) Depreciation related to assets held for sale	–	–	(674,117)
(v) Depreciation related to reclassification of unsold assets held for sale	–	674,117	–
Net (loss) income attributable to holders of ordinary shares under IFRS	\$ (118,795,872)	\$ 84,480,441	\$ (77,191,497)
Net (loss) income per share under IFRS	\$ (0.01)	\$ 0.01	\$ (8.48)



# Notes to the Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003  
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## 31. DIFFERENCES BETWEEN US GAAP AND INTERNATIONAL FINANCIAL REPORTING STANDARDS (Continued)

	2005	2004	2003
Stockholders' equity as reported under US GAAP	<b>\$3,026,098,524</b>	\$3,109,483,921	\$1,485,115,445
(ii) Presentation of minority interest	<b>38,781,863</b>	–	–
(iii) Depreciation of incremental costs allocated to plant and equipment	–	(124,944)	–
(iii) Classification of equity portion of promissory notes	–	–	1,833,022
(iii) Accumulated amortization of discount on promissory notes	–	124,944	124,944
(v) Additional depreciation in respect of assets held for sale	–	–	(674,117)
Stockholders' equity under IFRS	<b>\$3,064,880,387</b>	\$3,109,483,921	\$1,486,399,294

	2005	2004	2003
Assets held for sale			
As reported	\$ –	\$ 1,831,972	\$ 32,591,363
IFRS adjustment			
(v) Reclassification to			
– land use rights, net	–	–	(6,744,622)
– plant and equipment, net	–	–	(25,172,624)
Additional depreciation	–	–	(674,117)
Under IFRS	\$ –	\$ 1,831,972	\$ –
Land use rights, net – current portion			
As reported	\$ –	\$ –	\$ –
IFRS adjustment			
(vi) Current portion adjustment for land use right	<b>650,581</b>	522,114	1,013,269
Under IFRS	\$ <b>650,581</b>	\$ 522,114	\$ 1,013,269
Land use rights, net			
As reported	\$ <b>34,767,518</b>	\$ 39,197,774	\$ 41,935,460
IFRS adjustments			
(v) Reclassification from assets held for sale	–	–	6,744,622
(vi) Current portion adjustment for land use right	<b>(650,581)</b>	(522,114)	(1,013,269)
Under IFRS	\$ <b>34,116,937</b>	\$ 38,675,660	\$ 47,666,813



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For the years ended December 31, 2005, 2004 and 2003  
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## 31. DIFFERENCES BETWEEN US GAAP AND INTERNATIONAL FINANCIAL REPORTING STANDARDS (Continued)

	2005	2004	2003
Accumulated deficit			
As reported	\$ (247,919,043)	\$ (136,384,949)	\$ (207,290,355)
IFRS adjustments			
(i) Recognizing an expense for share-based payment	(7,261,778)	–	–
(i) Retrospective adjustment on adoption of IFRS 2	(23,126,538)	(23,126,538)	(12,650,913)
(iii) Accumulated amortization of discount on promissory notes	–	(124,944)	124,944
(iii) Depreciation of incremental costs allocated to plant and equipment	–	124,944	–
(iv) Deemed dividend	–	18,839,426	37,116,625
(iv) Carry forward prior year's adjustment on deemed dividend	55,956,051	37,116,625	–
(v) Additional depreciation related to assets held for sale	–	–	(674,117)
<b>Under IFRS</b>	<b>\$ (222,351,308)</b>	<b>\$ (103,555,436)</b>	<b>\$ (183,373,816)</b>
Cost of sales			
As reported	\$1,069,656,073	\$ 704,630,241	\$ 354,239,521
IFRS adjustments			
(i) Recognizing an expense for share-based payment	3,366,722	–	–
(i) Retrospective adjustment on adoption of IFRS 2	–	4,496,905	2,815,061
<b>Under IFRS</b>	<b>\$1,073,022,795</b>	<b>\$ 709,127,146</b>	<b>\$ 357,054,582</b>
Operating expenses			
As reported	\$ 173,530,378	\$ 176,056,422	\$ 78,790,949
IFRS adjustments			
(i) Recognizing an expense for share-based payment	3,895,056	–	–
(i) Retrospective adjustment on adoption of IFRS 2	–	5,978,720	2,998,503
<b>Under IFRS</b>	<b>\$ 177,425,434</b>	<b>\$ 182,035,142</b>	<b>\$ 81,789,452</b>
Other income			
As reported	\$ 27,305,802	\$ 7,547,974	\$ 6,601,741
IFRS adjustments			
(iii) Amortization of discount on promissory notes	–	–	102,749
(v) Additional depreciation related to assets held for sale	–	–	(674,117)
(v) Depreciation related to reclassification of unsold assets held for sale	–	674,117	–
<b>Under IFRS</b>	<b>\$ 27,305,802</b>	<b>\$ 8,222,091</b>	<b>\$ 6,030,373</b>

# Notes to the Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003

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## 31. DIFFERENCES BETWEEN US GAAP AND INTERNATIONAL FINANCIAL REPORTING STANDARDS (Continued)

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 2005, 2004 and 2003, 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 2005, 2004 and 2003.

### (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. Deferred tax assets and liabilities are always classified as non-currents. Under US GAAP, all deferred tax assets are recognized, subject to a valuation allowance, to the extent that it is "more likely than not" that some portion or all of the deferred tax assets will not be realized. "More likely than not" is defined as a likelihood of more than 50%.

With respect of the measurement of the deferred 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.

No significant GAAP difference was noted in 2005, 2004 and 2003.

# Notes to the Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003  
(In U.S. dollars)

## 31. DIFFERENCES BETWEEN US GAAP AND INTERNATIONAL FINANCIAL REPORTING STANDARDS (Continued)

### (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.

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.

### (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 only 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 2005, 2004 and 2003.

# Notes to the Consolidated Financial Statements

For the years ended December 31, 2005, 2004 and 2003

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## 31. DIFFERENCES BETWEEN US GAAP AND INTERNATIONAL FINANCIAL REPORTING STANDARDS (Continued)

### (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 in use. Value in use is measured on a discounted present value basis. An impairment loss is recognized for the excess of the carrying amount of such assets over their recoverable amounts. A reversal of previous provision of impairment is allowed to the extent of the loss previously recognised as expense in the income statement.

Under US GAAP, 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 2005, 2004 and 2003.

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For the years ended December 31, 2005, 2004 and 2003  
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## 31. 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 2005, 2004 and 2003.

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For the years ended December 31, 2005, 2004 and 2003

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## 31. DIFFERENCES BETWEEN US GAAP AND INTERNATIONAL FINANCIAL REPORTING STANDARDS (Continued)

### (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.





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