

Silicon Motion Technology CORP

Form 20-F

July 02, 2007

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 20-F

.. REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (g) OF THE SECURITIES EXCHANGE ACT OF 1934
OR

x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2006

OR

.. TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from _____ to _____

OR

.. SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
Date of event requiring this shell company report: N/A

Commission file number: 000-51380

Silicon Motion Technology Corporation

(Exact name of Registrant as specified in its charter)

Cayman Islands

(Jurisdiction of incorporation or organization)

No. 20-1, Taiyuan St.,

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Jhubei City Hsinchu County 302

Taiwan

(Address of principal executive offices)

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

Title of each class	Name of each exchange on which registered
Ordinary Shares, par value US\$0.01 per share*	Nasdaq Global Market
American Depositary Shares, each representing four ordinary shares	

* Not for trading, but only in connection with the listing on the Nasdaq Global Market of American Depositary Shares, or ADSs, each representing four ordinary shares.

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

None

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report: 123,780,268 ordinary shares, US\$0.01 par value per share.

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Sections 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

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

Large accelerated filer Accelerated filer Non-accelerated filer

Indicate by check mark which financial statement item the registrant has elected to follow. Item 17 Item 18

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act): Yes No

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CONVENTIONS THAT APPLY TO THIS ANNUAL REPORT

Unless otherwise indicated, references in this annual report to:

ADRs are to the American depositary receipts that evidence our ADSs;

ADSs are to our American depositary shares, each of which represents four ordinary shares;

CAGR are to compound annual growth rate;

China or PRC are to the People's Republic of China excluding the special administrative regions of Hong Kong and Macau;

Korea are to the Republic of Korea, or South Korea;

Nasdaq are to the Nasdaq National Market;

NT dollar, NT dollars or NT\$ are to New Taiwan dollars, the legal currency of Taiwan;

ROC or Taiwan are to Taiwan, the Republic of China, the official name of Taiwan;

shares or ordinary shares are to our ordinary shares, with par value US\$0.01 per share;

U.S. GAAP are to generally accepted accounting principles in the United States;

U.S. dollar, U.S. dollars or US\$ are to United States dollars, the legal currency of the United States; and

we, us, our company, our and Silicon Motion are to Silicon Motion Technology Corporation, its predecessor entities and subsidiaries including (i) Silicon Motion, Inc., incorporated in Taiwan, or SMI Taiwan, and formerly known as Feiya Technology Corporation and (ii) Silicon Motion, Inc., a California, USA, corporation, or SMI USA.

Silicon Motion, the Silicon Motion logo, FCI, the FCI logo, airRF, basicRF, ezRF, ezSYS, powerRF, twinRF, zipRF and zipSYS are our trademarks or registered trademarks. We may also refer to trademarks of other corporations and organizations in this document.

Unless otherwise indicated, our financial information presented in this annual report has been prepared in accordance with U.S. GAAP.

Solely for your convenience, this annual report contains translations of certain NT dollar amounts into U.S. dollars at specified rates. All translations from NT dollar to U.S. dollar amounts are made at the noon buying rate in the City of New York for cable transfers of NT dollars as certified for customs purposes by the Federal Reserve Bank of New York. Unless otherwise stated, the translation from NT dollars into U.S. dollars and from U.S. dollars into NT dollars has been made at the noon buying rate in effect on December 31, 2006, which was NT\$32.59 to US\$1.00. No representation is made that the NT dollar or U.S. dollar amounts referred to in this annual report could have been or could be

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converted into U.S. dollar or NT dollar amounts, as the case may be, at any particular rate or at all. See [Risk Factors](#) [Fluctuation in exchange rates could result in foreign exchange losses](#) for discussions on how fluctuating exchange rates could affect our profitability and your investment in us. On June 28, 2007, the noon buying rate was NT\$32.82 to US\$1.00.

The [Glossary of Technical Terms](#) contained in Annex A of this report sets forth the description of certain technical terms and definitions used in this annual report. This annual report also contains statistical data and forecasted information that we obtained from industry publications and reports generated by International Data Corporation, or IDC. Industry publications generally indicate that they have obtained their information from sources believed to be reliable, but do not guarantee the accuracy and completeness of their information. Although we believe that the publications are reliable, we have not independently verified their data.

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SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This annual report contains forward-looking statements. These statements relate to future events or our future financial performance, our ability to continue to control our costs and maintain the quality of our products, the expected growth of and change in the semiconductor and multimedia consumer electronics industries worldwide, and involve known and unknown risks, uncertainties and other factors that may cause our actual results, levels of activity, performance or achievements to differ materially from any future results, levels of activity, performance or achievements expressed or implied by these forward-looking statements. These risks and other factors include those listed under Risk Factors and elsewhere in this annual report. In some cases, you can identify forward-looking statements by terminology such as may, will, should, expect, intend, plan, anticipate, believe, estimate, predict, potential, continue or the negative of these terms or other comparable variety of factors, some of which are outside of our control, may cause our operating results to fluctuate significantly. They include:

unpredictable volume and timing of customer orders, which are not fixed by contract but vary on a purchase order basis;

the loss of one or more key customers or the significant reduction, postponement, rescheduling or cancellation of orders from these customers;

general economic conditions or conditions in the semiconductor or multimedia consumer electronics market;

our ability to successfully integrate our acquisition of Future Communications IC, Inc.;

decreases in the overall average selling prices of our products;

changes in the relative sales mix of our products;

changes in our cost of finished goods;

the availability, pricing and timeliness of delivery of other components and raw materials used in our customers' products;

our customers' sales outlook, purchasing patterns and inventory adjustments based on consumer demands and general economic conditions;

our ability to successfully develop, introduce and sell new or enhanced products in a timely manner; and

the timing of new product announcements or introductions by us or by our competitors.

One or more of these factors could materially and adversely affect our operating results and financial condition in future periods. We cannot assure you that we will attain any estimates or maintain profitability or that the assumptions on which they are based are reliable.

Except as required by law, we undertake no obligation to update or revise publicly any forward-looking statements, whether as a result of new information, future events or otherwise after the date of this annual report. All forward-looking statements contained in this annual report are qualified by reference to this cautionary statement.

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PART I

ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS
Not applicable.

ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE
Not applicable.

ITEM 3. KEY INFORMATION
Selected Consolidated Financial Data

You should read the following information with our consolidated financial statements and related notes and Item 5. Operating and Financial Review and Prospects included elsewhere in this annual report.

The selected consolidated statements of income and cash flow data for the years ended December 31, 2004, 2005 and 2006 and the selected consolidated balance sheet data as of December 31, 2005 and 2006 are derived from our audited consolidated financial statements included elsewhere in this annual report and should be read in conjunction with, and are qualified in their entirety by reference to, these consolidated financial statements and related notes. The selected consolidated statements of income and cash flow data for the years ended December 31, 2002 and 2003 and the selected consolidated balance sheet data as of December 31, 2002, 2003 and 2004 are derived from our audited consolidated financial statements which are not included in this annual report. These consolidated financial statements are prepared in accordance with U.S. GAAP.

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	Year Ended December 31,					
	2002 NT\$	2003 NT\$	2004 NT\$	2005 NT\$	2006 NT\$	2006 US\$
Consolidated Statements of Income Data:						
Net sales	456,874	915,070	2,166,727	2,686,492	3,460,459	106,182
Cost of sales	366,236	424,668	1,274,410	1,342,749	1,612,019	49,464
Gross profit	90,638	490,402	892,317	1,343,743	1,848,440	56,718
Operating expenses (income):						
Research and development	107,504	203,646	238,485	373,548	502,225	15,410
Sales and marketing	52,593	125,680	141,136	157,278	200,526	6,153
General and administrative	38,230	69,262	103,303	129,141	219,395	6,732
Amortization of intangible assets	8,048	24,145	17,758	4,501		
Impairment of intangible assets(1)		54,143	11,718			
In-process research and development	310,813					
Restructuring charge	10,170					
Compensation to customer				8,122		
Write-off of other receivable(2)					40,039	1,229
Gain from litigation settlement					(3,000)	(92)
Total operating expenses	527,358	476,876	512,400	672,590	959,185	29,432
Operating income	(436,720)	13,526	379,917	671,153	889,255	27,286
Total non-operating income (expenses)	10,477	2,512	21,187	44,204	79,268	2,432
Income (loss) before income taxes	(426,243)	16,038	401,104	715,357	968,523	29,718
Income tax (benefit) expense	9,573	(94,405)	133,101	42,055	21,032	645
Net income (loss)	(435,816)	110,443	268,003	673,302	947,491	29,073
Weighted average shares outstanding:						
Basic	66,752	96,901	103,878	114,083	123,251	123,251
Diluted	66,752	96,901	103,878	116,015	125,488	125,488
Earning (loss) per share:						
Basic	(6.53)	1.14	2.58	5.90	7.69	0.24
Diluted	(6.53)	1.14	2.58	5.80	7.55	0.23
Earning (loss) per ADS(3):						
Basic earnings per ADS	(26.12)	4.56	10.32	23.61	30.75	0.94
Diluted earnings per ADS	(26.12)	4.56	10.32	23.21	30.20	0.93

(1) In 2003 and 2004 we determined that impairment of our intangible assets occurred as a result of a significant decline in expected net sales from new consumer products such as broadband Internet video phones, car navigation systems, and Tablet PCs. As the development and market for these products did not materialize, the forecasted sales and cash flows were significantly reduced.

(2) Write-off of a non-trade related receivable, the collection of which is doubtful.

(3) Each ADS represents four ordinary shares.

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	2002 NT\$	2003 NT\$	As of December 31,		2006 NT\$	2006 US\$
			2004 NT\$	2005 NT\$		
Consolidated Balance Sheet Data:						
(in thousands)						
Cash and cash equivalents	358,440	763,545	727,165	1,581,993	1,808,042	55,478
Other current assets	267,802	459,634	1,324,343	2,341,402	3,141,162	96,384
Working capital	508,468	976,767	1,339,418	3,292,041	3,990,702	122,450
Long-term investments	17,027	7,195	3,142	15,954	170,942	5,245
Property and equipment, net	73,723	52,610	65,657	83,734	319,356	9,799
Intangible assets, net	116,368	38,080	6,843			
Other non-current assets	31,529	41,281	39,887	65,048	89,182	2,738
Total assets	864,889	1,362,345	2,167,037	4,088,131	5,528,684	169,644
Total liabilities	135,246	253,754	718,804	638,346	960,561	29,475
Total shareholders equity	729,643	1,108,591	1,448,233	3,449,785	4,568,123	140,169

	2002 NT\$	2003 NT\$	Year Ended December 31,		2006 NT\$	2006 US\$
			2004 NT\$	2005 NT\$		
Consolidated Cash Flow Data:						
(in thousands)						
Net cash provided by (used in) operating activities	(53,973)	128,322	234,703	539,008	596,763	18,311
Net cash provided by (used in) investing activities	(31,492)	9,706	(263,101)	(1,011,935)	(425,010)	(13,041)
Net cash provided by (used in) financing activities	12,353	268,562	(3,081)	1,278,868	59,929	1,839
Depreciation and amortization	19,541	28,210	21,734	23,906	35,596	1,092
Capital expenditures	(3,018)	(13,996)	(36,409)	(42,708)	(271,697)	(8,337)

Exchange Rate Information

We conduct our business primarily in Taiwan and our revenues and expenses are primarily denominated in NT dollars. This annual report contains translations of NT dollar amounts into U.S. dollar amounts at specific rates solely for the convenience of the reader. The translations of NT dollar amounts into U.S. dollar amounts in this annual report are based on the noon buying rate in the City of New York for cable transfers of the NT dollar as certified for customs purposes by the Federal Reserve Bank of New York. Unless otherwise noted, all translations from NT dollar amounts to U.S. dollar amounts and from U.S. dollar amounts to NT dollar amounts in this annual report were made at a rate of NT\$32.590 to US\$1.00, the noon buying rate in effect as of December 31, 2006. The noon buying rate as of June 28, 2007 was NT\$32.82 to US\$1.00.

We make no representation that any NT dollar or U.S. dollar amounts could have been, or could be, converted into U.S. dollar or NT dollar amounts, as the case may be, at any particular rate, the rates stated below, or at all.

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The following table sets forth information concerning exchange rates between NT dollars and U.S. dollars for the periods indicated. These rates are provided solely for your convenience and are not necessarily the exchange rates that we used in this annual report or will use in the preparation of our periodic reports or any other information to be provided to you. The source of these rates is the Federal Reserve Bank of New York.

	Noon Buying Rate NT\$ per US\$	
	High	Low
December 2006	32.74	32.27
January 2007	32.99	32.38
February 2007	33.08	32.86
March 2007	33.13	32.88
April 2007	33.33	33.05
May 2007	33.41	32.97
June 2007 (through June 28)	33.18	32.74

The following table sets forth the average noon buying rates between NT dollars and U.S. dollars for each of the periods indicated, calculated by averaging the noon buying rates on the last day of each month of the periods shown.

	Average Noon
	Buying Rate NT\$ Per US\$
2002	34.53
2003	34.40
2004	33.27
2005	32.16
2006	32.49

Risk Factors**Risks Related to Our Business**

Because our operating results for any period could be adversely affected by a number of factors and may therefore fluctuate significantly, our annual and quarterly operating results are difficult to predict.

Although we have been able to generate strong revenue and earnings growth and maintain relatively stable gross margins and operating margins, we cannot assure you that we will be able to maintain in the future growth rates and margins similar to those of past periods. A variety of factors may cause our growth rates and margins to decline, including:

continuing downward pressure on the average selling prices of our products caused by intense competition in our industry and other reasons;

decreases in demand for multimedia consumer electronics products, including mobile phones, into which our semiconductor solutions are directly or indirectly incorporated;

our customers' sales outlook, purchasing patterns and inventory adjustments based on consumer demands and general economic conditions;

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the loss of one or more key customers or the significant reduction, postponement, rescheduling or cancellation of orders from these customers;

changes in the seasonality of our sales, which generally has a tendency toward increased sales in the second half of each year;

our ability to develop or acquire, introduce, market and transition to volume production new or enhanced products and technologies, and in a cost-effective and timely manner;

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changes in the relative sales mix of our products;

the availability and pricing of third party semiconductor foundry, assembly and test capacity and raw materials, as well as other changes in our cost of finished goods;

the availability, pricing and timeliness of delivery of other components and raw materials used in our customers' products;

unpredictable volume and timing of customer orders, which are not fixed by contract but vary on a purchase order basis;

superior product innovations by our competitors;

the timing of new product announcements or introductions by us or by our competitors;

competitors offering comparable products at cheaper prices;

our ability to scale our operations in response to increasing demand by customers for our new or existing products;

our ability to timely and accurately predict market requirements and evolving industry trends and to identify and capitalize upon opportunities in new markets; and

the overall cyclicity of, and changing economic and market conditions in, the semiconductor industry.

The result of these and other factors, as well as our recent rapid growth, makes it difficult for us to assess our future performance. Our quarterly sales and operating results are difficult to predict and have in the past, and will likely in the future, fluctuate from quarter to quarter. We could fail to achieve the operating targets that we have announced, such as revenue growth, gross margin, operating margins, and earnings per ADS. In addition, our operating results in the future may be below the expectations of public market analysts or investors, which would likely cause the market price of our ADSs to decline. Any variations in our period-to-period performance may also cause the market price of our ADSs to fluctuate. Accordingly, you should not rely on the results of any prior periods as a reliable indicator of our future operating performance.

We depend on a small number of customers for a significant portion of our revenues and a loss of some of these customers would result in the loss of a significant portion of our revenues.

We have derived a substantial portion of our past revenue from sales to a relatively small number of customers. As a result, the loss of any significant customer could materially and adversely affect our financial condition and results of operations. Sales to our five largest customers represented approximately 35%, 40% and 57% of our net revenue in 2006, 2005 and 2004, respectively. We only had one customer in 2006 and 2005 that accounted for 10% or more of our sales, and three customers in 2004 that accounted for 10% or more of our sales. The identities of our largest customers and their respective contributions to our net revenue have varied and will likely continue to vary from period to period.

Sales to our customers may be significantly higher if indirect sales are included with direct sales. In 2006, Samsung Electronics was our sixth largest customer and accounted for approximately 4% of our sales. In 2006, ATP Electronics and Barun Electronics were our second and seventh largest customers and accounted for approximately 9% and 4% of our sales, respectively. We believe a substantial portion of our sales to ATP Electronics and Barun Electronics are included in the products of Samsung Electronics and that such direct and indirect sales to Samsung Electronics amounted to between 13% and 15% of our net sales. We believe that if our sales to ATP Electronics and Barun Electronics were included in our sales to Samsung Electronics in 2005 and 2004, such direct and indirect sales to Samsung Electronics would amount to between 10% and 12% and 4% and 5% in the respective years. In 2006, 2005 and 2004, Lexar Media was our ninth, fourth and second largest customer and accounted for approximately 3%, 7% and 13% of our sales in the respective years. We believe a substantial portion of our sales to Power

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Digital Card and Macrotron Systems in 2006, 2005 and 2004 are included in Lexar Media's products and that such indirect and direct sales to Lexar Media amounted up to 8% of our net sales in 2006, up to 18% in 2005 and up to 35% of our net sales in 2004.

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We expect that we will continue to depend on a relatively limited number of customers for a substantial portion of our net sales and our ability to maintain good relationships with these customers will be important to the ongoing success of our business. We cannot assure you that the revenue generated from these customers, individually or in the aggregate, will reach or exceed historical levels in any future period. Our failure to meet the demands of these customers could lead to a cancellation or reduction of business from these customers. In addition, loss, cancellation or reduction of business from, significant changes in scheduled deliveries to, or decreases in the prices of products sold to, any of these customers could significantly reduce our revenues and adversely affect our financial condition and operating results. Moreover, any difficulty in collecting outstanding amounts due from our customers particularly customers who place large orders, would harm our financial performance. In addition, if our relationships with our largest customers are disrupted for any reason, it could have a significant impact on our business.

The acquisition of FCI could result in operating difficulties, loss of key personnel and other harmful consequences.

We do not have significant experience acquiring companies. Although our previous business combination, which involved the acquisition of SMI USA by Feiya, has been successful, we cannot assure you that our acquisition of Future Communications IC, Inc., or FCI, on April 30, 2007 will be similarly successful. The process of integrating FCI may create unforeseen operating difficulties and expenditures. The areas where we may face risks include:

implementation or remediation of controls, procedures and policies at FCI;

diversion of management time and focus from operating our business to acquisition integration challenges;

challenges associated with integrating employees from FCI into our organization such as different cultures and languages;

integration of FCI's accounting, management information, human resource and other administrative systems; and

other unique risks such as currency, economic, political and regulatory risks.

In addition, our success depends in part on the abilities and continued service of each of the current executives of FCI. We have service agreements in place with certain key FCI senior executives and have non-compete agreements with these senior FCI executives and other key FCI executives. Our executives at FCI along with other Silicon Motion executives and employees all benefit from long term employee retention programs which include participation in our Share-based Compensation Plans. If we are not able to retain the services of our FCI executives and incur the loss of their services, in the absence of adequate replacements, our ability to implement our business strategy for FCI and operate the business effectively would be harmed.

We may not be able to sustain our current growth rates, and even if we do maintain them, we are susceptible to many challenges relating to our growth.

We have experienced significant growth in the scope and complexity of our business. Our net sales grew from approximately NT\$915.1 million in 2003 to approximately NT\$2,166.7 million in 2004 to approximately NT\$2,686.5 million in 2005 and to approximately NT\$3,460.5 million (US\$106.2 million) in 2006. This growth has placed and will continue to place a strain on our management, personnel, systems and resources. If we are unable to manage our growth effectively, we may not be able to take advantage of market opportunities, develop new products, enhance our technological capabilities, satisfy customer requirements, execute on our business plan or respond to competitive pressures. In particular, the success of our goal to penetrate the MP3 market is highly contingent on the viability of our strategy and the success of our growth plans. To successfully manage our growth, we believe we must effectively:

hire, train, integrate and manage additional qualified engineers, sales and marketing personnel and financial and information technology personnel;

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implement additional and improve existing administrative, financial and operations systems, procedures and controls;

continue to enhance our manufacturing and customer resource management systems;

continue to expand and upgrade our core semiconductor design and software development capabilities;

manage multiple relationships with foundries, distributors, suppliers and certain other third parties; and

manage our financial condition.

Our success also depends largely on our ability to anticipate and respond to expected changes in future demand for our products. In the event the timing of our expansion does not match market demand, our business strategy may need to be revised, and there could be delays in our roll-out of new products, which may adversely affect our growth and future prospects. If we over-expand and demand for our products does not increase as we may have projected, our financial results will be materially and adversely affected. However, if we do not expand, and demand for our products increases sharply, our business could be seriously harmed because we may not be as cost-effective as our competitors due to our inability to take advantage of increased economies of scale. In addition, we may not be able to satisfy the needs of our current customers or attract new customers, and we may lose credibility and our relationships with our customers may be negatively affected. Moreover, if we do not properly allocate our resources in line with future demand for particular products, we may miss changing market opportunities and our business and financial results could be materially and adversely affected. We cannot assure you that we will be able to successfully sustain our current growth rate or that we will be able to manage our growth in the future.

Industry standards and demands in the multimedia consumer electronics market are continuously and rapidly evolving, and our success depends on our ability to anticipate and meet these changes and trends.

In order to remain competitive in the future, we must ensure that our products meet continuously evolving industry standards and are compatible with rapidly changing customer requirements. If our products do not keep pace with evolving industry standards or if our products are not in compliance with prevailing industry standards for an extended period of time, we could be required to invest significant time, effort and funds to redesign our products to ensure compatibility with relevant standards. If we are slow to anticipate changing trends and respond to such changes in a timely manner, we could miss opportunities to capture potential customers and we could lose our existing market share or existing customers. Currently, our primary products are controllers used in flash memory storage devices. If new technologies for storing digital media are developed that compete with flash memory technology or render it obsolete and if we are not able to shift our product offerings accordingly, demand for our products would likely decline and our business would be materially and adversely affected.

In addition, we may not have sufficient financial resources to fund all of the required research to develop future innovations and meet changing industry standards. Moreover, even if we have adequate financial resources, our future innovations may be outpaced by competing innovations. As a result, we may lose customers and significant sales, and our business and operating results may be materially and adversely affected.

If demand for our products declines in the major end markets that we serve, our selling prices and our overall sales will decrease.

Demand for our products is affected by a number of factors, including the general demand for the products in the end markets that we serve and price attractiveness. A significant amount of our sales revenue is derived from customers who use our microcontrollers in removable and irremovable flash memory storage solutions used in communications, consumer electronics and computing devices, such as mobile phones, smart phones, digital cameras, PDAs, MP3 players and notebook and desktop PCs. Any significant decrease in the demand for these devices may decrease the demand for our semiconductor solutions and may result in a decrease in our revenues and earnings. A variety of factors, including economic, political and social instability, could contribute to a

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slowdown in the demand for non-essential communications, consumer electronics and computing devices as consumers delay purchasing decisions or reduce their discretionary spending. In addition, the historical and continuing trend of declining average selling prices of communications, consumer electronics and computing devices places pricing pressure on our semiconductor solutions. As a result, we expect that the average selling prices for many of our semiconductor solutions will continue to decline over the long term. If we are not able to introduce higher margin products, reduce our manufacturing costs to offset expected declines in average selling prices or maintain a high capacity utilization rate, our gross margin will continue to decline, which could have a material and adverse effect on our financial condition and operating results.

If the semiconductor industry suffers a shortage of flash memory, which is a key component in many of our customers' end products, our revenues could be adversely affected.

In 2004 and 2005, some of our customers indicated that they were unable to acquire enough flash memory to meet all of the anticipated demand for their products. Several manufacturers of flash memory have increased manufacturing capacity for flash memory since then. However, we cannot assure you that there will continue to be enough additional capacity to satisfy worldwide demand for flash memory. According to IDC (Worldwide Flash Memory Card 2006-2010 Forecast, May 2006), the demand for flash memory cards is expected to rise rapidly through 2010. Because flash memory is a key component of most of the products manufactured by our customers, if any shortage in the supply of flash memory occurs and is not remedied, our customers may not be able to purchase enough flash memory to manufacture their products and may therefore purchase fewer semiconductor solutions from us than they would have otherwise purchased. Our ability to increase revenues and grow our profits could be materially and adversely affected as a result of any shortage or decrease in the supply of flash memory.

A failure to accurately forecast customer demand may result in excess or insufficient inventory, which may increase our operating costs and harm our business.

To ensure the availability of our products for our customers, in some cases we cause our manufacturers to begin manufacturing our products based on forecasts provided by these customers in advance of receiving purchase orders. However, these forecasts do not represent binding purchase commitments, and we do not recognize revenue from these products until they are shipped to the customer. As a result, we incur inventory and manufacturing costs in advance of anticipated revenue. Because demand for our products may not materialize, manufacturing based on forecasts subjects us to risks of high inventory carrying costs and increased obsolescence and may increase our costs. If we overestimate customer demand for our products or if purchase orders are cancelled or shipments delayed, we may end up with excess inventory that we cannot sell, which could have a material and adverse effect on our financial results. Conversely, if we underestimate demand, we may not have sufficient product inventory and may lose market share and damage customer relationships, which could also harm our business.

The average selling prices of our products could decrease rapidly.

We may experience period-to-period fluctuations in future operating results if our average selling prices decline. We may be forced to reduce the average unit price of our products in response to new product introductions by us or our competitors, competitive pricing pressures and other factors. The semiconductor market is extremely cost sensitive, which may result in declining average selling prices of the components comprising our products. We expect that these factors will create downward pressure on our average selling prices and operating results. To maintain acceptable operating results, we will need to develop and introduce new products and product enhancements on a timely basis and continue to reduce our costs. If we are unable to offset any reductions in our average selling prices by increasing our sales volumes or reducing corresponding production costs, or if we fail to develop and introduce new products and enhancements on a timely basis, our sales and operating results will be materially and adversely affected.

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We rely primarily on a small number of distributors to market and distribute certain of our products, and if we fail to maintain or expand these sales channels, our revenues would likely decline.

Most of our embedded graphics processors and some of our other products are sold through independent distributors. Sales of these products to distributors generate a material amount of our revenues. Our business will depend on our ability to maintain and expand our relationships with distributors, develop additional channels for the distribution and sale of our products and effectively manage these relationships. Because not all of our distributors are required to make a specified minimum level of purchases from us, we cannot be certain that they will sell our products on a priority basis. As we continue to expand our indirect sales capabilities, we will need to manage the potential conflicts that may arise within our indirect sales force. We also rely on our distributors to accurately and timely report to us their sales of our products and to provide certain engineering support services to customers. Our inability to obtain accurate and timely reports and to successfully manage these relationships would have a material and adverse effect on our financial results.

The loss of any of our key personnel or the failure to attract or retain specialized technical and management personnel could impair our ability to grow our business.

We rely heavily on the services of our key employees, including Wallace C. Kou, our President and Chief Executive Officer. In addition, our engineers and other key technical personnel are a significant asset and are the source of our technological and product innovations. We believe our future success will depend upon our ability to retain these key employees and our ability to attract and retain other skilled managerial, engineering, technical and sales and marketing personnel. The competition for such personnel, particularly technical personnel, is intense in our industry. We may not be successful in attracting and retaining sufficient numbers of technical personnel to support our anticipated growth. These technical personnel are required to refine the existing hardware system and application programming interface and to introduce enhancements in future applications. Despite the incentives we provide, our current employees may not continue to work for us, and if additional personnel were required for our operations, we may not be able to obtain the services of additional personnel necessary for our growth. In addition, we do not maintain key person life insurance for any of our senior management or other key employees. The loss of any of our key employees or our inability to attract or retain qualified personnel, including engineers, could delay the development and introduction of, and have an adverse effect on our ability to sell, our products as well as our overall growth.

In addition, if any other members of our senior management or any of our other key personnel joins a competitor or forms a competing company, we may not be able to replace them easily and we may lose customers, business partners, key professionals and staff members. Substantially all of our senior executives and key personnel have entered into confidentiality and non-disclosure agreements. In the event of a dispute between any of our senior executives or key personnel and SMI Taiwan, we cannot assure you the extent, if any, to which these provisions may be enforceable in Taiwan due to uncertainties involving the Taiwan legal system.

We may be unsuccessful in developing and selling new products or in penetrating new markets required to maintain or expand our business.

Our revenue growth has been primarily from sales of our semiconductor solutions. Although we believe that our acquisition of FCI will enable us to offer more comprehensive solutions for mobile devices, our future success depends, in part, on our ability to develop successful new semiconductor solutions in a cost-effective and timely manner. We continually evaluate expenditures for planned product developments and choose among alternatives based upon our expectations of future market trends. The development of our semiconductor solutions is highly complex, and successful product development and market acceptance of our products depends on a number of factors, including:

our accurate prediction of the changing requirements of our customers;

our timely completion and introduction of new designs;

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the availability of third-party manufacturing, assembly and test capacity;

the ability of our foundries to achieve high manufacturing yields for our products;

our ability to transition to smaller manufacturing process geometries;

the quality, price, performance, power efficiency and size of our products and those of our competitors;

our management of our indirect sales channels;

our customer service capabilities and responsiveness;

the success of our relationships with existing and potential customers; and

changes in industry standards.

We cannot assure you that we will be able to develop and introduce new or improved products in a timely and cost-effective manner, that the products we introduce will generate significant revenues or that we will be able to accurately anticipate or respond to future market trends.

We may not be able to deliver our products on a timely basis if our relationships with our suppliers, our semiconductor foundries or our assembly and test subcontractors are disrupted or terminated.

We do not own or operate a semiconductor fabrication facility. Instead, we rely on third parties to manufacture our semiconductors. Three outside foundries, UMC, in Taiwan, SMIC, in China, and STMicroelectronics in Europe currently manufacture the majority of our semiconductors. As a result, we face several significant risks, including higher wafer prices, lack of manufacturing capacity, quality assurance, manufacturing yields and production costs, limited control over delivery schedules and product quality, increased exposure to potential misappropriation of our intellectual property, labor shortages or strikes and actions taken by third party contractors that breach our agreements.

The ability of each foundry to provide us with semiconductors is limited by its available capacity. We do not have long-term agreements with any of these foundries and we place orders on a purchase order basis. We place our orders based on our customers' purchase orders and sales forecasts. However, the foundries can allocate capacity to the production of the products of their other customers and reduce deliveries to our manufacturing logistics partners on short notice or increase the price they charge us. It is possible that other foundry customers that are larger and better financed than we are, or have long-term agreements with these foundries, may induce these foundries to reallocate capacity to them. Any reallocation could impair our ability to secure the supply of semiconductors that we need for our products. In addition, interruptions to the wafer manufacturing processes caused by a natural disaster or human error could result in partial or complete disruption in supply until we are able to shift manufacturing to another fabrication facility. It may not be possible to obtain sufficient capacity or comparable production costs at another foundry. Migrating our design methodology to a new third-party foundry could involve increased costs, resources and development time comparable to a new product development effort. Any reduction in the supply of semiconductors for our products could significantly delay our ability to ship our products and potentially have negative effects on our relationships with existing customers and our results of operations. In addition, if our subcontractors terminate their relationships with us, we would be required to qualify new subcontractors, which could take as long as six months, resulting in unforeseen operations problems, and our operating results may be materially and adversely affected.

If the foundries that provide us with the products for our operations do not achieve satisfactory yield or quality, or if the assembly and testing services fail us in the quality of their output, then our revenue, operating results and customer relationships will be affected.

The manufacture of semiconductors is a highly complex process. Minor deviations in the manufacturing process can cause substantial decreases in yield. In some situations, such deviations may cause production to be suspended. The foundries that manufacture our semiconductors have from time to time experienced lower than

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anticipated manufacturing yields, including yields for our semiconductors, typically during the production of new products or architectures or during the installation and start-up and ramp-up of new process technologies or equipment. If the foundries that manufacture our semiconductors do not achieve planned yields, our product costs could increase, and product availability would decrease.

After the wafer fabrication processes, our wafers are shipped to our assembly and testing subcontractors. We have a system to maximize consistent product quality, reliability and yield which involve our quality assurance team working closely with pertinent subcontractors in the various phases of the assembly and testing processes. We also emphasize a strong supplier quality management practice through which our quality assurance team pre-qualifies our manufacturing suppliers and subcontractors. However, despite our efforts to strengthen supplier quality management, if our foundries fail to deliver fabricated silicon wafers of satisfactory quality in the volume and at the price we require, or if our assembly and testing subcontractors fail to efficiently and accurately assemble and test our products, we will be unable to meet our customers demand for our products or to sell those products at an acceptable profit margin, which would have a material and adverse effect on our sales and margins and damage our customer relationships.

Failure to protect our proprietary technologies or maintain the right to certain technologies may negatively affect our ability to compete.

We believe that the protection of our intellectual property rights will continue to be important to the success of our business. We rely on a combination of patent, copyright, trademark and trade secret laws and restrictions on disclosure to protect our intellectual property rights. We also enter into confidentiality or license agreements with our employees, business partners and other third parties, and have implemented procedures to control access to and distribution of our documentation and other proprietary information. Despite these efforts, we cannot assure you that these measures will provide meaningful protection of our intellectual property rights. Further, these agreements do not prevent others from independently developing technologies that are equivalent to or superior to our technology. In addition, unauthorized parties may attempt to copy or otherwise obtain and use our proprietary technology. Monitoring unauthorized use of our technology is difficult, and we cannot be certain that the steps we have taken will prevent unauthorized use of our technology, particularly in foreign countries, such as China, where the laws may not protect our proprietary rights as fully as do the laws of the United States. In addition, if the foundries that manufacture our semiconductors lose control of our intellectual property, it would be more difficult for us to take remedial measures because our foundries are located in countries that do not have the same protection for intellectual property that is provided in the United States. Also, some of our contracts, including license agreements, are subject to termination upon certain types of change-of-control transactions.

We currently have more than 60 patents. We also have 78 patent applications pending in five countries. We cannot be certain that patents will be issued as a result of our pending applications nor can we be certain that any issued patents would protect or benefit us or give us adequate protection from competing products. For example, issued patents may be circumvented or challenged and declared invalid or unenforceable or provide only limited protection for our technologies. We also cannot be certain that others will not design around our patented technology, independently develop our unpatented proprietary technology or develop effective competing technologies on their own.

Failure to successfully defend against intellectual property lawsuits brought against us may adversely affect our business.

As technology is an integral part of our design and product, we have, in the past, received communications alleging that our products infringe or misappropriate certain intellectual property rights held by others, and may continue to receive such communications in the future. We recently agreed with O2Micro International Limited to settle several intellectual property disputes and both parties have started to withdraw their claims and applications. See Our Business Legal Proceedings. If any third party were to make valid intellectual property infringement or misappropriation claims against us, we may be required to:

discontinue using disputed manufacturing process technologies;

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stop selling products that contain allegedly infringing technology;

pay substantial monetary damages;

seek to develop non-infringing technologies, which may not be feasible; or

seek to acquire licenses to the infringed technology, which may not be available on commercially reasonable terms, if at all.

If our products are found to infringe or misappropriate third-party intellectual property rights, we may be subject to significant liabilities and be required to change our manufacturing processes or products. This could restrict us from making, using, selling or exporting some of our products, which could in turn materially and adversely affect our business and financial condition. Our failure to develop non-infringing technologies or license intellectual property rights in a timely and cost-effective manner could materially and adversely affect our business and financial condition. In addition, any litigation, whether to enforce our patents or other intellectual property rights or to defend ourselves against claims that we have infringed the intellectual property rights of others, could, regardless of the ultimate outcome, materially and adversely affect our operating results by requiring us to incur significant legal expenses and diverting the resources of the company and the attention of management.

Failure to achieve and maintain technological leadership in our various multimedia consumer electronics markets could erode our competitiveness and cause our profits to decrease.

The consumer electronics market and the semiconductor components used in such market are constantly changing with increased demand for improved features such as low power or smaller size. If we do not anticipate these changes in technologies and rapidly develop and introduce new and innovative technologies, we may not be able to provide advanced semiconductor solutions on competitive terms. If we are unable to maintain the ability to provide advanced semiconductor solutions on competitive terms, some of our customers may buy semiconductor solutions from our competitors instead of us. To be competitive, we must anticipate the needs of the market and successfully develop and introduce innovative new products in a timely fashion. We cannot assure you that we will be able to successfully complete the design of our new products, have these products manufactured at acceptable manufacturing yields, or obtain significant purchase orders for these products. Furthermore, if our future innovations are ahead of the then-current technological standards in our industry, customers may be unwilling to purchase our platforms until the multimedia consumer electronics market is ready to accept them. The introduction of new products may adversely affect sales of existing products and contribute to fluctuations in our operating results from quarter to quarter. Our introduction of new products also requires that we carefully manage our inventory to avoid inventory surplus and obsolescence. Our failure to do so could have a material and adverse effect on our operating results. Furthermore, failure to achieve advances in technology or processes or to obtain access to advanced technologies or processes developed by others could erode our competitive position.

Development of new platforms and products may require us to obtain rights to use intellectual property that we currently do not have. If we are unable to obtain or license the necessary intellectual property on reasonable terms or at all, our product development may be delayed, the gross margins on our planned products may be lower than anticipated and our business and operating results would be materially and adversely affected.

Because the markets in which we compete are highly competitive and many of our competitors have greater resources than we have, we cannot be certain that our products will compete favorably in the market place.

We face competition from a large number of competitors in each of our targeted areas. We currently compete with other companies that produce flash storage controllers, such as Alcor Micro, Chipsbank, Genesys, Incomm, Phison, Samsung, Skymedi, and USBest. We may also face competition from some of our customers who may develop products or technologies internally that compete with our solution. For multimedia SoC

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products, the companies with whom we compete include Actions, ALi, AMD, NVIDIA, Rockchip, SigmaTel, and Vimicro. For mobile communications products, the companies with whom we compete include Analog Devices, Infineon, Qualcomm, NXP, RFMD and Skyworks. We expect to face increased competition in the future from our current and potential competitors. In addition, some of our customers have developed products and technologies that could replace their need for our products or otherwise reduce their demand for our products.

Many of our current and potential competitors have longer operating histories, greater name recognition, access to larger customer bases and significantly greater financial, sales and marketing, manufacturing, distribution, technical and other resources than we have. As a result, they may be able to respond more quickly to changing customer demands or to devote greater resources to the development, promotion and sales of their products than we can. Our current and potential competitors may develop and introduce new products that will be priced lower, provide superior performance or achieve greater market acceptance than our products. In addition, in the event of a manufacturing capacity shortage, these competitors may be able to obtain capacity when we are unable to do so.

The multimedia consumer electronics market, which is a principal end market for our products, has historically been subject to intense price competition. In many cases, low-cost, high-volume producers have entered the markets and driven down profit margins. If a low-cost, high-volume producer should develop products that compete with our products, our sales and profit margins would suffer.

Fluctuations in exchange rates could result in foreign exchange losses.

Our reporting currency is the NT dollar. However, a significant portion of our operating expenses is denominated in currencies other than the NT dollar, primarily U.S. dollars, but also, to a lesser extent, Japanese Yen, Renminbi, Euros, and South Korean Won. As a result, appreciation or depreciation of other currencies in relation to the NT dollar could result in material transaction or translation gains or losses that could adversely affect, or cause fluctuations in, our results of operations. We do not currently engage in currency hedging activities.

Our products must meet exacting specifications and undetected defects and failures may occur, which may cause customers to return or stop buying our products and may expose us to product liability risk and risks of indemnification against defects in our products.

Our products are complex and may contain undetected hardware or software defects or failures, especially when first introduced or when new versions are released. These errors could cause us to incur significant re-engineering costs, divert the attention of our engineering personnel from product development efforts and materially affect our customer relations and business reputation. If we deliver products with errors or defects, our credibility and the market acceptance and sales of our products could be harmed. Defects could also lead to liability for defective products as a result of lawsuits against us or against our customers. We have agreed to indemnify some of our customers in some circumstances against liability from defects in our products. A successful product liability claim could require us to make significant damage payments.

Our intellectual property indemnification practices may adversely impact our business.

We may be required to indemnify our customers and our third-party intellectual property providers for certain costs and damages of intellectual property infringement in circumstances where our products are a factor in creating the customer's or these third-party providers' infringement exposure. This practice may subject us to significant indemnification claims by our customers and our third-party providers. In some instances, our products are designed for use in devices manufactured by our customers that comply with international standards, such as the MP3 compression standard. These international standards are often covered by patent rights held by third parties, which may include our competitors. The combined costs of identifying and obtaining licenses from

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all holders of patent rights essential to such international standards could be high and could reduce our profitability or increase our losses. The cost of not obtaining these licenses could also be high if a holder of the patent rights brings a claim for patent infringement. In the contracts under which we distribute semiconductor products, we generally have agreed to indemnify our customers against losses arising out of claims of unauthorized use of intellectual property. In some of our licensing agreements, we have agreed to indemnify the licensor against losses arising out of or related to our conduct or services. We cannot assure you that additional claims for indemnification will not be made or that these claims would not have a material and adverse effect on our business, operating results or financial condition.

Major earthquakes, fires or other natural disasters and resulting systems outages may cause us significant losses.

Our principal executive offices and a significant part of our operations are based in Taiwan. Many of our suppliers, providers of semiconductor manufacturing services for us, including semiconductor foundries and primary subcontractors for the assembly and testing of our products are located in Taiwan.

Taiwan is particularly susceptible to earthquakes. For example, in September 1999, Taiwan experienced a severe earthquake that caused significant property damage and loss of life, particularly in the central part of Taiwan. Although earthquakes and other natural disasters in Taiwan have not caused serious damages to us, if we, our suppliers, providers of semiconductor manufacturing services and primary subcontractors are affected by an earthquake or other natural disasters, such as typhoons, our production schedule could be interrupted or delayed. As a result, a major earthquake, natural disaster or other disruptive events in Taiwan could severely disrupt the normal operation of business and have a material and adverse effect on our financial condition and operating results.

The manufacturers of our semiconductors use highly flammable materials such as alcohol, acetone, photo resistance, AsH₃ and pH₃, in the manufacturing processes and are therefore subject to the risk of loss arising from explosion and fire. The risk of explosion and fire associated with these materials cannot be completely eliminated. Semiconductor companies experience explosion and fire damage from time to time. If any of their fabs or assembly facilities were to be damaged or cease operations as a result of an explosion or fire, it could reduce their manufacturing capacity. Such a reduction in the manufacturing capacity of our manufacturers could disrupt the production schedule of our products thereby causing us to miss orders from our customers, which will in turn have a material and adverse effect on our business and operating results.

The recurrence of a severe acute respiratory syndrome outbreak or an outbreak of avian influenza or other outbreaks could materially and adversely affect our operating results and financial conditions.

In early 2003, China and certain other areas in Asia experienced an outbreak of severe acute respiratory syndrome, or SARS. In addition, in the spring of 2004, China had several reported cases of deaths caused by SARS. A general downturn in most Asian economies accompanied the outbreak.

In 2003, an outbreak of avian influenza affected bird and poultry populations in countries throughout Southeast Asia and other parts of Asia, including China, Hong Kong and Japan. Avian influenza resulted in human deaths in Vietnam and Thailand. Any recurrence of SARS, avian influenza or other outbreak may have a negative effect on our operations. Our operations may be impacted by a number of health-related factors, including, among other things, quarantines or closure of our offices, the sickness or death of our key officers and employees and a general slowdown in the economies of China, Hong Kong and Taiwan, among other countries where we have operations.

Our inability to achieve and maintain effective internal control over financial reporting could negatively impact our business, our results of operations and the market price of our ADSs.

SEC rules implementing Section 404 of the Sarbanes-Oxley Act of 2002 require us to include in our Annual Reports on Form 20-F a report by our management on our internal control over financial reporting that contains

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our management's assessment of the effectiveness of our internal control over financial reporting. In addition, beginning next year, our independent auditor must attest to and report on management's assessment. We expect to incur additional costs and use significant management and other resources in an effort to comply with Section 404 of the Sarbanes-Oxley Act and other requirements associated with our public company reporting requirements that we did not incur as a private company.

Our management could potentially conclude that our internal controls over financial reporting are not effective. Even if our management concludes that our internal controls are effective, our independent auditor may disagree with management's assessment. Alternatively, our independent auditor may decline to attest to our management's assessment or may issue an adverse opinion if its interpretation of the requirements differs from our or it is otherwise dissatisfied with our internal control over financial reporting or the level at which our internal control over financial reporting is documented, designed, operated or reviewed. Any of these possible scenarios could cause investors to lose confidence in the reliability of our consolidated financial statements, which could result in a decline in the market price of our ADSs. Moreover, if we fail to maintain acceptable internal control over financial reporting, fail to implement required new or improved controls, or experience difficulties in their implementation, our business and operating results could suffer, we could fail to meet our reporting obligations, and the market price of ADSs could decline as a result.

Our stock price has been, and may continue to be, volatile, which could result in investors losing all or part of their investments.

The market price of our ADSs has fluctuated significantly in the past and may continue to fluctuate in the future. We believe that such fluctuations will continue as a result of many factors, including future announcements concerning us, our competitors or the semiconductor industry in general or principal customers regarding financial results or expectations, technological innovations, industry supply dynamics, new product introductions, governmental regulations, the commencement or results of litigation or changes in earnings estimates by analysts. In addition, in recent years the stock market has experienced significant price and volume fluctuations and the market prices of the securities of high technology and semiconductor companies have been especially volatile, often for reasons outside the control of the particular companies. These fluctuations as well as general economic, political and market conditions may have an adverse affect on the market price of our ADSs.

We may make acquisitions that are dilutive to existing stockholders, result in unanticipated accounting charges or otherwise adversely affect our results of operations, and result in difficulties in assimilating and integrating the operations, personnel, technologies, products and information systems of acquired companies or businesses.

We continually evaluate and explore strategic opportunities as they arise, including business combinations and capital investments. If we issue equity securities in connection with an acquisition, the issuance may be dilutive to our existing stockholders. Alternatively, acquisitions made entirely or partially for cash would reduce our cash reserves.

Acquisitions may require significant capital infusions, typically entail many risks and could result in difficulties in assimilating and integrating the operations, personnel, technologies, products and information systems of acquired companies. In order to realize the intended benefits of acquisitions, we will have to successfully integrate and retain key personnel. We may experience delays in the timing and successful integration of acquired technologies and product development through volume production, unanticipated costs and expenditures, changing relationships with customers, suppliers and strategic partners, or contractual, intellectual property or employment issues. In addition, key personnel of an acquired company may decide not to work for us. The acquisition of another company or its products and technologies may also result in our entering into a geographic or business market in which we have little or no prior experience. These challenges could disrupt our ongoing business, distract our management and employees, harm our reputation, subject us to an increased risk of intellectual property and other litigation and increase our expenses. These challenges are

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magnified as the size of the acquisition increases, and we cannot assure you that we will realize the intended benefits of any acquisition. Acquisitions may require large one-time charges and can result in increased debt or contingent liabilities, adverse tax consequences, substantial depreciation or deferred compensation charges, the amortization of identifiable purchased intangible assets or impairment of goodwill, any of which could have a material adverse effect on our business, financial condition or results of operations.

Mergers and acquisitions of high-technology companies are inherently risky and subject to many factors outside of our control, and no assurance can be given that our previous or future acquisitions will be successful and will not materially adversely affect our business, operating results, or financial condition. Failure to manage and successfully integrate acquisitions could materially harm our business and operating results. Even when an acquired company has already developed and marketed products, there can be no assurance that such products will be successful after the closing, will not cannibalize sales of our existing products, that product enhancements will be made in a timely fashion or that pre-acquisition due diligence will have identified all possible issues that might arise with respect to such company.

Political, Regulatory and Economic Risks

We face substantial political risks associated with doing business in Taiwan because of the tense political relationship between Taiwan and the People's Republic of China.

While we also, through our acquisition of FCI, maintain substantive operations in Korea, our principal executive offices and a majority of our employees and a significant amount of our research and development and operations are based in Taiwan. In addition, two of our primary third party manufacturers, UMC and SMIC, are located in Taiwan and China, respectively. Accordingly, our business and results of operations and the market price of our ADSs may be affected by changes in Taiwan governmental policies, taxation, inflation or interest rates and by social instability and diplomatic and social developments in or affecting Taiwan that are outside of our control. Taiwan has a unique international political status. China does not recognize the sovereignty of Taiwan. Although there have been significant economic and cultural ties between the Taiwan and China in recent years, the political relations have often been strained. The government of China has indicated that it may use military force to gain control over Taiwan, particularly under what it considers as highly provocative circumstances, such as a declaration of independence by Taiwan or the refusal by Taiwan to accept China's stated "one China" policy. On March 14, 2005, the National Peoples' Congress of China passed what is widely referred to as the "anti-secession" law, a law authorizing the Chinese military to attack in order to block moves by Taiwan toward formal independence. Past developments in relations between Taiwan and China have on occasion depressed the market prices of the securities of Taiwanese companies. Relations between Taiwan and China and other factors affecting military, political or economic conditions in Taiwan could have a material adverse effect on our financial condition and results of operations, as well as the market price of our ADSs.

The relations between Taiwan and China and other factors affecting military, political or economic conditions in Taiwan could also have a material and adverse effect on the financial condition of two of our primary foundries that manufacture most of our semiconductors. One of the foundries, UMC, is located in Taiwan, and the other, SMIC, is located in China. Such relations between Taiwan and China and other factors could also have a material and adverse effect on the financial condition of SPIL and King Yuan Electronics, two of our primary subcontractors for the assembly and testing of our products, which are also located in Taiwan. In addition, any expansion or development of our research and development team in China could be restricted or jeopardized, and our sales and marketing performance may be affected.

Our business depends on the support of the Taiwan government, and a decrease in this support may increase our tax liabilities and decrease our net income.

The Taiwan government has been very supportive of technology companies such as ours. In particular, we, like many Taiwanese technology companies, have benefited from tax incentives provided by the Taiwan

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government. For example, under the Statute for Upgrading Industries of Taiwan, we are granted tax credits by the Taiwan Ministry of Finance at rates set at certain percentages of the amounts utilized in qualifying research and development costs and in qualifying employee training expenses. If such tax credits cannot be utilized in the fiscal year in which the relevant costs or expenses were incurred, they may be carried forward for up to the next four years. In addition, Taiwan law offers preferential tax treatments to industries that are encouraged by the Taiwan government. These preferential tax treatments include 5-year tax exemptions for income attributable to expanded production capacity or newly developed technologies funded in whole or in part by proceeds from initial capital investments made by our shareholders, or subsequent capital increases, or capitalization of our retained earnings. Such tax exemptions may be available either to the shareholders of a company, or, if the shareholders so determine, to the company itself. SMI Taiwan has filed three applications for such tax exemptions as SMI Taiwan had used the proceeds of the new share offerings received in 2002, 2003 and 2004 to fund eligible research and development projects. In the first quarter of 2005, SMI Taiwan received certain requisite consents or approvals for tax exemptions. See Management's Discussion and Analysis of Financial Conditions and Results of Operations—Principal Factors Affecting Our Results of Operations—Provision for income taxes and note 13 to our consolidated financial statements for a more detailed description of our ability to enjoy these preferential tax treatments. If any of our tax credits or our ability to take advantage of these preferential tax treatments are curtailed or eliminated, our net income may decrease materially.

If we are unable to satisfy the conditions set by the Investment Commission of the Taiwan Ministry of Economic Affairs, or the IC, the effectiveness of the share exchange leading to the establishment of our current corporate structure could be challenged by the ROC government authorities.

Our current corporate structure is established as a result of a share exchange between us and the shareholders of SMI Taiwan. Approval from the IC was sought and successfully granted for the share exchange. However the IC granted the approval on condition that SMI Taiwan must firstly, apply for at least five patents in each of 2005, 2006 and 2007, secondly, employ between 15 to 20 research and development engineers in each of 2005, 2006, and 2007, and finally, maintain research and development expenditures in the amount of at least NT\$100 million (US\$3.0 million) in each of 2005, 2006, and 2007. We are required to submit to the IC SMI Taiwan's annual financial statements audited by a certified public accountant and other relevant supporting documents in connection with the implementation of those three conditions within four months after the end of each of 2005, 2006 and 2007. To the extent that we are unable to satisfy any of those three conditions, the IC may revoke our rights of repatriation of profits to be distributed by SMI Taiwan or rescind its approval of the share exchange. This would have an adverse effect on our corporate structure and consequently, materially and adversely affect our ability to conduct our business.

ITEM 4. INFORMATION ON THE COMPANY
History and Development of the Company

Silicon Motion Technology Corporation (Silicon Motion) was incorporated in the Cayman Islands in January 2005 and acquired Silicon Motion, Inc., a Taiwan corporation (SMI Taiwan) in April 2005. Originally SMI Taiwan was known as Feiya Technology Corporation (Feiya), a Taiwan corporation which was incorporated in April 1997 but had changed its name to SMI Taiwan after acquiring in August 2002 Silicon Motion, Inc., a California corporation (SMI USA), which was incorporated in November 1995. Feiya was originally a flash memory products company and SMI USA a graphics processor company. In April 2007, we acquired Future Communications IC, Inc. (FCI), a leading designer of RF ICs for mobile TV and wireless communications based in South Korea.

Our principal executive offices are located at No. 20-1, Taiyuan St., Jhubei City, Hsinchu County 302, Taiwan. The address of our United States subsidiary, SMI USA is 1591 McCarthy Blvd., Milpitas, CA 95035. Our ADSs have been listed and traded on the Nasdaq National Market since June 2005.

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Our corporate group chart is set out below.

Overview

We are a fabless semiconductor company that designs, develops and markets universally compatible, high-performance, low-power semiconductor solutions for the multimedia consumer electronics market. We have three major product lines: our mobile storage business, multimedia SoC business, and mobile communications business. Our mobile storage business is our significantly larger business and is composed of microcontrollers, also commonly known as controllers, used in NAND flash memory storage products such as flash memory cards, USB flash drives and card readers. These flash memory storage products are widely used by consumers to store data on multimedia consumer electronics devices such as mobile phones, digital still cameras, personal digital assistants, personal navigation devices and personal multimedia players, and notebook and desktop personal computers. Our multimedia SoC business is composed of products that support MP3 and personal multimedia players, PC cameras and embedded graphics applications. Our mobile communications business is composed of mobile TV tuners, CDMA RF ICs and electronics toll collection RF ICs, which became our new product line as a result of our recent acquisition of FCI.

We sell our semiconductor solutions to leading original equipment manufacturers (OEMs) and original design manufacturers (ODMs) worldwide. We provide our high performance flash memory storage controller to companies such as Lexar Media, Samsung, Sony, STMicroelectronics, and Transcend. We are a leading supplier of controllers used in flash memory cards sold bundled with mobile phones manufactured by the handset

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industry's leading OEMs. Our multimedia SoCs are important components of MP3 and embedded graphics applications that are sold by companies such as Advantech, Fuji Xerox, GE, Intel, Kontron, Mattel, Panasonic, Philips, Sharp, Siemens, Sony, Thomson and Toshiba. We provide our innovative mobile communications ICs to LG Electronics, Pantech & Curitel, Samsung and other companies. We sell our products through our direct sales force and distributors in Canada, China, Europe, Japan, Korea, Singapore, Taiwan and the United States.

We have experienced rapid growth in our net sales. Our net sales grew from approximately NT\$915.1 million in 2003 to approximately NT\$2,166.7 million in 2004 to approximately NT\$2,686.5 million in 2005 to approximately NT\$3,460.5 million (US\$106 million) in 2006, representing a compound annual growth rate, or CAGR of approximately 56%.

Recent Acquisition of Future Communications IC, Inc.

In April 2007, we acquired Future Communications IC, Inc. FCI is a leading designer of RF ICs for mobile TV and wireless communications based in Seoul, South Korea. The final purchase price for the transaction was approximately US\$50 million in cash and US\$40 million in our ordinary shares and options to purchase our ordinary shares. We have agreed to pay FCI shareholders up to an additional \$12 million in cash under certain circumstances. The first condition is that FCI achieves, for its fiscal year 2007 ending December 31, 2007, a \$33 million revenue target and a 53% product margin target. The second condition relates to the performance of our stock. If both the FCI revenue and product margin targets are reached, we have agreed to pay to FCI shareholders in cash the difference between US\$12 million and 90% of the appreciation of our ADSs over an agreed period of time in the stock portion of the consideration received as part of this transaction. Before the inclusion of FCI acquisition-related charges, management expects that the transaction will be slightly accretive to earnings in 2007 and meaningfully accretive in 2008 and beyond.

Industry Background

The convergence of consumer electronics, communications, and computing devices has been accelerating at a faster rate in recent years as advances in technology enable different categories of electronic devices to offer similar functionalities, which often involve the processing, storage, and transfer of digital multimedia content. Mobile phones for example have been transformed into multimedia consumer electronics devices with camera, video recorder, music player, e-mail, internet access, television, and other functions, because mobile phones have increasingly sophisticated multimedia applications processing, data storage, and data transfer capabilities. Personal computers have also been transformed into multimedia consumer electronics devices by multimedia data processing, storage, and transfer technologies that include wireless connectivity, internet telephony, video telephony, and more advanced video and audio capabilities. Several important semiconductor technology developments have led to the significant improvement by electronics devices to process, store, and transfer digital multimedia content and these include the development of NAND flash as a widely used data storage medium, various high-performance multimedia application processors and advanced communication-related RF ICs.

Some of the key factors that are currently driving digital media semiconductor development include:

Proliferation of digital media content. Advances in digital technology have enabled audio, photo and video content to be digitized, transmitted, stored and catalogued. As the accessibility of digital media content continues to proliferate, demand has increased for a range of new digital consumer devices such as mobile phones with multimedia features, MP3 and other personal multimedia players, PC cameras, notebook PCs, and car navigation systems. Due to the proliferation of these devices, consumers will demand the ability to create, store, exchange and play back more digital media content than ever before. Two of the leading types of mobile storage of digital media content are flash memory cards and USB flash drives.

Greater storage capacity and advances in storage technologies. As technology advances, more and more memory-intensive applications have been developed to cater to consumer demands. For example, the resolution of consumer digital still cameras has increased from approximately one megapixel to eight megapixels or greater.

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The average resolution of camera phones has also been increasing. Correspondingly, greater capacity is required to store the increasingly larger size of digital photo collections, personal digital audio libraries and digital videos. Rapid increase in NAND flash storage capacity and performance and rapid reduction in cost of NAND flash have allowed memory card using NAND flash to become the predominant memory medium to store such increasing digital media content.

Demand for greater mobility. Consumers are increasingly using portable devices to compute and exchange data, enjoy music including radio, take pictures and video, watch television and communicate with each other. Developments in high-speed wireless transmission protocols, such as CDMA, WCDMA, DAB, DVB-H, T-DMB, and S-DMB facilitate the one-way or two-way sharing and exchange of content and depend on high sensitivity, low power, high performance, small size, and low cost RF ICs for the sending and receiving of data.

Demand for smaller, lighter and more power-efficient electronic devices. Consumers are increasingly demanding portable electronic devices that enable them to enjoy digital media, communicate, and compute independent of physical location. To respond to demand for smaller, lighter and more power-efficient portable electronic devices, manufacturers are increasingly seeking highly-integrated multimedia solutions, such as system on chip (SoC) for MP3 players, embedded graphics applications and PC cameras.

Our Markets and Products

We design, develop and supply a portfolio of products targeted to multimedia consumer electronics applications. Our current product offerings are primarily targeted at three main markets: mobile storage, multimedia SoCs and mobile communications markets. The following is a brief description of each of our target markets.

Mobile Storage Products

We offer a broad range of controllers for NAND flash memory storage products, including flash memory cards, USB flash drives and card readers, and have recently began offering embedded controller solutions and controllers for solid state drives. Flash memory storage products are widely used by consumers to store data for multimedia consumer electronics devices such as mobile phones, digital still cameras, personal digital assistants, personal navigation devices, personal multimedia players, and notebook and desktop PCs. F