

Phison Electronics Corp. and Subsidiaries

**Consolidated Financial Statements for the
Years Ended December 31, 2005 and 2004 and
Independent Auditors' Report**

REPRESENTATION LETTER

The affiliates of Phison Electronics Corp.(the Corporation), which should have been included in the combined financial statements of the Corporation and its affiliates as of and for the year ended December 31, 2005 based on the “Regulations Governing The Preparation of Combined Financial Statements of Public Companies and Their Affiliates” in the Republic of China (ROC), are the same as those included in the consolidated financial statements of the Corporation and its subsidiaries as of and for the year ended December 31, 2005, prepared under the Statement of Financial Accounting Standards No. 7, “Consolidated Financial Statements,” in the ROC. The information required to be disclosed in the combined financial statements has already been disclosed in the above consolidated financial statements. Consequently, there is no need to prepare separate combined financial statements of the Corporation and its affiliates.

Very truly yours,

PHISON ELECTRONICS CORP.

By

EN MIN JOW
Chairman

February 23, 2006

INDEPENDENT AUDITORS' REPORT

The Board of Directors and Shareholders
Phison Electronics Corp.

We have audited the accompanying consolidated balance sheets of Phison Electronics Corp. (the Corporation) and subsidiaries as of December 31, 2005 and 2004, and the related consolidated statements of income, changes in shareholders' equity and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the Rules Governing Auditing and Certification of Financial Statements by Certified Public Accountants and auditing standards generally accepted in the Republic of China. Those rules and standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Phison Electronics Corp. and subsidiaries as of December 31, 2005 and 2004, and the results of their operations and their cash flows for the years then ended, in conformity with the Guidelines Governing the Preparation of Financial Reports by Securities Issuers and accounting principles generally accepted in the Republic of China.

February 23, 2006, except Note 18 significant subsequent events as of February 27, 2006

Notice to Readers

The accompanying financial statements are intended only to present the financial position, results of operations and cash flows in accordance with accounting principles and practices generally accepted in the Republic of China and not those of any other jurisdictions. The standards, procedures and practices to audit such financial statements are those generally accepted and applied in the Republic of China.

For the convenience of readers, the auditors' report and the accompanying financial statements have been translated into English from the original Chinese version prepared and used in the Republic of China. If there is any conflict between the English version and the original Chinese version or any difference in the interpretation of the two versions, the Chinese-language auditors' report and financial statements shall prevail.

PHISON ELECTRONICS CORP. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

DECEMBER 31, 2005 AND 2004

(In Thousands of New Taiwan Dollars, Except Par Value)

ASSETS	2005		2004		LIABILITIES AND SHAREHOLDERS' EQUITY	2005		2004	
	Amount	%	Amount	%		Amount	%	Amount	%
CURRENT ASSETS					CURRENT LIABILITIES				
Cash and cash equivalents (Notes 2 and 3)	\$ 779,908	27	\$ 365,512	23	Notes and accounts payable				
Short-term investments (Notes 2 and 4)	-	-	97,499	6	Third parties	\$ 628,011	22	\$ 518,846	33
Notes and accounts receivables					Related parties (Note 15)	228,249	8	112,106	7
Third parties, net (Notes 2 and 5)	1,037,556	36	532,835	34	Income tax payable (Notes 2 and 11)	19,554	1	5,142	-
Related parties (Note 15)	68,312	2	124,659	8	Other payables (Note 17)	45,000	1	45,000	3
Inventories, net (Notes 2 and 6)	637,783	22	230,306	15	Accrued expenses (Note 15)	146,359	5	56,463	4
Deferred income tax assets, net (Notes 2 and 11)	52,051	2	8,132	1	Other	33,837	1	6,120	-
Restricted assets (Note 16)	14,959	1	17,097	1					
Prepayments and other (Notes 2 and 18)	118,742	4	65,194	4	Total current liabilities	1,101,010	38	743,677	47
Total current assets	2,709,311	94	1,441,234	92	OTHER LIABILITIES				
LONG-TERM INVESTMENTS (Notes 2 and 7)					Accrued pension cost (Notes 2 and 10)	1,385	-	718	-
Cost method	24,650	1	9,500	1	Guarantee deposits received	-	-	168	-
PROPERTIES (Notes 2 and 8)					Total other liabilities	1,385	-	886	-
Cost					Total liabilities	1,102,395	38	744,563	47
Testing equipment	23,224	1	15,087	1	SHAREHOLDERS' EQUITY (Note 13)				
Office equipment	4,842	-	3,519	-	Capital stock - \$10 par value				
Leasehold improvements	12,056	1	4,585	1	Authorized - 60,000 thousand shares				
Other equipment	4,499	-	4,294	-	Issued - 52,212 thousand and 36,232 thousand shares				
Total cost	44,621	2	27,485	2	as of December 31, 2005 and 2004 respectively	522,121	18	362,321	23
Less: Accumulated depreciation	17,017	1	9,458	1	Capital surplus - additional paid-in capital	501,962	18	51,962	3
Prepayments for equipment	1,780	-	1,958	-	Retained earnings				
Net properties	29,384	1	19,985	1	Legal reserve	69,113	2	34,280	3
INTANGIBLE ASSETS (Notes 2, 9 and 15)					Unappropriated retained earnings	676,382	24	379,692	24
	43,016	2	5,799	-	Total retained earnings	745,495	26	413,972	27
OTHER ASSETS					Total shareholders' equity	1,769,578	62	828,255	53
Guarantee deposits paid (Note 16)	41,970	1	81,371	5					
Deferred charges, net (Note 2)	22,844	1	9,285	1					
Deferred income tax assets, net (Notes 2 and 11)	423	-	5,644	-					
Miscellaneous	375	-	-	-					
Total other assets	65,612	2	96,300	6					
TOTAL	\$ 2,871,973	100	\$ 1,572,818	100	TOTAL	\$ 2,871,973	100	\$ 1,572,818	100

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

PHISON ELECTRONICS CORP. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME YEARS ENDED DECEMBER 31, 2005 AND 2004

(In Thousands of New Taiwan Dollars, Except Earnings Per Share)

	2005		2004	
	Amount	%	Amount	%
OPERATING REVENUE (Notes 2 and 15)				
Gross sales	\$ 6,352,540	101	\$ 4,012,336	101
Less: Sale returns and discounts	<u>48,021</u>	<u>1</u>	<u>26,753</u>	<u>1</u>
Net sales	6,304,519	100	3,985,583	100
Service revenue	<u>3,770</u>	<u>-</u>	<u>5,749</u>	<u>-</u>
Total operating revenue	6,308,289	100	3,991,332	100
OPERATING COSTS (Notes 12 and 15)	<u>5,319,062</u>	<u>84</u>	<u>3,425,995</u>	<u>86</u>
GROSS PROFIT	<u>989,227</u>	<u>16</u>	<u>565,337</u>	<u>14</u>
OPERATING EXPENSES (Notes 12 and 15)				
Marketing	91,044	1	46,816	1
General and administrative	48,255	1	29,891	1
Research and development	<u>240,478</u>	<u>4</u>	<u>113,176</u>	<u>3</u>
Total operating expenses	<u>379,777</u>	<u>6</u>	<u>189,883</u>	<u>5</u>
OPERATING INCOME	<u>609,450</u>	<u>10</u>	<u>375,454</u>	<u>9</u>
NONOPERATING INCOME AND GAINS				
Foreign exchange gain, net (Note 2)	16,397	-	-	-
Interest income	6,486	-	1,857	-
Gain on sales of short-term investments, net (Note 2)	3,369	-	2,997	-
Other	<u>4,859</u>	<u>-</u>	<u>1,286</u>	<u>-</u>
Total nonoperating income and gains	<u>31,111</u>	<u>-</u>	<u>6,140</u>	<u>-</u>
NONOPERATING EXPENSES AND LOSSES				
Losses on inventory valuation and obsolescence (Notes 2 and 5)	60,000	1	1,393	-
Interest expense	545	-	71	-
Foreign exchange loss, net (Note 2)	-	-	19,031	-
Other	<u>103</u>	<u>-</u>	<u>572</u>	<u>-</u>
Total nonoperating expenses and losses	<u>60,648</u>	<u>1</u>	<u>21,067</u>	<u>-</u>

(Continued)

	<u>2005</u>		<u>2004</u>	
	<u>Amount</u>	<u>%</u>	<u>Amount</u>	<u>%</u>
INCOME BEFORE INCOME TAX	\$ 579,913	9	\$ 360,527	9
INCOME TAX EXPENSE (BENEFIT) (Notes 2 and 11)	<u>(10,173)</u>	<u>-</u>	<u>12,198</u>	<u>-</u>
CONSOLIDATED NET INCOME	<u>\$ 590,086</u>	<u>9</u>	<u>\$ 348,329</u>	<u>9</u>
ATTRIBUTED TO SHAREHOLDERS OF THE PARENT	<u>\$ 590,086</u>		<u>\$ 348,329</u>	
	<u>2005</u>		<u>2004</u>	
	<u>Before</u>	<u>After</u>	<u>Before</u>	<u>After</u>
	<u>Income</u>	<u>Income</u>	<u>Income</u>	<u>Income</u>
	<u>Tax</u>	<u>Tax</u>	<u>Tax</u>	<u>Tax</u>
EARNINGS PER SHARE (Note 14)				
Basic	<u>\$ 12.04</u>	<u>\$ 12.25</u>	<u>\$ 7.72</u>	<u>\$ 7.46</u>
Diluted	<u>\$ 11.80</u>	<u>\$ 12.01</u>	<u>\$ 7.56</u>	<u>\$ 7.30</u>

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

PHISON ELECTRONICS CORP. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY YEARS ENDED DECEMBER 31, 2005 AND 2004 (In Thousands of New Taiwan Dollars, Except Per Share Data)

	Capital Stock Issued and Outstanding		Capital Surplus	Legal Reserve	Retained Earnings		Total Shareholders' Equity (Note 13)
	Shares (Thousands)	Amount	Additional Paid-in Capital		Unappropriated	Total	
BALANCE, JANUARY 1, 2004	17,695	\$ 176,951	\$ 51,962	\$ 9,423	\$ 258,521	\$ 267,944	\$ 496,857
Appropriation of 2003 earnings							
Legal reserve	-	-	-	24,857	(24,857)	-	-
Bonus to employees - stock	3,900	39,000	-	-	(39,000)	(39,000)	-
Stock dividends - \$8 per share	14,156	141,560	-	-	(141,560)	(141,560)	-
Cash dividends - \$1 per share	-	-	-	-	(17,695)	(17,695)	(17,695)
Remuneration to directors and supervisors	-	-	-	-	(4,046)	(4,046)	(4,046)
Balance after appropriation	35,751	357,511	51,962	34,280	31,363	65,643	475,116
Issuance of stock due to exercise of stock options	481	4,810	-	-	-	-	4,810
Consolidated net income in 2004	-	-	-	-	348,329	348,329	348,329
BALANCE, DECEMBER 31, 2004	36,232	362,321	51,962	34,280	379,692	413,972	828,255
Appropriation of 2004 earnings							
Legal reserve	-	-	-	34,833	(34,833)	-	-
Bonus to employees - stock	1,800	18,000	-	-	(18,000)	(18,000)	-
Bonus to employees - cash	-	-	-	-	(18,000)	(18,000)	(18,000)
Stock dividends - \$2.4938 per share	9,058	90,580	-	-	(90,580)	(90,580)	-
Cash dividends - \$3.4913 per share	-	-	-	-	(126,812)	(126,812)	(126,812)
Remuneration to directors and supervisors	-	-	-	-	(5,171)	(5,171)	(5,171)
Balance after appropriation	47,090	470,901	51,962	69,113	86,296	155,409	678,272
Issuance of stock due to exercise of stock options	622	6,220	-	-	-	-	6,220
Issuance of capital stock as of October 17, 2005 - \$110 per share	4,500	45,000	450,000	-	-	-	495,000
Consolidated net income in 2005	-	-	-	-	590,086	590,086	590,086
BALANCE, DECEMBER 31, 2005	<u>52,212</u>	<u>\$ 522,121</u>	<u>\$ 501,962</u>	<u>\$ 69,113</u>	<u>\$ 676,382</u>	<u>\$ 745,495</u>	<u>\$ 1,769,578</u>

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

PHISON ELECTRONICS CORP. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS YEARS ENDED DECEMBER 31, 2005 AND 2004 (In Thousands of New Taiwan Dollars)

	2005	2004
CASH FLOWS FROM OPERATING ACTIVITIES		
Consolidated net income	\$ 590,086	\$ 348,329
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Losses on inventory valuation and obsolescence	60,000	1,393
Deferred income tax	(38,698)	3,180
Amortization	20,134	7,654
Depreciation	8,619	6,029
(Reversal of) allowance for doubtful receivables	(4,611)	8,474
Net gains on disposal of properties	-	(60)
Net changes in operating assets and liabilities		
Notes and accounts receivable	(443,763)	(103,669)
Inventories	(467,477)	10,684
Prepayments and other current assets	(53,548)	(33,466)
Notes and accounts payable	225,308	114,516
Income tax payable	14,412	(6,096)
Accrued expenses	63,616	(16,720)
Other current liabilities	20,773	4,103
Accrued pension cost	292	506
Net cash provided by (used in) operating activities	<u>(4,857)</u>	<u>344,857</u>
CASH FLOWS FROM INVESTING ACTIVITIES		
Decrease in short-term investments	97,499	43,837
Decrease (increase) in guarantee deposits paid	39,401	(40,583)
Increase in deferred charges	(22,283)	(5,399)
Increase in intangible assets	(22,104)	(5,540)
Increase in long-term investments	(15,300)	(9,500)
Acquisition of properties	(11,317)	(13,822)
Decrease in restricted assets	2,138	973
Cash dividends received from long-term investments in current year	150	-
Proceeds from disposal of properties	-	700
Net cash provided by (used in) investing activities	<u>68,184</u>	<u>(29,334)</u>
CASH FLOWS FROM FINANCING ACTIVITIES		
Cash dividends paid	(126,812)	(17,695)
Proceeds from issuance of capital stock	495,000	-
Bonus to employees and remuneration to directors and supervisors	(23,171)	(4,046)
Proceeds from exercise of stock options	6,220	4,810
Increase (decrease) in guarantee deposits received	(168)	168
Decrease in short-term loans	-	(30,609)
Net cash provided by (used in) financing activities	<u>351,069</u>	<u>(47,372)</u>

(Continued)

	2005	2004
NET INCREASE IN CASH AND CASH EQUIVALENTS	\$ 414,396	\$ 268,151
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	<u>365,512</u>	<u>97,361</u>
CASH AND CASH EQUIVALENTS, END OF YEAR	<u>\$ 779,908</u>	<u>\$ 365,512</u>
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Interest paid	<u>\$ 545</u>	<u>\$ 131</u>
Income tax paid	<u>\$ 14,113</u>	<u>\$ 15,114</u>
CASH PAID FOR ACQUISITION OF PROPERTIES		
Increase in properties	\$ 18,261	\$ 14,732
Less: Increase in payables to contractors and equipment suppliers (included in other current liabilities)	<u>6,944</u>	<u>910</u>
	<u>\$ 11,317</u>	<u>\$ 13,822</u>
Increase in intangible assets	\$ 48,384	\$ 5,540
Less: Increase in accrued expense	<u>26,280</u>	<u>-</u>
	<u>\$ 22,104</u>	<u>\$ 5,540</u>

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

PHISON ELECTRONICS CORP. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS YEARS ENDED DECEMBER 31, 2005 AND 2004

(In Thousands of New Taiwan Dollars, Unless Stated Otherwise)

1. ORGANIZATION AND OPERATIONS

The Corporation was incorporated on November 8, 2000 under the Company Law of the Republic of China (ROC). The Corporation mainly designs and sells flash memory controllers and peripheral system applications as well as designs the TI DSP (Texas Instruments' digital signal processor) system.

The Corporation's shares have been traded on the Gre-Tai Securities Market (the over-the-counter securities exchange of the ROC) since December 6, 2004.

As of December 31, 2005 and 2004, the Corporation and subsidiaries had 210 and 125 employees, respectively.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The consolidated financial statements have been prepared in conformity with the Guidelines Governing the Preparation of Financial Reports by Securities Issuers and accounting principles generally accepted in the Republic of China (ROC). In preparing financial statements in conformity with these guidelines and principles, the Corporation is required to make certain estimates and assumptions that could affect the amounts of allowance for sales returns and allowance; allowance for doubtful receivables, allowance for inventory valuation, pension, probable litigation loss, depreciation of properties, and amortization of intangible assets and deferred charges, etc. Actual results could differ from those estimates.

For the convenience of readers, the accompanying financial statements have been translated into English from the original Chinese version prepared and used in the Republic of China. If there is any conflict between the English version and the original Chinese version or any difference in the interpretation of the two versions, the Chinese-language financial statements shall prevail.

Significant accounting policies are summarized as follows:

Basis of Consolidation

1) The consolidated subsidiaries included the following:

Investor	Subsidiary	Nature of Business	Percentage of Ownership as of December 31, 2005	Percentage of Ownership as of December 31, 2004	Description
The Corporation	Lian Xu Dong Investment Corp.	Investment	100%	-	The Corporation invested in Lian Xu Dong Investment Corp. in July 2005.

2) The subsidiaries not included in the consolidated financial statements: None.

- 3) There were no significant transactions between the Corporation and subsidiaries.
- 4) The subsidiary, Lian Xu Dong, was incorporated in July 2005, so the consolidated financial statements for 2004 only presented the amounts of the Corporation.

Current and Noncurrent Assets and Liabilities

Unrestricted cash and cash equivalents and other assets to be sold or consumed within one year from the balance sheet date are classified as current. Liabilities to be repaid within one year from the balance sheet date are classified as current. All other assets and liabilities are classified noncurrent.

Cash Equivalents

Short-term bill and bonds acquired under repurchase agreements that require them to be sold within three months are classified as cash equivalents.

Short-term Investments

Short-term investments are carried at the lower of aggregate costs or market value. An allowance for losses is provided when the aggregate carrying value of the investments exceeds the total market value. Any recovery of the market value to the extent of the original carrying value is recognized as income.

Costs of investments sold are determined using the weighted-average method.

Allowance for Doubtful Accounts

Allowance for doubtful accounts is provided on the basis of a review of the aging and collectibility of receivables.

Inventories

Inventories are stated at the lower of weighted-average cost or market value. Market value is based on replacement cost or net realizable value.

Long-term Investments

Long-term investments are accounted for by the cost method. Cash dividends received within one year of investment acquisition are accounted for as reductions of the carrying value of the long-term investments, and cash dividends received in subsequent years are recognized as dividend income.

Stock dividends received are recorded as an increase in the number of shares held and do not affect investment income or the carrying value of the investments. If the decline in the carrying value of investments in unlisted stocks is considered irrecoverable, the related reduction is charged to current income.

Costs of investments sold are determined using the weighted-average method.

Properties

Properties are stated at cost less accumulated depreciation. Significant, renewals and betterment are capitalized; while maintenance and repairs are expensed currently.

Depreciation is calculated using straight-line method over the following estimated service lives: testing equipment - 3 years; office equipment - 3 years; leasehold improvements - 2 to 3 years; and other equipment - 2 to 5 years.

If an asset is still in use beyond its initially estimated service life, its residual value is written off over its newly estimated service life.

When properties are retired or disposed of, the related cost and accumulated depreciation are removed from the accounts, and the resulting gains or losses are credited or charged to nonoperating gains or losses.

Intangible Assets

Intangible assets, consisting of costs to acquire royalty, patents and trademarks, are amortized using the straight-line method over three to six years.

Deferred Charges

Deferred charges, mainly the costs of acquiring computer software, are amortized using the straight-line method over three to five years.

Asset Impairment

The Corporation and subsidiaries adopted ROC Statements of Financial Accounting Standards (SFAS) No. 35, "Accounting for Impairment of Assets," on January 1, 2005. This accounting change had no significant impact on the financial statements for the year ended December 31, 2005.

SFAS No. 35 requires the Corporation and subsidiaries to review on the balance sheet date of certain assets, including fixed assets, intangible assets, and deferred charges as well as long-term equity-method investments for any impairment. If impairment is identified, any excess of the carrying amount of an asset over its recoverable amount is recognized as impairment loss. If the recoverable amount increases in the future period the amount previously recognized as impairment loss would be reversed and recognized as a gain. However, the adjusted amount may not exceed the carrying amount that would have been determined, net of amortization or depreciation, had no impairment loss been recognized. In addition, reversal of an impairment loss on goodwill is prohibited.

Pension Costs

The Corporation has two types of pension plans: defined benefit and defined contribution.

Pension costs under the defined benefit pension plan are recognized on the basis of actuarial calculations. Pension costs under the defined contribution pension plan are recognized as current expenses during the employees' service years.

If the pension plan is amended, the prior service costs are amortized on a straight-line basis over the average period from the amendment date to the date the benefits become vested. As soon as the benefits become vested, the Corporation should recognize prior service costs as expenses.

Sales and Allowances for Sales Returns and Discounts

Sales are recognized when titles to products and risk of ownerships are transferred to customers, primarily upon shipment, since the earnings process is completed or virtually completed and earnings are realized or realizable. For products shipped for further processing, sales are not recognized because there is no transfer of titles and risks. Provisions for sales returns and discounts are estimated on the basis of historical experience.

Sales are determined at fair value under price negotiation between the Corporation and buyers, taking into account related sales discounts. If the terms of sale receivables are within one year, the amounts of receivables are not significantly different from fair value, and the transactions are frequent, then the sale revenues are not discounted to fair value.

Income Tax

The Corporation and subsidiaries uses inter-period tax allocation. Deferred income tax assets and liabilities are recognized for the tax effects of temporary differences and unused investment tax credits. Valuation allowance is provided for deferred income tax assets that are not certain to be realized. A deferred tax asset or liability should be classified as current or noncurrent according to the classification of related asset or liability for financial reporting. However, if a deferred tax asset or liability cannot be related to an asset or liability in the financial statements, it should be classified as current or noncurrent on the basis of the expected realization date of the temporary difference.

Tax credits for certain purchase of equipment and technology, research and development expenditures and personnel training expenditures are accounted for by the flow-through method.

Adjustments of prior years' tax are added to or deducted from the current year's tax expense.

Income taxes (10%) on undistributed earnings generated since 1998 are recorded as expense in the year when the stockholders resolve to retain these earnings.

Derivative Financial Instruments

Forward exchange contracts are used for hedging and are recorded at the spot rate on the starting date of the contracts. The difference between the rate on the contract starting date and the forward rate is amortized over the term of the contracts and credited or charged to income. Any resulting gain or loss on the balance sheet date or settlement date is credited or charged to income. In addition, receivables and payables on forward exchange contracts that are open on the balance sheet date are netted out, and the difference is listed as an asset or a liability.

Foreign-currency Transactions

Foreign-currency transactions, except derivative transactions, are recorded in New Taiwan dollars at the rates of exchange in effect when the transactions occur. Gains or losses resulting from the application of prevailing exchange rates when foreign-currency assets and liabilities are settled, are credited or charged to income in the year of settlement. The year-end balances of foreign-currency assets and liabilities are restated at prevailing exchange rates, and the resulting differences are credited or charged to current income.

3. CASH AND CASH EQUIVALENTS

	2005	2004
Cash on hand	\$ 50	\$ 82
Savings accounts	358,044	37,565
Certificates of deposits	118,669	61,400
Foreign accounts	32,709	107,370
Checking accounts	31	65
Cash equivalents - short-term bill and bonds acquired under repurchase agreements	<u>270,405</u>	<u>159,030</u>
	<u>\$ 779,908</u>	<u>\$ 365,512</u>

4. SHORT-TERM INVESTMENTS

	2004
Open-end bond funds	<u>\$ 97,499</u>
Market value	<u>\$ 97,501</u>

The market value of the investment was based on the net asset value on December 31, 2004.

5. NOTES AND ACCOUNTS RECEIVABLE - THIRD PARTIES, NET

	2005	2004
Notes receivable	\$ 51,509	\$ 15,045
Accounts receivable	<u>1,009,120</u>	<u>545,474</u>
	1,060,629	560,519
Less: Allowance for sales returns and discounts	1,652	1,652
Allowance for doubtful accounts	<u>21,421</u>	<u>26,032</u>
	<u>\$ 1,037,556</u>	<u>\$ 532,835</u>

6. INVENTORY, NET

	2005	2004
Finished goods	\$ 32,100	\$ 13,623
Semifinished goods	84,244	34,002
Work in process	135,510	25,020
Raw materials	<u>458,531</u>	<u>170,263</u>
	710,385	242,908
Less: Allowance for inventory valuation and obsolescence losses	<u>72,602</u>	<u>12,602</u>
	<u>\$ 637,783</u>	<u>\$ 230,306</u>

7. LONG-TERM EQUITY INVESTMENTS

	<u>2005</u>		<u>2004</u>	
	<u>Carrying</u>	<u>% of</u>	<u>Carrying</u>	<u>% of</u>
	<u>Amount</u>	<u>Owner-</u>	<u>Amount</u>	<u>Owner-</u>
		<u>ship</u>		<u>ship</u>
Cost method - unlisted stocks				
Trison Technology Corporation	\$ 20,000	12	\$ 9,500	19
Ours Technology Inc.	<u>4,650</u>	1	<u>-</u>	-
	<u>\$ 24,650</u>		<u>\$ 9,500</u>	

In July 2005, the Corporation invested in Ours Technology Inc., which manufactures, wholesales and retails electronic components.

In February 2004, the Corporation invested in Trison Technology Corporation, which manufactures SMT (surface mount technology) equipment.

8. PROPERTIES

	<u>2005</u>	<u>2004</u>
Accumulated depreciation:		
Testing equipment	\$ 9,467	\$ 4,994
Office equipment	2,183	1,347
Leasehold improvements	2,915	750
Other equipment	<u>2,452</u>	<u>2,367</u>
	<u>\$ 17,017</u>	<u>\$ 9,458</u>

9. INTANGIBLE ASSETS

	<u>2005</u>	<u>2004</u>
Technology license fees	\$ 2,281	\$ 2,903
Patents	1,545	1,687
Royalty	39,107	1,169
Trademarks	<u>83</u>	<u>40</u>
	<u>\$ 43,016</u>	<u>\$ 5,799</u>

10. PENSION PLAN

The Labor Pension Act (the "Act") took effect on July 1, 2005. An employee on board before June 30, 2005 may choose to continue to be subject to the pension plan under the Labor Standards Law (the "Law") or be subject to the new pension plan under the Act, with their service years accumulated as of July 1, 2005 to be retained and subject to the pension plan under the Law. Starting from July 1, 2005, new employees may only choose to be subject to the pension plan under the Act.

The Act provides for a defined contribution pension plan. Starting from July 1, 2005, the Corporation should contribute monthly an amount equal to at least 6% of the employees' monthly wages to the employees' individual pension accounts.

Pension cost under the defined contribution pension plan was \$2,542 thousand in the last half year of 2005.

The Law provides for a defined benefit pension plan. This pension plan provides benefits based on the employee's length of service and average salary or wage before retirement. The Corporation contributes an amount equal to 3% of monthly salaries and wages to a pension fund. The fund is administered by the employees' pension fund committee and deposited in committee's name in the Central Trust of China. As of December 31, 2005 and 2004, the pension fund balances were \$5,786 thousand and \$3,511 thousand, respectively.

Pension information is summarized as follows:

a. Components of pension cost

	2005	2004
Service cost	\$ 1,057	\$ 2,036
Interest cost	161	104
Expected return on plan assets	(97)	(88)
Amortization	<u>29</u>	<u>40</u>
Net pension cost	<u>\$ 1,150</u>	<u>\$ 2,092</u>

b. Reconciliation of the fund status of the plan and prepaid (accrued) pension cost

	2005	2004
Benefit obligation		
Vested	\$ -	\$ -
Nonvested	<u>(2,743)</u>	<u>(2,244)</u>
Accumulated	(2,743)	(2,244)
Additional benefits based on future salaries	<u>(2,484)</u>	<u>(2,066)</u>
Projected	(5,227)	(4,310)
Fair value of plan assets	<u>5,786</u>	<u>3,511</u>
Funded status	559	(799)
Unrecognized net transitional obligation	700	729
Unrecognized net gain	<u>(884)</u>	<u>(648)</u>
Prepaid (accrued) pension cost	<u>\$ 375</u>	<u>\$ (718)</u>
Vested benefits	<u>\$ -</u>	<u>\$ -</u>

c. Actuarial assumptions

Discount rate used in determining present values	3.75%	3.75%
Future salary increase rate	3.00%	3.00%
Expected rate of return on plan assets	2.75%	2.75%

11. INCOME TAX

- a. A reconciliation of income tax on pretax income at the statutory rate and current income tax expense payable was as follows:

	2005	2004
Income tax on pretax income at statutory rate (25%)	\$ 144,968	\$ 90,132
Add (deduct) tax effects of		
Permanent difference	(833)	(749)
Temporary difference	10,801	6,113
Tax-exempt income	(105,404)	(78,564)
Additional 10% tax on unappropriated earnings	7,881	8,034
Investment tax credits	<u>(28,702)</u>	<u>(12,483)</u>
Current income tax expense payable	<u>\$ 28,702</u>	<u>\$ 12,483</u>

The balance of income taxes payable as of December 31, 2005 and 2004 were net of prepaid income taxes of NT\$9,148 thousand and NT\$7,341 thousand, respectively.

- b. Income tax expense (benefit) consisted of:

	2005	2004
Current income tax expense payable	\$ 28,702	\$ 12,483
Net change in deferred income tax for the period	(38,698)	3,180
Adjustments to prior year's taxes	<u>(177)</u>	<u>(3,465)</u>
Income tax expense (benefit)	<u>\$ (10,173)</u>	<u>\$ 12,198</u>

- c. Deferred income tax assets consisted of:

Current, net		
Investment tax credits	\$ 28,702	\$ 7,866
Allowance for inventory valuation and obsolescence losses	18,150	3,150
Allowance for doubtful accounts	2,533	-
Foreign exchange loss	2,071	4,275
Others	<u>595</u>	<u>594</u>
	52,051	15,885
Less: Valuation allowance	<u>-</u>	<u>7,753</u>
	<u>\$ 52,051</u>	<u>\$ 8,132</u>
Noncurrent, net		
Investment tax credits	\$ 78,601	\$ 11,986
Others	<u>432</u>	<u>-</u>
	79,033	11,986
Less: Valuation allowances	<u>78,610</u>	<u>6,342</u>
	<u>\$ 423</u>	<u>\$ 5,644</u>

The effective tax rate used for computing deferred income tax assets on December 31, 2005 and 2004 was 25%.

- d. As of December 31, 2005, investment tax credits were as follows:

Regulatory Basis of Tax Credits	Items	Total Creditable Amounts	Remaining Creditable Amounts	Expiry Year
Statute for Upgrading Industries	Purchase of machinery and equipment	\$ 64	\$ 64	2008
		<u>126</u>	<u>126</u>	2009
		<u>\$ 190</u>	<u>\$ 190</u>	
	Research and development expenditures	\$ 21,762	\$ 16,123	2008
		<u>90,990</u>	<u>90,990</u>	2009
		<u>\$ 112,752</u>	<u>\$ 107,113</u>	

- e. The Corporation's net operating income generated from the following expansion projects is exempt from income taxes:

	<u>Tax-exemption Period</u>
First expansion and construction of the Corporation's factories	September 15, 2002 to September 14, 2007
Second expansion and construction of the Corporation's factories	August 1, 2004 to July 31, 2009

- f. Information on the Imputed Income Tax System (briefly described in Note 12) is as follows:

	2005	2004
Balance of imputation credit account (ICA)		
Corporation	<u>\$ 11,686</u>	<u>\$ 16,122</u>
Lian Xu Dong	<u>\$ -</u>	

The expected and actual creditable tax ratios of the Corporation for the 2005 and 2004 earnings were 3.28% and 3.81%, respectively.

The tax credits allocable to the shareholders are based on the balance of ICA on the dividend distribution date. Accordingly, the expected imputed tax credit ratio for 2005 may be adjusted because the actual tax credit may differ from the expected tax credit.

The subsidiary, Lian Xu Dong, had net loss for 2005, so there was no earnings to be appropriated.

- g. As of December 2005, the unappropriated earnings of the Corporation were generated before January 1, 1998.
- h. Income tax returns through 2003 had been examined by the tax authorities. However, the Corporation disputed the tax-exemption income by the tax authorities on the 2003 and 2002 return. The Corporation will file an appeal for tax authorities to reexamine the 2003 and 2002 return. Nevertheless, the Corporation believes that the effect of possible tax liabilities should not be material.

12. LABOR COST, DEPRECIATION AND AMORTIZATION EXPENSES

	<u>2005</u>		
	Classified as Operating Cost	Classified as Operating Expense	Total
Labor cost			
Salary	\$ 28,678	\$ 115,365	\$ 144,043
Labor and health insurance	1,506	5,723	7,229
Pension cost	949	2,743	3,692
Other	<u>3,196</u>	<u>12,759</u>	<u>15,955</u>
	<u>\$ 34,329</u>	<u>\$ 136,590</u>	<u>\$ 170,919</u>
Depreciation	\$ 2,727	\$ 5,892	\$ 8,619
Amortization	-	20,134	20,134
	<u>2004</u>		
	Classified as Operating Cost	Classified as Operating Expense	Total
Labor cost			
Salary	\$ 13,861	\$ 68,379	\$ 82,240
Labor and health insurance	1,036	3,793	4,829
Pension cost	409	1,683	2,092
Other	<u>2,466</u>	<u>6,544</u>	<u>9,010</u>
	<u>\$ 17,772</u>	<u>\$ 80,399</u>	<u>\$ 98,171</u>
Depreciation	\$ 2,394	\$ 3,635	\$ 6,029
Amortization	-	7,654	7,654

13. SHAREHOLDERS' EQUITY

a. Capital surplus

Under the Company Law, capital surplus can only be used to offset a deficit. However, capital surplus generated from the issue price in excess of the par value of capital stock, including the stock issued for new capital and the buyback of treasury stock, may be transferred to capital as stock dividends, and this transfer is restricted to a certain percentage of the capital surplus and may be made only within prescribed limits each time.

b. Appropriation of earnings and dividend policy

The Corporation's Articles of Incorporation provide that, under the board of directors' resolution, annual net income (less any deficit and 10% as legal reserve) less special reserve based on relevant laws and regulations and any portion decided to be retained plus unappropriated earnings of prior years should be distributed as follows:

- 1) 2%, as remuneration to directors and supervisors;
- 2) 10% to 20%, as bonus to employees; and
- 3) The remainder, as dividends.

The Corporation's dividend appropriation is based on its profitability. In addition, since the Corporation is expanding fast, dividends will be appropriated considering the current and future investment environment, capital requirements, domestic and international competition, capital budget plans, stockholders' interests, balance between cash and stock dividends, and the Corporation's long-term financial plans. The board of directors prepares the proposal on annual earnings distribution for the stockholders' approval.

Profits may be distributed as cash or stock dividend; however, the ratio for cash dividend should be at least 10% of total distribution, but the Corporation's operating results should be considered.

Legal reserve should be appropriated until the reserve equals the Corporation's paid-in capital. The reserve can only be used to offset an accumulated deficit. When the reserve balance exceeds 50% of the Corporation's paid-in capital, the excess can be distributed as dividends and bonuses when there was no unappropriated earnings, or the half of the reserve balance which reached 50% of the Corporation's paid-in capital can be distributed as paid-in capital when there was no deficit.

The appropriation of earnings should be resolved by the stockholders in the year following the year of earnings generation and given effect to in the financial statements of that following year.

Under the Imputed Income Tax System, ROC-resident stockholders are allowed tax credit for the income tax paid by the Corporation. Tax credits allocated to stockholders are based on the balance of the imputation credit account (ICA) on the dividend distribution date.

The appropriations of the 2004 and 2003 earnings proposed by the Board of Directors were approved in the stockholders' meetings on June 16, 2005 and June 15, 2004, respectively. The appropriations and dividends per share were as follows:

	Appropriation of Earnings		Dividends Per Share (Dollars)	
	Fiscal Year 2004	Fiscal Year 2003	Fiscal Year 2004	Fiscal Year 2003
Legal reserve	\$ 34,833	\$ 24,857	\$ -	\$ -
Bonus to employees - in stock	18,000	39,000	-	-
Bonus to employees - in cash	18,000	-	-	-
Common stock dividends				
Stock dividends	90,580	141,560	2.4938	8.0000
Cash dividends	126,812	17,695	3.4913	1.0000
Remuneration to directors and supervisors	<u>5,171</u>	<u>4,046</u>	-	-
	<u>\$ 293,396</u>	<u>\$ 227,158</u>		

Had the above employee bonus and remuneration to directors and supervisors been charged against the incomes of 2004 and 2003, the basic EPS after income tax in 2004 and 2003 would have decreased from NT\$9.72 to NT\$8.57 and from NT\$14.19 to NT\$11.73, respectively. The shares distributed as bonus to employees were 4.97% and 22.04% of the Corporation's total outstanding common shares as of December 31, 2004 and 2003, respectively.

As of February 23, 2006, the date of the independent auditors' report, the Board of Directors had not resolved the appropriation of the 2005 earnings. Information on earnings appropriation can be accessed through the Market Observation Post System on Website of the Taiwan Stock Exchange.

c. Stock options

On May 16, 2003 and October 21, 2003, the Securities and Futures Commission (the name of the Securities and Futures Bureau before July 1, 2004) approved the Corporation's Employee Stock Option Plans (the "Plans"), which provided qualified employees with 640 thousand and 1,200 thousand units of option rights, respectively, with each unit representing one common share. The option rights on both plans are valid for three years from the date of issuance and exercisable at certain percentages after the second year of issuance.

Under the Plans, the options are granted at an exercise price equal to the closing price of the Corporation's common shares as shown on the OTC exchange on the grant date. Based on the Plans, the number of outstanding options and exercise prices have been adjusted to reflect the appropriation of dividends.

The changes in outstanding stock options in 2005 and 2004 were as follows:

	<u>2005</u>		<u>2004</u>	
	Outstanding Option Rights (Thousands)	Exercise Price (NT\$)	Outstanding Option Rights (Thousands)	Exercise Price (NT\$)
Beginning balance	1,359	\$10-15.41	1,840	\$10-24
Options increased	-	-	-	-
Options granted	(622)	10	(481)	10
Options canceled	<u>(122)</u>	10	<u>-</u>	-
Ending balance	<u>615</u>		<u>1,359</u>	

As of December 31, 2005, outstanding and exercisable options were as follows:

Exercise Price (NT\$)	Number of Outstanding Options (Thousands)	Weighted- average Remaining Contractual Life (Years)	Weighted- average Exercise Price (NT\$)	Number of Exercisable Options (Thousands)	Weighted- average Exercise Price (NT\$)
\$ 10	15	0.1700	\$ 10	15	\$ 10
10	<u>600</u>	0.8993	10	600	10
	<u>615</u>				

In 2005, stock options consisting of 622 thousand units had been converted to 622 thousand common shares. Capital stock was increased by NT\$6,220 thousand.

14. EARNINGS PER SHARE

The amounts used in computing earnings per share (EPS) were as follows:

	<u>Amounts</u> <u>(Numerator)</u>		<u>Shares</u> <u>(Denominator)</u> <u>(Thousands)</u>	<u>EPS (Dollars)</u>	
	<u>Before</u> <u>Income</u> <u>Tax</u>	<u>After</u> <u>Income</u> <u>Tax</u>		<u>Before</u> <u>Income</u> <u>Tax</u>	<u>After</u> <u>Income</u> <u>Tax</u>
<u>2005</u>					
Basic EPS					
Consolidated income available to common stockholders	\$ 579,913	\$ 590,086	48,163	<u>\$ 12.04</u>	<u>\$ 12.25</u>
Effect of dilutive potential common stock - stock options	<u>-</u>	<u>-</u>	<u>975</u>		
Diluted EPS					
Consolidated income available to common stockholders (including effect of dilutive potential common stock)	<u>\$ 579,913</u>	<u>\$ 590,086</u>	<u>49,138</u>	<u>\$ 11.80</u>	<u>\$ 12.01</u>
<u>2004</u>					
Basic EPS					
Consolidated income available to common stockholders	\$ 360,527	\$ 348,329	46,718	<u>\$ 7.72</u>	<u>\$ 7.46</u>
Effect of dilutive potential common stock - stock options	<u>-</u>	<u>-</u>	<u>980</u>		
Diluted EPS					
Consolidated income available to common stockholders (including effect of dilutive potential common stock)	<u>\$ 360,527</u>	<u>\$ 348,329</u>	<u>47,698</u>	<u>\$ 7.56</u>	<u>\$ 7.30</u>

The average number of shares outstanding for EPS calculation had been adjusted retroactively for the distribution of stock dividends and stock bonuses (see Note 13). The retroactive adjustment caused the basic EPS before income tax and after income tax in 2004 to decrease from NT\$10.06 to NT\$7.72 and from NT\$9.72 to NT\$7.46, respectively. The diluted of EPS before income tax and after income tax in 2004 from NT\$9.63 to NT\$7.56 and from NT\$9.30 to NT\$7.30, respectively.

15. RELATED-PARTY TRANSACTIONS

a. The Corporation and subsidiaries' related parties were as follows:

<u>Related Party</u>	<u>Relationship with the Corporation</u>
Toshiba Corporation, Japan ("Toshiba")	A member of the Corporation's board of directors
Toshiba Electronics Europe GmbH	Subsidiary of Toshiba
Toshiba Electronics Taiwan Corp.	Subsidiary of Toshiba
Toshiba Digital Media Network Taiwan Corporation	Subsidiary of Toshiba
Taiwan Toshiba International Procurement Corp.	Subsidiary of Toshiba
M-Systems B.V.	A member of the Corporation's board of directors
M-Systems Flash Disk Pioneers Ltd. ("M-Systems")	Parent company of M-Systems B.V.

(Continued)

<u>Related Party</u>	<u>Relationship with the Corporation</u>
M-Systems Asia Ltd.	Subsidiary of M-Systems B.V.
TwinSys Data Storage Limited Partnership (TwinSys)	Subsidiary of M-Systems

b. The significant transactions with the related parties are summarized as follows:

	<u>2005</u>		<u>2004</u>	
	Amount	%	Amount	%
<u>For the year</u>				
1) Net sales				
M-Systems	\$ 440,204	7	\$ 50,896	1
TwinSys	80,771	1	93,902	3
M-Systems Asia Ltd.	42,490	1	18,020	-
Other	<u>696</u>	<u>-</u>	<u>389</u>	<u>-</u>
	<u>\$ 564,161</u>	<u>9</u>	<u>\$ 163,207</u>	<u>4</u>
2) Service revenue				
Toshiba	<u>\$ -</u>	<u>-</u>	<u>\$ 2,809</u>	<u>49</u>
3) Purchase				
Toshiba Electronics Taiwan Corp.	\$ 2,251,734	42	\$ 1,480,620	47
M-Systems	22,964	1	-	-
Other	<u>12,485</u>	<u>-</u>	<u>15,674</u>	<u>-</u>
	<u>\$ 2,287,183</u>	<u>43</u>	<u>\$ 1,496,294</u>	<u>47</u>
4) Sales expense (included in royalty, Note 17d)				
M-Systems	<u>\$ 25,552</u>	<u>28</u>	<u>\$ 4,928</u>	<u>11</u>
<u>At end of year</u>				
Accounts receivable				
M-Systems	\$ 65,979	6	\$ 34,468	5
TwinSys	618	-	90,074	14
Other	<u>1,715</u>	<u>-</u>	<u>117</u>	<u>-</u>
	<u>\$ 68,312</u>	<u>6</u>	<u>\$ 124,659</u>	<u>19</u>
Royalty				
M-Systems	\$ 38,207	89	\$ -	-
Toshiba	<u>899</u>	<u>2</u>	<u>1,169</u>	<u>20</u>
	<u>\$ 39,106</u>	<u>91</u>	<u>\$ 1,169</u>	<u>20</u>

(Continued)

	<u>2005</u>		<u>2004</u>	
	<u>Amount</u>	<u>%</u>	<u>Amount</u>	<u>%</u>
Accounts payable				
Toshiba Electronics Taiwan Corp.	\$ 223,638	26	\$ 112,106	18
Toshiba Digital Media Network Taiwan Corporation	<u>4,611</u>	<u>1</u>	<u>-</u>	<u>-</u>
	<u>\$ 228,249</u>	<u>27</u>	<u>\$ 112,106</u>	<u>18</u>
Accrued expenses				
M-Systems	<u>\$ 34,225</u>	<u>23</u>	<u>\$ 4,928</u>	<u>8</u>

The transaction terms and prices for related and third parties were similar.

16. PLEDGED ASSETS

The following assets are pledged or mortgaged as collaterals for bank loans, the issuance of letters of credit for purchasing materials, as refundable deposits for the Customs Duty Bureau and the Court as follows:

	2005	2004
Refundable deposits - certificates of deposits	\$ 40,000	\$ 80,000
The issuance of L/C for purchasing materials - certificates of deposits	5,000	6,093
Refundable deposits for the Customs Duty Bureau - certificates of deposits	5,058	4,990
Compensating balance - saving accounts	<u>4,901</u>	<u>6,014</u>
	<u>\$ 54,959</u>	<u>\$ 97,097</u>

17. SIGNIFICANT COMMITMENTS AND CONTINGENCIES

The significant commitments and contingencies of the Corporation as of December 31, 2005 were as follows:

- a. The Corporation rents its office under operating lease agreements expiring on December 31, 2007. The annual rent was NT\$6,256 thousand per year.

As of December 31, 2005, future remaining lease payments were as follows:

Period	Amount
2006	\$ 7,451
2007	<u>7,451</u>
	<u>\$ 14,902</u>

- b. Unused letters of credit amounted to US\$28 thousand and NT\$45,000 thousand.

- c. On August 15, 2002, Feiya Technology Corp. ("Feiya," which was later renamed Silicon Motion, Inc.) filed a case with the Hsinchu District Court against the Corporation and the Corporation's president, Mr. Pua Khein Seng, and vice president, Mr. Aw Yong Chee Kong, who were former employees of Feiya. Feiya claimed damages of NT\$45,000 thousand for alleged theft by the Corporation's two officials of trade secrets. The claim was overruled by Hsinchu District Court because Feiya could not provide evidences for its charge. However, Feiya disagreed with this decision and filed an appeal with the Taiwan High Court on April 26, 2004. According to the Corporation's lawyer, as of December 31, 2005, the superior court was reviewing this case. The Corporation's lawyer believes this litigation would have no material effects on the Corporation's financial statements. However, following the principle of conservatism, the Corporation deposited NT\$40,000 thousand as litigation guarantee and recognized a probable loss of NT\$45,000 thousand on the guarantee deposit (included in other payables) on this litigation.
- d. In November 2004, the Corporation signed a license agreement on pen drive products with M-Systems. Under this agreement, the Corporation should pay M-System royalties and commissions at a percentage of net sales over six years.
- e. On February 21, 2006, the Corporation received a formal complaint from CARRY COMPUTER ENG. Co., Ltd. ("Carry") about its "UFD with display which can show the density and related data" (Product). Carry claimed that the Corporation, the Corporation's president and engineers infringed the copyright, reneged loyalty, and violated trade secrets of Carry.

Corporation renders these factors, and thinks the accusation is not sustainable.

- 1) No evidence that the information disclosed by Carry are Copyright or trade secret.
- 2) Such kind of product concept has been disclosed by Carry during 2005 Cebit Show held in Germany.
- 3) Carry is not inventor of such kind of product. Many prior arts can be searched in the patent database, which make such kind of concept public.
- 4) Corporation's same kind of product is based on different technology.

In addition, Corporation's shipment quantity on this kind of product is less than 10 thousands units from last quarter four, therefore Corporation believes the complaint would not have material effect on the Corporation's financial statements.

18. SIGNIFICANT SUBSEQUENT EVENTS

On February 27, 2006, Quan Yi Technology, the Corporation's outsourcing partner, was stolen of products which Corporation's included. Is short, the Corporation lost approximately NT\$60,000 thousand of inventory, which was fully covered by insurance. The Corporation has already requested the insurance company to facilitate the compensation for the loss. The Corporation believes that the event would not have material effect on the Corporation's financial statements.

19. FINANCIAL INSTRUMENT TRANSACTIONS

a. Derivative transactions

The Corporation entered into derivative transactions to hedge exchange rate fluctuations of net foreign currency-denominated assets or liabilities. The derivative financial instruments are solely for hedging market risks the Corporation is exposed to, i.e., the instruments will not be used for speculative purposes. The subsidiary, Lian Xu Dong, didn't enter into derivative transactions.

Certain information was as follows:

1) Contract amount, notional amount and credit risk

The Corporation's outstanding forward exchange contracts as of December 31, 2004 were as follows:

Financial Instruments	Contract Amount (in Thousands)	Risk
Sell	US\$1,000	NT\$510
Area of the counter-parties		
The Republic of China	US\$1,000	NT\$510

The Corporation will be exposed to credit risk if counter-parties default on contracts. Credit risk represents the positive net settlement amount of derivative contracts with positive fair values on the balance sheet date. The positive net settlement amount represents the loss to be incurred by the Corporation if the counter-parties breach the contracts. The financial institutions, which are the counter-parties to the foregoing derivative financial instruments, are reputable. Thus, management believes its exposure due to the counter-parties' default is low.

2) Market risk

All derivative financial instruments transactions are intended as hedges for exchange rate fluctuations of net foreign currency-denominated assets or liabilities. Gains or losses on these hedging instruments are likely to offset the gains or losses on the hedged items. Thus, the potential market risk is insignificant.

3) Liquidity risk, cash flow risk and uncertainty of future cash demand.

The Corporation had no forward exchange contracts outstanding as of December 31, 2005, so there are no cash flow risk, liquidity risk and future cash demand.

4) The purpose of derivative financial instruments held or issued and the strategies to meet the purpose

The Corporation entered into forward contracts to hedge the effect of exchange rate fluctuations in the market on net foreign currency-denominated assets and liabilities. The Corporation uses hedging instruments with changes in fair values that are of high negative correlation with the changes in the fair values of the hedged items and periodically evaluates the effectiveness of the instruments.

5) Presentation in financial statements, please see Note 2. Gains or losses on these derivative financial instruments were not material in 2005 and 2004.

b. Fair value of financial instruments:

	2005		2004	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Nonderivative Financial Instruments				
<u>Financial assets</u>				
Financial assets - with fair value approximating carrying amounts	\$ 1,900,735	\$ 1,900,735	\$ 1,040,103	\$ 1,040,103
Short-term investments	-	-	97,499	97,501
Long-term investments	24,650		9,500	
Guarantee deposits paid	41,970	41,970	81,371	81,371
<u>Financial liabilities</u>				
Financial liabilities - with fair values approximating carrying amounts	901,260	901,260	675,952	675,952
Guarantee deposits received	-	-	168	168
<u>Derivative financial instruments</u>				
Forward exchange contracts (sell)	-	-	605	510
<u>Area of the counter-parties</u>				
The Republic of China	-	-	605	510

The following bases were used to estimate the fair values of financial instruments:

- 1) For short-term financial instruments (other than short-term investments), the carrying amounts of cash and cash equivalents, notes and accounts receivable, other financial assets - current, restricted assets, notes and accounts payable and other payables approximate their fair values because of the short maturities of these instruments.
- 2) Fair value of short-term investments is based on quoted market prices.
- 3) Fair value of long-term investments is estimated at available market prices. If market prices of long-term investments are not available, the fair value of long-term investments was not disclosed.
- 4) For guarantee deposits paid and received, fair values are estimated at their carrying amounts because these deposits do not have specific due dates.
- 5) Fair value of derivative financial instruments is the amount receivable from or payable to the counter-party if the contracts are terminated on the balance sheet date.

Certain financial instruments and all nonfinancial instruments are excluded from disclosure of fair values. Thus, the aggregate fair value presented above does not represent the underlying value of the Corporation and subsidiaries.

20. ADDITIONAL DISCLOSURES

Following are the additional disclosures required by the Securities and Futures Bureau for the Corporation and its investees:

- a. Financing provided: None
- b. Endorsement/guarantee provided: None

- c. Marketable securities held: Table 1 (attached)
- d. Marketable securities acquired and disposed of at costs or prices of at least \$100 million or 20% of the paid-in capital: Table 2 (attached)
- e. Acquisition of individual real estate at costs of at least \$100 million or 20% of the paid-in capital: None
- f. Disposal of individual real estate at prices of at least \$100 million or 20% of the paid-in capital: None
- g. Total purchases from or sales to related parties amounting to at least \$100 million or 20% of the paid-in capital: Table 3 (attached)
- h. Receivables from related parties amounting to at least \$100 million or 20% of the paid-in capital: None
- i. Names, locations, and related information of investees on which the Corporation exercised significant influence: Table 4 (attached)
- j. Derivative transactions: Note 18
- k. Investment in Mainland China: None

21. SEGMENT INFORMATION

- a. Industry information

The Operates Inside and Outside the ROC	2004			Consolidated
	Electronics Department	Investment Department	Adjustments and Elimination	
Segment revenue from unaffiliated customers	\$ 6,308,289	\$ -	\$ -	\$ 6,308,289
Segment operating income	\$ 609,487	\$ (37)	\$ -	\$ 609,450
Nonoperating income and gains				31,111
Nonoperating expenses and losses				60,648
Income before income tax				\$ 579,913
Identifiable assets	\$ 2,827,358	\$ 19,965	\$ -	\$ 2,847,323
Long-term investments				24,650
Total assets				\$ 2,871,973
Depreciation and amortization				\$ 28,753
Capital expenditure				\$ 11,317

- b. Geographic information

As of December 31, 2005, the Corporation and the subsidiary had no revenue-generating operating unit outside the Republic of China.

c. Information of export sales

Geographic Area	2005	2004
Europe	\$ 1,326,697	\$ 376,375
United States	1,060,916	845,617
Asia	1,488,276	625,729
Australia	2,641	179,513

d. Information of major customers

Customers of the Corporation and subsidiaries with sales at least 10% of the consolidated total sales were as follows:

Customers	2005		2004	
	Amount	%	Amount	%
A	\$ 682,418	11	\$ 218,661	6
B	432,769	7	403,390	10

PHISON ELECTRONICS CORP. AND SUBSIDIARIES

MARKETABLE SECURITIES HELD

DECEMBER 31, 2005

(Amounts in Thousands of New Taiwan Dollars)

Holding Company Name	Marketable Securities Type and Name	Relationship with the Holding Company	Financial Statement Account	December 31, 2005				Note
				Shares (Thousands)	Carrying Value	Percentage of Ownership	Net Asset Value	
Phison Electronics Corp. (the "Corporation")	<u>Common stock</u> Lian Xu Dong Investment Corporation	Subsidiary	Long-term investments	2,000	\$ 19,963 (Note 2)	100	\$ 19,963	-
	Trison Technology Corporation	Cost-method investee	Long-term investments	2,000	20,000	12	17,254	-
	Ours Technology Inc.	Cost-method investee	Long-term investments	315	4,650	1	3,317	-

Note 1: The Corporation held marketable securities that had not been used as guarantee, pledged or mortgaged as collaterals or restricted by other commitments.

Note 2: All were eliminated in the consolidated financial statements.

PHISON ELECTRONICS CORP. AND SUBSIDIARIES

MARKETABLE SECURITIES ACQUIRED AND DISPOSED OF AT COSTS OR PRICES OF AT LEAST NT\$100 MILLION OR 20% OF THE PAID-IN CAPITAL

YEAR ENDED DECEMBER 31, 2005

(Amounts in Thousands of New Taiwan Dollars)

Acquiring or Selling Company Name	Marketable Securities Type and Name	Financial Statement Account	Counter-party	Nature of Relationship	Beginning Balance		Acquisition		Disposal				Ending Balance	
					Units (Thousands)	Amount	Units (Thousands)	Amount	Units (Thousands)	Amount	Carrying Value	Gain on Disposal	Units (Thousands)	Amount
The Corporation	Ta Chong Bond Fund	Short-term investments	-	-	-	\$ -	18,084	\$ 230,077	18,084	\$ 230,478	\$ 230,077	\$ 401	-	\$ -
	The Forever Fund	Short-term investments	-	-	-	-	12,032	170,072	12,032	170,361	170,072	289	-	-
	Sheng Hua 1699 Bond Fund	Short-term investments	-	-	-	-	11,514	140,012	11,514	140,276	140,012	264	-	-
	Fuhwa Bond Fund	Short-term investments	-	-	2,344	29,190	13,578	170,295	15,922	200,008	199,485	523	-	-
	The IIT Wan Pao Fund	Short-term investments	-	-	-	-	6,749	100,000	6,749	100,280	100,000	280	-	-
	Fuhwa Advantage Bond Fund	Short-term investments	-	-	1,590	16,149	9,370	95,571	10,960	111,992	111,720	272	-	-

PHISON ELECTRONICS CORP. AND SUBSIDIARIES

**TOTAL PURCHASES FROM OR SALES TO RELATED PARTIES AMOUNTING TO AT LEAST NT\$100 MILLION OR 20% OF THE PAID-IN CAPITAL
YEAR ENDED DECEMBER 31, 2005**

(Amounts in Thousands of New Taiwan Dollars)

Company Name	Related Party	Nature of Relationship	Transaction Details				Abnormal Transaction		Notes/Accounts (Payable) or Receivable		Note
			Purchase/ (Sale)	Amount	% to Total	Payment Terms	Unit Price	Payment Terms	Ending Balance	% to Total	
The Corporation	Toshiba Electronics Taiwan Corp. M-System Flash Disk Pioneers Ltd.	A member of the Corporation's Board of Directors Parent company of a member of the Corporation's Board of Directors	Purchase	\$ 2,251,734	42	30 days after monthly closing	None	None	\$ (223,638)	(26)	-
			Sales	(440,204)	(7)	30 days after monthly closing	None	None	65,979	6	

PHISON ELECTRONICS CORP. AND SUBSIDIARIES

NAMES, LOCATIONS, AND OTHER INFORMATION OF INVESTEEES ON WHICH THE COMPANY EXERCISES SIGNIFICANT INFLUENCE
 YEAR ENDED DECEMBER 31, 2005
 (Amounts in Thousands of New Taiwan Dollars)

Investor Company	Investee Company	Location	Main Businesses and Products	Original Investment Amount		Balance as of December 31, 2005			Net Income (Loss) of the Investee	Investment Income (Loss)	Note
				December 31, 2005	December 31, 2004	Shares (Thousands)	Percentage of Ownership	Carrying Value			
Phison Electronics Corp.	Lian Xu Dong Investment Corp.	Hsinchu, Taiwan	Investment	\$ 20,000	\$ -	2,000	100	\$ 19,963	\$ (37)	\$ (37)	Subsidiary

Note: All were eliminated in the consolidated financial statements.